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Our July Insurance Update features three cases from state high courts.

- The Massachusetts Supreme Judicial Court, on certified question from the First Circuit, addresses whether the duty to defend (or pay defense costs) includes the costs to prosecute the insured's counterclaims.

- The Texas Supreme Court considers whether the underlying proceeding was sufficiently adversarial when assessing an assignment of insurance rights to the claimant.

- The West Virginia Supreme Court of Appeals, in a case of first impression, decides whether an earth movement exclusion applies to both natural and man-made landslides.

Two of the remaining cases, one by the Sixth Circuit and the other by the New Jersey Appellate Division, discuss the "insured versus insured" exclusion. In the last case, a California federal district court considers whether a gas station owner's claim is barred by the negligent work exclusion.

We hope you find these cases informative.

Robert Tugander
Insurance Update Editor

Insurer's Duty to Defend Did Not Require That It Also Prosecute Affirmative Counterclaims on Insured's Behalf, Massachusetts Top Court Decides

The Supreme Judicial Court of Massachusetts has ruled that, where an insurance policy provided that the insurer had the "duty to defend any claim" initiated against the insured, the insurer's duty to defend did not require that it also prosecute affirmative counterclaims on behalf of its insured.

The Case

A manufacturer of lens cleaning and eye safety products terminated one of its employees. The employee sued the company, asserting claims of age discrimination, unlawful termination in violation of the covenant of good faith and fair dealing, breach of contract, and promissory estoppel.

The company's insurer appointed panel counsel to defend the company. Counsel filed an answer stating that the company had three nondiscriminatory reasons for terminating the employee: his poor job performance, insubordination, and suspected misappropriation of company funds.

Counsel, however, did not file a counterclaim for the suspected misappropriation. The insurer maintained that the policy did not require it to prosecute a counterclaim for misappropriation of funds, arguing that the duty to defend did not include the duty to prosecute an affirmative counterclaim.

The insurer then asked the U.S. District Court for the District of Massachusetts to rule that its duty to the company did not require that it prosecute or pay for the prosecution of the counterclaim for misappropriation of funds.

The district court ruled in favor of the insurer, declaring that its duty to defend the company did not require that it also prosecute the counterclaim. It also ruled that the absence of such a duty did not create a conflict of interest with the company, so that the insurer did not have to pay the costs of independent counsel.

The company appealed to the U.S. Court of Appeals for the First Circuit, which asked the Supreme Judicial Court of Massachusetts to decide whether the insurer had a duty to the company to prosecute its counterclaim for damages.

The Massachusetts Supreme Judicial Court's Decision

The court ruled that where an insurance policy provided that the insurer had the "duty to defend any claim" initiated against the insured, the insurer's duty to defend did not require it to prosecute affirmative counterclaims on behalf of its insured.

In its decision, the court said that the meaning of the word "defend" was "clear," and that the essence of what it meant to "defend" was "to work to defeat a claim that could create liability against the individual being defended."

The court rejected the company's contention that the duty to "defend" under its insurance policy meant anything a reasonable defense attorney would do to reduce the liability of the insured – including prosecuting counterclaims. In the court's view, that interpretation required adding provisions to the policy that the parties had not included.

The court also was not persuaded by the company's argument that the insurer had an obligation to prosecute its counterclaim under the "in for one, in for all" rule, which generally provides that where an insurer was obligated to defend an insured on one of the counts alleged against it, the insurer had to defend the insured on all counts, including those that were not covered. That rule, the court declared, "did not change the meaning of the word 'defend.'"

Finally, the court decided that because the duty to pay defense costs has the same scope as the duty to defend in Massachusetts, the duty to pay defense costs also did not require an insurer to fund the prosecution of any counterclaim on behalf of an insured.

The case is *Mount Vernon Fire Ins. Co. v. Visionaid, Inc.*, No. SJC-12142 (Mass. June 22, 2017).

Texas Supreme Court Explains When Judgment against Insured Is Enforceable against Insurer

The Texas Supreme Court has issued a decision explaining when a judgment against an insured defendant is the product of a "fully adversarial trial" and, therefore, is enforceable against the defendant's insurer in a case brought by the underlying plaintiff against the insurer.

The Case

Homeowners sued a builder alleging that the builder had not constructed their home in a good and workmanlike manner. The builder tendered a claim to its commercial general liability insurer. The insurer refused to defend the builder in that suit, a position the insurer later conceded was erroneous.

The homeowners' case against the builder went to trial, resulting in a judgment in the homeowners' favor. The builder then assigned most of its claims against its insurer to the homeowners, who, in turn, sued the insurer to recover the amount of the judgment against the builder.

The insurer argued that the judgment against the builder was not binding on it because it had not been the product of a "fully adversarial trial" as required by Texas law. The trial court ruled in favor of the homeowners. The court of appeals affirmed, and the case reached the Texas Supreme Court.

The Texas Supreme Court's Decision

The court reversed, ruling that the judgment against the builder was not binding on the builder's insurer in the homeowners' lawsuit against the insurer.

In its decision, the court explained that, generally, an insurer that wrongfully refused to defend its insured (as in this case) was barred from collaterally attacking a judgment or settlement between the insured and the underlying plaintiff – as long as the judgment against the insured had been the product of a "fully adversarial trial."

The court reasoned that proceedings were "adversarial" when the parties opposed each other. It then declared that the "controlling factor" was whether, at the time of the underlying trial or settlement, "the insured bore an actual risk of liability for the damages awarded or agreed upon" or had "some other meaningful incentive" to ensure that the judgment or settlement accurately reflected the plaintiff's damages and, therefore, the insured's "covered liability loss."

The court decided that the homeowners' judgment in this case did not meet that test. It found that the homeowners and builder had entered into an agreement before their trial that had "eliminated any meaningful incentive" the builder had to contest the judgment. Specifically, before trial, the homeowners had agreed not to enforce any resulting judgment against the builder's personal assets and to rely, instead, on the builder's insurance policy.

The court declared that when parties reached an agreement before trial or settlement that deprived one of the parties of its incentive to oppose the other, the proceeding was "no longer adversarial." It held that the presence of such an agreement created a "strong presumption" that

the judgment had not resulted from an adversarial proceeding, while the absence of such an agreement created a "strong presumption" that it had.

The court reasoned that proceedings lost their adversarial nature when, by agreement, one party had "no stake in the outcome" and thus "no meaningful incentive to defend itself." When a plaintiff agreed to forgo execution of a judgment against a defendant's assets, whether in conjunction with a settlement or before trial, the defendant no longer had a financial stake in the outcome and thus likely had "no interest in either avoiding liability altogether or minimizing the amount of damages," the court said.

The court stated that adversity turned on the insured defendant's "incentive to defend (or lack thereof)," and an after-the-fact evaluation of the parties' trial strategies had "no place in the analysis."

The pretrial agreement reached by the homeowners and the builder in this case had "effectively removed" any financial stake the builder had in the outcome of the homeowners' suit, the court found, thereby eliminating any incentive the builder had to oppose their claims. This turned the homeowners' suit into a "mere formality," a "pass-through trial" aimed not at obtaining a judgment reflective of the homeowners' loss, but instead at obtaining a potentially inflated judgment to enforce against the insurer.

Accordingly, the court concluded, the homeowners' judgment against the builder was not binding on the insurer, and because the homeowners had not litigated the disputed underlying issues with the insurer in a way that cured the defect, the court remanded the case to the trial court for a new trial.

The case is *Great American Ins. Co. v. Hamel*, No. 14-1007 (Tex. June 16, 2017).

Earth Movement Exclusion Precluded Coverage of Natural or Man-Made Landslide, West Virginia's Top Court Rules

The Supreme Court of Appeals of West Virginia, in a case of first impression for the court, has ruled that an earth movement exclusion precluded coverage for damages caused by a natural or a man-made landslide.

The Case

Soil and rock slid down a hill and damaged property leased to a motorcycle shop in St. Albans, West Virginia. The property owners submitted a claim to their insurance company.

An adjuster for the insurer examined the damage and observed that a mass of rock and soil had fallen down the steep slope behind the property. The insurer then denied coverage based on the policy's earth movement exclusion.

The property owners sued the insurer. The West Virginia trial court found coverage under the policy based on evidence of earth movement caused by both natural and man-made events; specifically, an improperly excavated hillside. The trial court further found that the policy did not unambiguously exclude damage caused by rockfall due to man-made events and that the

insureds reasonably could expect coverage for the earth movement that had damaged their property.

The dispute reached West Virginia's highest court. The insurer argued that the policy excluded coverage for all earth movement and that the earth movement exclusion applied regardless of whether damage "is caused by an act of nature or is otherwise caused."

The West Virginia Supreme Court of Appeals' Decision

The court agreed with the insurer and reversed the trial court.

In its decision, the court noted that it had not previously addressed this particular exclusionary language and that its decision in this case was on a matter of first impression. It then ruled that the earth movement exclusion "clearly and unambiguously" excluded coverage for a landslide "resulting from a natural event or otherwise."

The court stated that a provision in an insurance policy excluding a loss regardless of whether the loss had been caused by "an act of nature" or "otherwise caused" was "not ambiguous" and excluded coverage for the loss whether it was caused by a man-made or by a naturally-occurring event.

Therefore, the court held that whether the event had been triggered by natural forces or improper excavation of the hillside at the rear of the property, the exclusion applied.

The case is *Erie Ins. Property and Cas. Co. v. Chaber*, No. 16-0490 (W.Va. June 1, 2017).

Insured Versus Insured Exclusion Precluded Coverage of Liquidation Trust's Claims against Company's Officers after Company's Bankruptcy

The U.S. Court of Appeals for the Sixth Circuit has ruled that an "insured versus insured" exclusion in a management liability insurance policy precluded coverage of claims against the insured company's officers that the company had assigned to a liquidation trust after entering bankruptcy.

The Case

Capitol Bancorp, a holding company incorporated in Michigan, owned community banks in numerous states when it went bankrupt in 2012. In 2014, the company and its creditors agreed to a liquidation plan that required Capitol to assign all of its causes of action to a liquidation trust, which could pursue those claims on behalf of Capitol's creditors.

Thereafter, the liquidation trustee sued Capitol's founder, chairman, and chief executive officer and his daughter, who served as president, alleging that they had breached their fiduciary duties to Capitol through a number of improper actions.

The defendants notified the insurer that had issued a management liability insurance policy to Capitol of the lawsuit against them. The insurer went to court, seeking a declaratory judgment that it had no obligation to cover the defendants for any damages from the lawsuit because the trust's claims fell within the policy's insured versus insured exclusion.

The U.S. District Court for the Western District of Michigan held that the exclusion applied, and the coverage issue reached the Sixth Circuit.

The Sixth Circuit's Decision

The circuit court affirmed.

In its decision, the circuit court explained that if Capitol itself had sued the defendants for mismanagement, that would have been a claim "by" the company (an insured person) against its own officers (also insured persons). The exclusion would have barred coverage of that claim, the circuit court said.

It then found that the result had to be the same in this case, where the claimant was not Capitol but, rather, the liquidation trust to which Capitol had assigned its rights. The Sixth Circuit reasoned that, as a voluntary assignee, the trust stood in Capitol's shoes and possessed "the same rights subject to the same defenses." Just as the exclusion covered a lawsuit "by" Capitol, it covered a lawsuit "by" the trust "in the . . . right" of Capitol, the circuit court decided.

The circuit court said that this result was not affected by Capitol's bankruptcy or the fact that the bankruptcy court had approved the plan transferring the bankruptcy estate's causes of action from Capitol to the liquidation trust. A lawsuit by Capitol after its bankruptcy filing on behalf of its bankruptcy estate remained a lawsuit "by" Capitol and still fit within the insured-versus-insured exclusion, the circuit court concluded.

The case is *Indian Harbor Ins. Co. v. Zucker*, Nos. 16-1695, 16-1697, 16-1698 (6th Cir. June 20, 2017).

Insured Versus Insured Exclusion Precluded Coverage of Counterclaims against Company's CEO

An appellate court in New Jersey has ruled that the "insured versus insured" exclusion in a directors and officers liability insurance policy precluded coverage of counterclaims brought by a limited liability company and members of the company against its chief executive officer in his lawsuit against them – even in the absence of any showing of collusion among the insureds.

The Case

The chief executive officer ("CEO") and owner of a 40 percent interest in a limited liability company ("LLC") that operated and leased PET/CT equipment sued the company and a number of its members and managers. The CEO alleged that the member-managers had tried to remove him from the company's board of managers and from his position as CEO.

In their responsive pleading, the company and several of the individual defendants asserted various counterclaims against the CEO.

The CEO subsequently filed a declaratory judgment action seeking indemnity and defense costs for the counterclaims filed against him under the company's directors and officers ("D&O") liability insurance policy. The insurer denied coverage based on the policy's insured versus insured exclusion.

The CEO contended that the exclusion applied only if there had been collusion and that whether there had been collusion presented a genuine issue of material fact.

The trial court granted summary judgment in favor of the insurer, and the CEO appealed.

The Appellate Court's Decision

The appellate court affirmed.

In its decision, the appellate court found that the exclusion "plainly and unambiguously" barred coverage because the counterclaims against the CEO fell within the policy's insured versus insured exclusion.

It reasoned that the exclusion disallowed coverage when a claim was raised either by an executive of the company or the company itself. Because the claims raised against the CEO had been brought by the company and its executives, the exclusion barred coverage.

The appellate court rejected the CEO's contention that applying the exclusion violated his reasonable expectations of coverage. It observed that the policy provided commercial insurance to a "presumably sophisticated consumer" and that the policy language was "straightforward" and not so confusing that the "average policyholder" could not make out the boundaries of the coverage.

Finally, the appellate court rejected the CEO's contention that proof of collusion was a prerequisite to applying the insured versus insured exclusion, reasoning that the exclusion was intended to exclude coverage of collusive suits as well as suits arising out of those "particularly bitter disputes" that erupted when members of a corporate family had a falling out.

The case is *Abboud v. National Union Fire Ins. Co. of Pittsburgh, PA*, No. A-3434-14T1 (N.J. App. Div. June 21, 2017).

Negligent Work Exclusion Barred Coverage of Claim That Contractor's Negligence Had Damaged Insureds' Fuel Tank

A federal district court in California has ruled that a "negligent work" exclusion in an insurance policy issued to the owners and operators of a gas station and convenience store precluded coverage of their claim that a contractor's negligence had damaged their fuel tank.

The Case

The owners and operators of a gas station and convenience store in California alleged that their fuel tank had been damaged upon receiving a fuel delivery from its supplier. In attempting to determine the tank's fuel level, the delivery driver had dropped a measurement stick in the tank and punctured it. The gas station owners sought coverage for the damage from their insurer. The insurer denied coverage, contending that the policy's negligent work exclusion applied. The exclusion barred coverage for, among other things, "faulty, inadequate or defective … workmanship [or] work methods."

The insureds sued, and the insurer moved for judgment on the pleadings.

The District Court's Decision

The district court granted the insurer's motion.

The district court noted that although the exclusion was poorly drafted, it was not necessarily ambiguous. Taken as a whole, the purpose was to exclude coverage for any negligent work that is performed in readying for use or maintaining the covered buildings or fixtures. When viewed in this light, the district court found that the policy addressed and excluded the type of damage that allegedly had occurred in this case. The district court explained that a third-party contractor had been evaluating the fuel tank to maintain its usefulness to the business – that is, without checking the fuel level, the insureds would not have known when to refill the tank except to wait for the pumps to literally run dry, thus costing them valuable business.

Unfortunately, the district court continued, the third-party contractor allegedly used a negligent work method in maintaining the fuel tank's economic viability to the insureds' business, which in turn had harmed the tank and the insureds' business. Harm to the insureds' property caused by an allegedly negligent work method was excluded under the insureds' policy, the district court concluded.

The case is *Terra Nova Gas Station, Inc. v. AMCO Ins. Co.*, No.: 16cv1565-JLS (DHB) (S.D. Cal. June 26, 2017).

This publication does not contain legal advice. We hope that you find this useful and interesting. We invite your suggestions. If you have any questions, please contact Robert Tugander at (516) 357-3335 or robert.tugander@rivkin.com

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