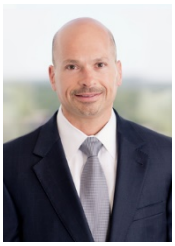
Lawyer Insights

Insured Directors Not 'Necessary' for Complete Adjudication of Insurer's Coverage Obligations

By Michael S. Levine, Geoffrey Fehling and Sima Kazmir
Published in Insurance Coverage Law Center | September 3, 2021



A federal court in New York denied an insurer's attempt to dismiss a coverage dispute, rejecting the insurer's contention that the individual insured directors were "necessary" parties. The insurer argued that, because the outcome of the coverage suit could jeopardize the directors' indemnity and thereby implicate the D&O policy's Side A coverage for non-indemnified losses, the directors had an indispensable interest in the litigation. The court disagreed.

The coverage dispute in LRN Corp. v. Markel Insurance Co., 1:20-cv-08431 (S.D.N.Y. Aug. 23, 2021), arose from an underlying lawsuit in the Delaware Chancery Court brought by an LRN shareholder against the company and three of its directors. The plaintiff in the underlying lawsuit alleged that a self-tender offer by LRN to acquire shares of LRN's common stock was coercive and part of a scheme that was in part orchestrated by the LRN's directors. LRN, though dismissed from the underlying lawsuit, continued to pay legal fees for the named directors.

LRN commenced its coverage action in the Southern District of New York, seeking coverage for the underlying lawsuit under a For Profit Management Liability Policy. The defendant directors in the underlying lawsuit are insureds under the LRN policy. The insurer moved to dismiss the coverage action under Rules 12(b)(7) and 19 on the grounds that the director insureds were necessary parties.

The court's analysis focused on the meaning of "necessary" parties under Rule 19(a), which asks (i) whether the court can accord "complete relief" among existing parties in the absence of the allegedly required person's absence, (ii) whether disposing of the action in the person's absence may impair or impede the ability of that person to protect his or her interests, and (iii) whether disposing of the action creates a substantial risk of incurring double, multiple, or inconsistent obligations because of the absent person's interests in the case.

LRN argued that, because the case sought solely to adjudicate the insurer's duty to defend the company under Side B of the policy (because the company was indemnifying the directors and seeking reimbursement), LRN is the only insured that has suffered a loss, and thus the directors are not necessary parties. The insurer countered that LRN's suit clearly requests a declaratory judgment on the duty to defend and indemnify the underlying suit generally, and LRN could cease indemnifying the directors, leading them to turn to Side A of the policy for coverage. Because the case would then decide whether the insurer had an obligation to afford coverage under Side A, the insurer argued that the directors are necessary parties.

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The court agreed with LRN, holding that, although the coverage dispute "will necessarily decide whether [the insurer] has a duty to defend and indemnify under Side A of the Policy," the insured directors were not necessary parties under Rule 19.

Specifically, the court held:

LRN and the insurer will be able to obtain "complete relief" because the court will be able to determine whether a Securities Transaction Exclusion applies, and thus whether the insurer has a duty to defend and indemnify LRN. Additionally, the parties are able to obtain "complete relief" because LRN is seeking relief from only the insurer. The directors' interests are virtually identical to LRN's, so their absence would not impede or impair their interests. In so holding, the court rejected the argument that a hypothetical future divergence in LRN's and the directors' interests was relevant at this stage, stating "LRN hypothetically ceasing indemnification in the future does not mean that LRN's and the directors' interests are not currently aligned in the issues presented by the complaint." The insurer did not face a "substantial risk of incurring double, multiple, or otherwise inconsistent obligations" because "principles of issue preclusion would likely bar [the directors] from relitigating the issue against [insurer]." The LRN decision underscores that a policyholder may seek declaratory relief without including every possible insured implicated by the underlying claim, and that a future possibility of certain insureds suffering losses or seeking coverage under a D&O policy does not make those insureds necessary parties for the purposes of Rule 19.

Michael S. Levine *is a partner in the firm's insurance coverage group in the firm's Washington office. Mike has more than 20 years of experience litigating insurance disputes and advising clients on insurance coverage matters. He can be reached at +1 (202) 955-1857 or mlevine@HuntonAK.com.*

Geoffrey B. Fehling *is Counsel in the firm's Insurance Coverage group in the firm's Washington D.C. office. Geoff represents corporate policyholders and their officers and directors in insurance coverage disputes involving directors' and officers' (D&O), errors and omissions (E&O), and other professional liability claims, cybersecurity and data breaches, representations and warranties, employee theft and fidelity claims, government investigations, breach of fiduciary duty, environmental liabilities, and property damage. He can be reached at +1 (202) 955-1944 or gfehling@HuntonAK.com.*

Sima Kazmir *is an associate in the firm's Insurance Coverage group in the firm's New York office. Sima is a proactive commercial litigator whose practice focuses on complex consumer finance, insurance coverage and business litigation. She can be reached at +1 (212) 309-1112 or skazmir@HuntonAK.com.*