

The Strategic Use Of Declaratory Judgment Actions In Fidelity Litigation

Scott L. Schmookler
Brian Bornstein

I. Introduction

Fidelity insurers invest significant time, effort and expense investigating complex fidelity claims, analyzing the compensability of claimed losses, and explaining their coverage analyses to the insured. While most fidelity claims are resolved amicably without litigation, the practical reality is that a reasonable settlement may not be possible in some claims, regardless of the thoroughness of the insurer's investigation or the correctness of its coverage position. Faced with an intractable insured, a fidelity insurer may be forced during the claims handling process to consider the possibility of litigation and prepare a litigation strategy to maximize its chances of resolving the claim satisfactorily, whether by settlement, dispositive motion or trial.

In devising its strategy, the primary strategic consideration for an insurer is whether to file a pre-emptive declaratory judgment action against the insured or wait until the insured files a lawsuit seeking recovery for its claim. In some cases, it may be to the carrier's advantage to file a pre-emptive action, so it can choose the venue and craft the pleadings to define the dispute. In other cases, however, it may be to the carrier's advantage to defer filing suit and allow the insured to do so, because while the insurer loses its choice of venue and ability to define the dispute, it can immediately attack the claim with a dispositive motion, thereby potentially allowing it to efficiently dispose of the claim.

This delicate issue is often difficult to resolve because its resolution requires an insurer to consider more than simply whether one forum is more favorable than another forum. This consideration might ultimately be important, but other intangible factors may also weigh heavily upon this issue. An insurer must, therefore, also consider both venue and pleading issues (including the proclivities of the local judiciary, choice of law, and the strategic value of framing the pleadings) when deciding whether to pursue a declaratory judgment action.

This article will analyze these issues and provide a comprehensive overview of the substantive, tactical and procedural issues impacting a fidelity insurer's decision on whether to file a pre-emptive declaratory judgment action. Section II of this article reviews the historical evolution of declaratory judgment actions. Section III provides a substantive overview of the Federal Declaratory Judgment Act¹ and the Uniform

¹ 28 U.S.C. § 2201 (2001) [hereinafter FDJA].

Declaratory Judgment Act.² Section IV reviews the practical and strategic considerations weighing upon the decision of whether to file a declaratory judgment action.

II. Evolution of Declaratory Judgment Actions

The evolution of declaratory judgment actions is not tidy. While actions for declaratory judgment are now the norm in insurance coverage litigation, the FDJA and the UDJA were enacted seventy years ago. At that point, declaratory judgment was a novel concept, and met significant opposition. Although extolled by proponents as an efficient means of resolving disputes, critics charged that declaratory judgment was inherently unconstitutional because it allowed a party to seek relief before it had sustained damages. This split of opinion heralded what would be a fifteen-year fight in Congress and the states to win passage of the FDJA and the UDJA.

A. EARLY SUPPORTERS' VIEWS OF DECLARATORY JUDGMENT ACTIONS.

Although foreign jurisdictions had employed declaratory judgments to resolve disputes for some time, they were virtually unknown in the United States until this century.³ The original efforts to introduce declaratory judgments in this country were spearheaded by two law school professors — Professors Edson R. Sunderland and Edwin M. Borchard.⁴ Emphasizing the efficiency and flexibility of declaratory judgments, Professors Sunderland and Borchard attacked the common law system's almost exclusive limitation of jurisdiction to cases seeking damage awards and injunctions. Without provision for the declaratory judgment action, Professors Borchard and Sunderland argued the traditional remedies of the common law system left a litigant prey to a “variety of doubt, dilemmas, and uncertainties.”⁵

They challenged traditional remedies as being outdated and argued that they were inadequate to address three increasingly common scenarios in modern society. First, the common law system did not address the plight of a person who could not have his controversy judicially reviewed because the opposing parties held the traditional claim and had not yet commenced suit (e.g., an insurer could not, under the traditional system, seek confirmation of its coverage position because the underlying claim belonged to the

² UNIFORM DECLARATORY JUDGMENT ACT, § 2 (amended 1922), 12A U.L.A. 3 (Supp. 1996) [hereinafter UDJA].

³ When the first bill was introduced in Congress in 1919, no state had a declaratory judgment act, although New Jersey and Illinois had statutes that provided declaratory relief limited to the construction of wills and deeds. Donald L. Doernberg & Michael B. Mushlin, *The Trojan Horse: How the Declaratory Judgment Act Created a Cause of Action and Expanded Federal Jurisdiction While the Supreme Court Wasn't Looking*, 36 UCLA L. REV. 529 (1989).

⁴ Professor Borchard was the leading force behind the American declaratory judgment. In addition to his voluminous writings, he spoke often on the subject and testified before Congress on behalf of the FDJA. Both federal and state courts have referred to him as the father of the declaratory judgment in the United States. *See, e.g.*, *Steffel v. Thompson*, 415 U.S. 452, 468 n.18 (1974) (describing Borchard as “a principal proponent and author” of the FDJA); *United States Fid. & Guar. Co. v. Koch*, 102 F.2d 288, 290 (3d Cir. 1939); *Panama Processes, S.A. v. Cities Serv. Co.*, 362 F. Supp. 735, 738 (S.D.N.Y. 1973), *aff'd*, 496 F.2d 533 (2d Cir. 1974).

⁵ Edwin M. Borchard, *Judicial Relief for Peril and Insecurity*, 45 HARV. L. REV. 793, 854 (1932).

insured).⁶ Second, it did not provide a remedy for parties whose controversy was not yet justiciable under the traditional system (e.g., a party could not pursue legal recourse under the traditional system until it had sustained actual damages). Third, the traditional system did not provide an alternative to damage and injunctive awards (e.g., the traditional system only provided recourse for out-of-pocket damages).⁷

Recognizing that harm can often occur before the plaintiff's rights were invaded, Sunderland and Borchard promoted declaratory judgment as a procedural innovation designed to solve the inherent problems with the traditional common law remedies. Although acknowledging that this expansion of jurisdiction was previously unknown, they proposed providing courts jurisdiction to hear cases before a formal violation of right had occurred as long as a genuine dispute existed, regardless whether the plaintiff had a claim at common law.

Despite their arguments, this broad expansion of jurisdiction troubled the established legal community, including the United States Supreme Court. Focusing on the case or controversy requirements in Article III of the Constitution,⁸ critics argued that declaratory judgment was inherently unconstitutional because it provided a forum for resolving disputes before either party had sustained any damages, thereby allowing a party to obtain an unconstitutional advisory opinion.⁹

B. THE JUDICIAL BATTLE FOR RECOGNITION OF DECLARATORY JUDGMENTS

Given the novelty of declaratory judgment and its prospective impact upon the courts, it was also not warmly embraced by the judiciary.¹⁰ Providing a remedy to a party before it suffered a traditional injury troubled some courts, which saw the device thrusting the judiciary into areas beyond its constitutional power. The national debate on

⁶ Edwin M. Borchard, *The Declaratory Judgment--A Needed Procedural Reform*, 28 YALE L.J. 1, 12-14 (1918); see also David Gordon, *The Law of Declaratory Judgments and Its Progress*, 9 VA. L. REV. 169 (1923).

⁷ "The more highly organized a society becomes, the less occasion there is to display force in order to secure obedience to its decrees and adjudications The mere authoritative declaration of the reciprocal rights and obligations of the parties suffices to insure obedience." EDWIN M. BORCHARD, *DECLARATORY JUDGMENTS* 12-3 (2d ed. 1941); see also Edson R. Sunderland, *A Modern Evolution in Remedial Rights--The Declaratory Judgment*, 16 MICH. L. REV. 69, 70 (1917).

⁸ Article III of the Constitution provides that "[t]he judicial Power shall extend to all Cases, in Law and Equity, arising under this Constitution, the Laws of the United States, and Treaties made, or which shall be made, under their Authority; – to all Cases affecting Ambassadors, other public Ministers and Consuls; – to all Cases of admiralty and maritime Jurisdiction; – to Controversies to Which the United States shall be a Party; – to Controversies between two or more States; – between a State and Citizens of another State; between Citizens of the same State claiming Lands under Grants of different States, and between a State, or the Citizens thereof, and foreign States, Citizens or Subjects." U.S. CONST. art. III, § 2.

⁹ Doernberg & Mushlin, *supra* note 3, at 555-56.

¹⁰ "It is . . . not surprising that a new remedy . . . should have aroused hostility in some courts whose judges . . . had not heard the term 'declaratory judgments' . . . in their student days." Edwin M. Borchard, *Declaratory Judgments & Insurance Litigation*, Address by Professor Borchard (July 26, 1938), reprinted in AMERICAN BAR ASSOCIATION SECTION OF INSURANCE LAW 74 (1938).

this topic, triggered by decisions of state and federal courts, swirled for almost fifteen years.¹¹

*Anway v. Grand Rapids Railway*¹² was the first case to consider the constitutionality of declaratory judgment.¹³ In that case, a railroad conductor brought a friendly action against his employer for a declaration that a state labor law limiting working hours was unconstitutional, even though no one had threatened to enforce the law. Affirming dismissal of the case, the Michigan Supreme Court criticized the implications of a procedure permitting such a suit. Ignoring the merits of the plaintiffs claims, the court held the Michigan Declaratory Judgment Act unconstitutional because it permitted “determinations of abstract propositions of law” before a party had sustained any damages, thereby conferring non-judicial power on the courts.¹⁴

The *Anway* decision dealt a serious blow to the declaratory judgment movement, but did not resolve the debate. The debate persisted over the following seven years, peaking in three United States Supreme Court cases. The first case was *Liberty Warehouse Co. v. Grannis*.¹⁵ In that case, a tobacco warehouseman brought a declaratory judgment action in federal court against the State of Kentucky, claiming that a new state law regulating warehouses was unconstitutional. Since Congress had not yet passed the Federal Declaratory Judgment Act, the plaintiff sought relief under the Kentucky Declaratory Judgment Act, as applicable under the Conformity Act.¹⁶ Affirming dismissal of the plaintiffs claim, the Supreme Court held that the plaintiff was not entitled to declaratory relief because since the commonwealth had not threatened to enforce the warehouse act, the plaintiff’s claim was not ripe for adjudication. However, even if the dispute was ripe for determination, the court noted that the federal courts did not have jurisdiction to apply the Kentucky declaratory relief act because the act “neither purports to nor can extend the jurisdiction of the district courts beyond the constitutional limitations.”¹⁷

The second case, *Liberty Warehouse Co. v. Burley*,¹⁸ was a state court proceeding brought under the same warehouse act. After the resolution of *Liberty Warehouse I*, the State of Kentucky brought an enforcement proceeding against the warehouseman, alleging that his hours violated the warehouse act. The warehouseman counterclaimed for declaratory judgment, seeking to obtain a declaration that the act was unconstitutional,

¹¹ Doernberg & Mushlin, *supra* note 3, at 555-56.

¹² 179 N.W. 350 (1920).

¹³ At that point, Wisconsin, Florida, and Michigan had already passed their own acts. 1919 Fla. Laws 7857 (1919); 1919 Mich. Pub. Acts 150 (1919); 1919 Wis. Laws 242 (1919). In addition, four other states (Connecticut, Maryland, New Jersey, and Rhode Island) had limited and narrow statutes granting a limited power to render declaratory judgments. *Anway* was the first case to consider the constitutionality of these acts. For a detailed discussion of the debate over the constitutionality of declaratory judgment actions, see Edwin M. Borchard, *The Constitutionality of Declaratory Judgments*, 31 COLUM. L. REV. 561 (1931).

¹⁴ *Id.*

¹⁵ 273 U.S. 70 (1927) [hereinafter *Liberty Warehouse I*].

¹⁶ The Conformity Act permitted federal courts to apply state procedural laws in diversity actions. *Id.* at 76.

¹⁷ *Id.*

¹⁸ 276 U.S. 71 (1928) [hereinafter *Liberty Warehouse II*].

but the state court struck the counterclaim on the ground that only a plaintiff could seek a declaration under the Kentucky Declaratory Judgment Act. The Supreme Court affirmed, but did not address the merits of the warehouseman's position. Rather, it affirmed on procedural grounds, holding that "[t]his court has no jurisdiction to review a mere declaratory judgment."¹⁹

The final decision in the trilogy was *Willing v. Chicago Auditorium Association*.²⁰ In that case, a lessee of the Chicago Auditorium wanted to tear down the building to build a large commercial building, but the lease did not authorize it to do so. The lessee sued in state court for a declaration to resolve the dispute. The defendants removed the action to federal court and moved to dismiss. Affirming dismissal of the complaint, the Supreme Court held that declaratory relief exceeded the limits of judicial power because a party seeking relief before it suffered any damages did not present "a case or controversy within the meaning of article III."²¹

C. ENACTMENT OF THE UNIFORM DECLARATORY JUDGMENT ACT.

The Commissioners on Uniform State Laws proposed a uniform declaratory judgment act for passage by the states in 1920.²² The Commissioners, however, became concerned about the constitutionality of the act after the ruling in *Anway*. Although they intended the act to be limited to cases of actual controversy, the original act did not contain any jurisdictional limitations. They, therefore, became fearful that the act might be construed as "unconstitutional, null and void" and that this omission might "put a damper forever upon the great progressive movement of declaratory judgments."²³

Therefore, in 1922, the Commissioners amended the UDJA to limit jurisdiction to cases already within the courts' "respective jurisdictions."²⁴ This amendment was intended to signal what the drafters thought apparent, namely that the declaratory judgment was not designed to permit adjudication of moot cases or rendition of advisory opinions, but rather to provide an alternative remedy for ripe disputes.²⁵

Over the next few years, states began to adopt and enact the UDJA. In fact, at least twenty-three states had enacted the UDJA when Congress began to deliberate about the FDJA in 1928. By 1934, when the FDJA finally passed, a majority of the states had

¹⁹ *Id.* at 88-89.

²⁰ 277 U.S. 274 (1928)

²¹ *Id.* at 289.

²² HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS 188 (1920).

²³ HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS 81-82 (1921).

²⁴ Final Draft of a Bill for an Act Concerning Declaratory Judgments and Decrees, HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS 241 (1922) (Final Draft of a Bill for an Act Concerning Declaratory Judgments).

²⁵ Professor Borchart supported this amendment "[t]o avoid any possibility of doubt of the function to be performed by a declaratory judgment," although he continued to insist that the amendment was "surplusage," since the Act was always intended to be limited to cases of actual controversy. BORCHARD, *supra* note 7, at 154-5.

enacted a declaratory judgment act. The majority of remaining states quickly followed suit after Congress enacted the FDJA. By 1949, only Arkansas, Louisiana, Mississippi, and Oklahoma were without a declaratory judgment act.

D. ENACTMENT OF THE FEDERAL DECLARATORY JUDGMENT ACT OF 1934.

The first attempt to pass a federal act quickly followed Borchard's groundbreaking articles. The bill was introduced in every session of Congress from 1919 to 1932. However, despite the passage of the IJDJA, the FDJA was rejected each time. It passed the House three times, but was rejected by the Senate.

Although the Congress that passed the Act did so without any hearings and with virtually no discussion,²⁶ three hearings on earlier proposals for a declaratory judgment law were held in the 1920s.²⁷ These hearings, combined with discussions on the floor of Congress over the preceding years, provide a full record of congressional deliberations on this subject. This record demonstrates that Congress wanted to expand the subject matter jurisdiction of the federal courts to reap the benefits of declaratory judgment, but was concerned about preventing parties from litigating moot or advisory claims.²⁸ Given the Supreme Court's warnings that a declaratory judgment act would not be well received, Congress was reluctant to pass the FDJA unless it could be persuaded that the measure was not a legislative attempt to violate the constitutional limits established by Article III.

As a result, the bill laid dormant for five years, until the Supreme Court reversed itself in *Nashville, Chattanooga & St. Louis Railway v. Wallace*.²⁹ In that case, a railroad brought an action for a declaration that a state tax was unconstitutional and sought Supreme Court review of the state court's adverse ruling. Since the state was threatening to enforce the tax, the court was squarely presented with jurisdiction to review the permissibility of declaratory judgment. Discrediting the trilogy's comments about the

²⁶ There were no debates or hearings held in either the House or the Senate on the 1934 Bill. The consideration by each chamber was limited to a brief summary of the Bill by its sponsors, followed by a voice vote. 78 CONG. REC. 10564-65, 10919 (1934) (consideration of the Bill by the Senate); 78 CONG. REC. 8224 (1934) (consideration of the Bill by the House).

²⁷ Although there were no hearings before the enactment of the federal declaratory judgment act, a court may rely upon hearings conducted in Congress prior to the session in which the statute was enacted to discern the legislative intent. *E.g.*, *Kennedy v. Mendoza-Martinez*, 372 U.S. 144 (1963); *Arizona Power Auth. v. Morton*, 549 F.2d 1231 (9th Cir. 1977); *Panella v. United States*, 216 F.2d 622 (2d Cir. 1954); *Wilderness Soc'y v. Morton*, 479 F.2d 842, 856 (D.C. Cir. 1973) ("The legislative history of the bill that was finally enacted into law . . . contains no discussion [of the issue] The legislative history of similar bills in prior Congresses, however, is very revealing").

²⁸ Congress appreciated the benefits of declaratory judgments. Lawyers, scholars, and judges extensively testified that the Act would help eliminate the uncertainty in legal relations caused by the established remedies' inability to address genuine and pressing controversies, and permit parties otherwise unable to sue in federal court to use that forum. *See Hearings on H.R. 5623 Before a Subcomm. of the Senate Comm. on the Judiciary*, 70th Cong., 1st Sess., 2-9 (1928) (testimony of Charles P. Taft, Chairman of the American Bar Association Committee on Jurisprudence and Law Reform); *Hearings on H.R. 5365 Before the House Comm. on the Judiciary*, 69th Cong., 1st Sess., sec. 12, 2-8 (1926).

²⁹ 278 U.S. 249 (1933).

constitutionality of declaratory judgment acts,³⁰ the unanimous court held that “the Constitution does not require that the case or controversy should be presented by traditional forms of procedure, invoking only traditional remedies.” Reasoning that coercive relief “is not an indispensable adjunct to the exercise of the judicial function,” the court concluded that the dispute satisfied the case or controversy requirements of Article III because the railroad’s case was “real and substantial.”³¹

Wallace cleared the way for passage of the FDJA, which was passed less than a year thereafter in 1934.

III. Federal Declaratory Judgment Act and the Uniform Declaratory Judgment Act: An Overview

A. FEDERAL DECLARATORY JUDGMENT ACT

The FDJA is designed to permit a party to obtain an authoritative resolution of a dispute before it suffers traditional out-of-pocket damages, regardless of whether a coercive legal or equitable remedy is sought or available.³² 28 U.S.C. § 2201 provides that:

In a case of actual controversy within its jurisdiction, except with respect to Federal taxes other than actions brought under section 7428 of the Internal Revenue Code of 1986, a proceeding under section 505 or 1146 of title 11, or in any civil action involving an antidumping or countervailing duty proceeding regarding a class or kind of merchandise of a free trade area country (as defined in section 516(f)(10) of the Tariff Act of 1930), as determined by the administering authority, any court of the United States, upon the filing of an appropriate pleading, may declare the rights and other legal relations of any interested party seeking such declaration, whether further relief is or could be sought. Any such declaration shall have the force and effect of a final judgment or decree and shall be reviewable as such.³³

Although the FDJA authorizes federal courts to grant declaratory relief, it does not address the procedural mechanisms for requesting such relief. The Supreme Court, therefore, enacted Rule 57 of the Federal Rules of Civil Procedure to regulate the procedure for obtaining declaratory relief.³⁴ In effect, Rule 57 makes actions for declaratory judgment like all other civil actions, requiring litigants to prosecute a claim

³⁰ The Court made short shrift of the trilogy. The opinion does not mention *Liberty Warehouse I* and distinguished *Liberty Warehouse II* on the basis that the plaintiffs in that case sought “a decision advising what the law would be on an uncertain or hypothetical state of facts.” *Id.* at 262.

³¹ *Id.* at 263.

³² 28 U.S.C. § 2201 (2001).

³³ *Id.*

³⁴ Fed. R. Civ. P. 57, advisory committee’s note.

for declaratory relief in the same manner as in other civil actions, that is, in accordance with the applicable rules of civil procedure.³⁵

That said, an action for declaratory judgment raises certain unique issues not always present in other statutory actions. First, although the FDJA is a federal statute, it does not create federal jurisdiction, so a party must independently establish federal jurisdiction (either through diversity jurisdiction or federal question jurisdiction) before it may seek declaratory relief. Second, even though declaratory judgment is intended to allow a party to obtain relief before it sustains damages, a litigant must nonetheless establish an actual case or controversy, which is not typically an issue in an action for monetary damages. Third, since an action for declaratory judgment is subject to the Federal Rules of Civil Procedure, litigants must join all necessary parties, in accordance with Rule 11. Fourth, because the FDJA only grants federal courts discretion to grant declaratory judgment and does not impose a duty to entertain all claims for declaratory relief, a litigant must convince the trial court to accept jurisdiction over its claim.

1. Federal Jurisdiction

Federal jurisdiction is not normally an issue when a litigant seeks relief under a federal statute, because since the action arises under a federal statute, federal question jurisdiction necessarily exists.³⁶ This rule, however, does not apply to claims under the FDJA. The FDJA is remedial only. It does not expand federal jurisdiction or create an independent basis for jurisdiction.³⁷ Actions under the FDJA, therefore, are treated like other civil actions in federal court, meaning that a party seeking declaratory judgment must independently establish federal jurisdiction, whether by federal question or diversity jurisdiction.³⁸

a. *Federal Question Jurisdiction:* Federal question jurisdiction only exists if the action “arises under a federal law.” To meet this burden, either federal law must have created the cause of action or the well-pleaded allegations of the complaint must raise an

³⁵ Rule 57 provides “[t]he procedure for obtaining a declaratory judgment pursuant to Title 28, U.S.C., § 2201, shall be in accordance with these rules, and the right to trial by jury maybe demanded under the circumstances and in the manner provided in Rules 38 and 39. The existence of another adequate remedy does not preclude a judgment for declaratory relief in cases where it is appropriate. The court may order a speedy hearing of an action for declaratory judgment and may advance it on the calendar.”

³⁶ For a detailed discussion of federal question jurisdiction, see 12 MOORE’S FEDERAL PRACTICE, ¶ 104 (3d ed. 1999).

³⁷ *Skelly Oil Co. v. Phillips Petroleum Co.*, 339 U.S. 667 (1950) (DJA does not expand federal jurisdiction; court must have statutory authority and constitutional power to have jurisdiction to hear declaratory relief suit); *Pub. Serv. Comm’n of Utah v. Wycoff*, 344 U.S. 237 (1952) (same); *see also* *Gulf States Paper Corp. v. Ingram*, 811 F.2d 1464, 1467 (11th Cir. 1987), *abrogated on other grounds*, *King v. St. Vincent’s Hosp.*, 502 U.S. 215 (1991) (FDJA only “allow[s] parties to precipitate suits [in federal court] that otherwise might need to wait for the declaratory relief defendant to bring a coercive action, provided there is an underlying ground for federal jurisdiction”).

³⁸ *Skelly*, 339 U.S. at 671-72, *United Food & Comm. Workers Union v. Albertson’s, Inc.*, 207 F.3d 1193, 1200-01 (10th Cir. 2000); *Rueth v. United States Emtl. Prot. Agency*, 13 F.3d 227, 231 (7th Cir. 1993); *Texas Employers’ Ins. Ass’n v. Jackson*, 820 F.2d 1406, 1420 (5th Cir. 1987).

important issue of federal law.³⁹ Because the FDJA does not create an independent basis for jurisdiction, federal question jurisdiction only exists in declaratory judgment actions if resolution of a federal question is an essential element of the plaintiffs claim.⁴⁰

To invoke federal jurisdiction, the complaint's well-pleaded allegations must raise a substantial issue of federal law, in other words, the face of the complaint must reveal a substantial, disputed question of federal law. However, "the mere presence of a federal issue in a state cause of action does not automatically confer federal question jurisdiction."⁴¹ Rather, "the existence of federal question jurisdiction must be determined by 'principled, pragmatic distinctions,' and 'careful judgments about the exercise of federal judicial power'; only where the 'federal interest at stake' is substantial will federal jurisdiction lie."⁴²

"[T]he proper test for federal jurisdiction [is] 'the degree to which federal law must be in the forefront of the case and not collateral, peripheral or remote.'"⁴³ Federal question jurisdiction, therefore, only exists where (1) a federal issue constitutes a necessary element of a well-pleaded state law claim; (2) the federal issue is substantial; and (3) the federal issue is in dispute between the parties.⁴⁴

While the allegations in the complaint normally determine the existence of federal question jurisdiction, the issue becomes more complex when the action is brought by a prospective defendant against a prospective plaintiff, in anticipation of an affirmative action by the prospective plaintiff. In these cases, a question naturally arises concerning the application of the well-pleaded complaint doctrine. Does the fact that the plaintiff pleaded a federal question in the complaint automatically establish federal question jurisdiction? While one might logically assume so, it does not.

A party cannot establish federal question jurisdiction by asserting what is really a preemptive federal defense as the basis of his complaint.⁴⁵ "Where the complaint in an action for declaratory judgment seeks in essence to assert a defense to an impending or threatened . . . action, it is the character of the threatened action, and not of the defense, which will determine whether there is federal question jurisdiction in the District

³⁹ *Merrell Dow Pharm. v. Thompson*, 478 U.S. 804 (1986); *Smith v. Kansas City Tile & Trust Co.*, 255 U.S. 180 (1921).

⁴⁰ *Skelly*, 339 U.S. at 671-72 (the FDJA "enlarged the range of remedies available in the federal courts did not extend their jurisdiction"); see also *Pub. Serv. Comm'n v. Wycoff*, 344 U.S. 237, 248 (1952).

⁴¹ *Merrell Dow Pharm. Inc.*, 478 U.S. at 813.

⁴² *Custer v. Sweeney*, 89 F.3d 1156, 1168 (4th Cir. 1966) (quoting *Merrell Dow Pharm. Inc.*, 478 U.S. at 813-14).

⁴³ *Mulcahey v. Columbia Organic Chems. Comp., Inc.*, 29 F.3d 148, 152 (4th Cir. 1994) (quoting *Merrell Dow Pharm. Inc.*, 478 U.S. at 813).

⁴⁴ *Gully v. First Nat'l Bank*, 299 U.S. 109, 112 (1936) (federal question jurisdiction over state cause of action exists if resolution of federal issue is essential element of plaintiffs case); *Shulthis v. McDougal*, 225 U.S. 561, 569 (1912) (federal question jurisdiction over state cause of action exists if resolution of dispute depends on the validity, construction or effect of federal law and federal question is real and substantial issue).

⁴⁵ *Id.* (citing *Skelly Oil Co.*, 339 U.S. at 669).

Court.”⁴⁶ Stated differently, “if, but for the availability of the declaratory judgment procedure, the federal claim would arise only as a defense to a state created action, jurisdiction is lacking.”⁴⁷

Fidelity claims do not typically implicate federal question jurisdiction because, in the main, they do not involve disputes about federal law. There is, however, an exception when the FDIC pursues the claim.”⁴⁸ Although creation of a corporate entity under federal law does not itself create federal question jurisdiction,⁴⁹ “all suits of a civil nature at common law or in equity to which the [FDIC], in any capacity, is a party shall be deemed to arise under the laws of the United States.”⁵⁰ Federal question jurisdiction, therefore, automatically exists if the FDIC is a party to the action, regardless of whether the dispute otherwise involves a federal question.⁵¹

b. *Diversity Jurisdiction:* If the claim does not otherwise qualify for federal question jurisdiction, a litigant may pursue a claim under the FDJA if there is diversity jurisdiction. Under 28 U.S.C. § 1332, district courts have original jurisdiction of all civil actions where the matter in controversy exceeds the sum or value of \$75,000, exclusive of interest and costs, and is between:

- (1) citizens of different states;
- (2) citizens of a State and citizens or subjects of a foreign state;

⁴⁶ Pub. Service Comm’n of Utah, 344 U.S. at 248, *GNB Battery Tech., Inc. v. Gould, Inc.*, 65 F.3d 615, 619 (7th Cir. 1995).

⁴⁷ *Franchise Tax Board of State of Cal. v. Construction Laborer Vacation Trust Southern California*, 463 U.S. 1, 16 (1983); *Northeast Ill. Reg. Comm. R.R. Corp. v. Hoey Farina & Downes*, 212 F.3d 1010, 1014 (7th Cir. 2000); (“In declaratory judgment cases, the well-pleaded complaint rule dictates that jurisdiction is determined by whether federal jurisdiction would exist over the presumed suit by the declaratory judgment defendant”).

⁴⁸ Responsibility for regulatory supervision and enforcement is also allocated to the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. Although the agencies are responsible for regulating different financial institutions, they typically appoint the FDIC as receiver when an institution within their jurisdiction becomes insolvent. Therefore, while an action involving these agencies might arguably implicate federal question jurisdiction, this issue does not, as a practical matter, commonly arise in fidelity coverage litigation because the FDIC is generally appointed to pursue the underlying claim on behalf of the insolvent insured. Randall I. Marmor, *Obtaining Bank Examination Reports in the Investigation of Financial Institution Bond Claims* (unpublished paper presented at the annual meeting of the Surety Claims Institute, Absecon, New Jersey, June 2002).

⁴⁹ The Supreme Court originally held, in *Osborn v. Bank of U.S.*, 22 U.S. 738 (1824), that federal courts acquire federal question jurisdiction when a civil action involves a federally chartered bank. Congress, however, subsequently circumscribed *Osborn* when it enacted 28 U.S.C. § 1349 (1993). Section 1349 provides that “district courts shall not have jurisdiction of any civil action by or against any corporation upon the ground that it was incorporated by or under an Act of Congress, unless the United States is the owner of more than one-half of its capital stock.” *Id.*; *Viqueria v. First Bank*, 140 F.3d 12 (1st Cir. 1998); *City Nat’l Bank v. Edmisten*, 681 F.2d 942 (4th Cir. 1982).

⁵⁰ 12 U.S.C. § 1819 (1999).

⁵¹ *E.g.*, *Am. Cas. Co. of Reading, Pa. v. Continisio*, 7 F.3d 62 (3rd Cir. 1994); *Nat’l Union Fire Ins. Co. of Pittsburgh, Pa. v. Cont’l Ill. Corp.*, 113 F.R.D. 532 (N.D. Ill. 1986); *but see O’Neal v. CIGNA Prop. & Cas. Ins. Co.*, 878 F. Supp. 848, 849 (D.S.C. 1995) (no original jurisdiction exists when EDIC was not named as a party).

- (3) citizens of different States and in which citizens or subjects of a foreign state are additional parties; and
- (4) a foreign state, defined in section 1603(a) of this title, as plaintiff and citizens of a State or of different states.⁵²

Analyzing the propriety of diversity jurisdiction, therefore, raises two distinct issues: First, is there diversity of citizenship? Second, does the amount in controversy exceed \$75,000, exclusive of interest and costs?

The primary issue is diversity of citizenship. It is important to keep in mind that, in accordance with the purposes of diversity jurisdiction and to avoid undue expenditure of federal resources, diversity jurisdiction requires complete diversity of citizenship. Under this principle, jurisdiction only exists if *all* plaintiffs are from different states from *all* defendants. While this question is fairly simple in disputes between individuals (since diversity of citizenship is simply determined by the litigants' domicile), the issue becomes more complex in disputes involving corporate entities.

The domicile of corporate entities depends, in large measure, upon the nature of the corporation. For example, the domicile of a corporation is different than the domicile of a national banking association or a partnership or an unincorporated association.⁵³ It is, therefore, important to carefully study the diversity rules when analyzing diversity of citizenship. While this article is not intended to provide an in-depth analysis of diversity jurisdiction, the following are the diversity rules for common entities involved in fidelity claims:

Corporation: Under Section 1332(c), “a corporation [is] deemed to be a citizen of any State by which it has been incorporated and of the State where it has its principal place of business”⁵⁴

Unincorporated Division or Subsidiary of a Corporation: An unincorporated division or a corporation is deemed to have the citizenship of its parent company.⁵⁵

Defunct or Inactive Corporation: There is a three-way split of authority regarding the proper test to determine citizenship of a defunct or inactive corporation. Some courts have adopted the view that a defunct company is deemed to be a citizen of both its state of incorporation and the location in which it last transacted

⁵² 28 U.S.C. § 1332(a) (1997).

⁵³ For a complete discussion of diversity jurisdiction, see 15 MOORE'S FEDERAL PRACTICE, 102 (3d. ed 1999).

⁵⁴ 28 U.S.C. § 1132 (c) (1997). There is a limited exception for insurance companies. Section 1132 provides that “in any direct action against the insurer of a policy or contract of liability insurance, whether incorporated or unincorporated, to which action the insured is not joined as a party defendant, such insurer shall be deemed a citizen of the State of which the insured is a citizen, as well as of any State by which the insurer has been incorporated and of the State where it has its principal place of business.”

⁵⁵ See, e.g., *Brunswick Corp. v. Jones*, 784 F.2d 271 (7th Cir. 1986).

business.⁵⁶ Other courts, however, reject the notion that an inactive corporation can have a principal place of business and hold that an inactive corporation is a citizen only of its state of incorporation.⁵⁷ Yet other courts have rejected these bright-line approaches and held that citizenship is determined by weighing the facts and circumstances underlying the corporation dissolution to determine whether it is a citizen of any state.⁵⁸

National Banking Association: All national banking associations are deemed citizens of the states in which they are physically located.⁵⁹

Partnerships: There is no statutory authority establishing any special rule for partnerships with regards to diversity, as Section 1332(c) does for corporations. Therefore, a partnership is not a citizen of any state within the meaning of the statutes regulating jurisdiction, and its citizenship must be determined with reference to each of its partners.⁶⁰

Unincorporated Associations: Similar to a partnership and unlike a corporation, an unincorporated association is deemed to have the citizenship of each of its members.⁶¹

Lloyd's of London: Lloyd's of London consists of unincorporated groups of investors, referred to respectively as "syndicates," who appoint agents (referred to as underwriters) to act on their behalf. Although Lloyd's syndicates are unincorporated associations, courts are split on how to determine citizenship. In the main, courts have taken two approaches. While some courts have held that a syndicate is deemed a citizen of the state in which the active or managing underwriter is located⁶², the majority of courts have held

⁵⁶ See, e.g., *Wm. Passalacque Builders, Inc. v. Rednick Developers S., Inc.* 933 F.2d (2d Cir. 1991).

⁵⁷ See, e.g., *Midatlantic Nat'l Bank v. Hansen*, 48 F.3d 693 (3d Cir. 1995).

⁵⁸ See, e.g., *Athena Automotive, Inc. v. DiGregorio*, 166 F.3d 288 (4th Cir. 1999).

⁵⁹ See, e.g., *Bank of N.Y. v. Bank of Am.*, 861 F. Supp. 225 (S.D.N.Y. 1994); *Conn. Nat'l Bank v. Iacono*, 785 F. Supp. 30 (D.R.I. 1992).

⁶⁰ See, e.g., *Chapman v. Barney*, 129 U.S. 677 (1889); see also *Cosgrove v. Bartolotta*, 150 F.3d 731 (7th Cir. 1998); *Alumax Mill Prods. v. Congress Fin. Corp.*, 912 F.2d 996 (8th Cir. 1990)

⁶¹ See, e.g., *United Steelworkers of Am., AFL-CIO v. R.H. Bouligny, Inc.*, 382 U.S. 145 (1965); see also *Indiana Gas Co., Inc. v. Home Ins. Co.*, 141 F.3d 314 (7th Cir. 1998); *Aetna Cas. & Sur. Co. v. laoTex, Inc.*, 75 F.3d 216 (5th Cir. 1996); *United Food Local 919 v. Centermark Prop.*, 30 F.3d 298 (2d Cir. 1994); *Certain Interested Underwriters at Lloyd's, London, End. v. Layne*, 26 F.2d 39 (6th Cir. 1994).

⁶² *Advani Enterprises, Inc. v. Underwriters at Lloyd's*, 140 F.3d 157 (2d Cir. 1998); *Layne*, 26 F.3d at 39.

that a Lloyd's syndicate is a citizen of every state in which its individual investors are citizens.⁶³

If diversity of citizenship exists, the next issue is whether the claim satisfies the jurisdictional amount requirement. In general, the amount in controversy is governed by the amount stated in the complaint, unless it appears to a legal certainty that the claim is for less than the jurisdictional minimum.⁶⁴ Therefore, if the amount at issue in the claim (exclusive of interest, costs and attorney's fees) exceeds \$75,000, the claim satisfies the jurisdictional threshold for jurisdiction.⁶⁵

2. Justiciable Controversy

The FDJA was in no way intended to — nor constitutionally could it — authorize a federal court to issue an advisory opinion. Like all other actions heard in federal court, an action for declaratory judgment is subject to the case-or-controversy requirement of Article III of the Constitution.⁶⁶ Thus, although the FDJA enables a party to obtain a binding legal determination of its rights before that party suffers traditional damages, it extends only to those situations in which there is a live, concrete dispute between the parties. Stated differently, the underlying dispute must be of a justiciable nature, or ripe for adjudication.⁶⁷

The rationale for this rule is simple — federal courts may not issue advisory decrees on hypothetical facts. That said, the contingent nature of the right or obligation at issue does not itself preclude declaratory relief. Rather, in determining the existence of an actual controversy, the practical likelihood that the contingencies will occur, such that the controversy is real, is determinative.

The threshold question is “whether the facts alleged, under all the circumstances, show that there is a substantial controversy, between parties having adverse legal interests, of sufficient immediacy and reality to warrant the issuance of a declaratory judgment.”⁶⁸ The party seeking jurisdiction must show, at an “irreducible minimum,” that at the time the complaint was filed, it had suffered some actual or threatened injury

⁶³ E.R. Squibb & Sons, Inc. v. Acc. & Cas. Ins. Co., 160 F.3d 925 (2d Cir. 1998); Ind. Gas Co., Inc. v. Home Ins. Co., 141 F.3d 314 (7th Cir. 1998); Bath Iron Works Corp. v. Certain Members Cos. of the Inst. of London Underwriters, 870 F. Supp. 3 (D. Me. 1994).

⁶⁴ Hunt v. Wash. State Apple Advert. Comm'n, 432 U.S. 333 (1977); Horton v. Liberty Mut. Ins. Co., 367 U.S. 348 (1961); St. Paul Mercury Indem. Co. v. Red Cab Co., 303 U.S. 283 (1938).

⁶⁵ Interest, costs, and attorney's fees are not normally included in calculation of amount in controversy, unless the defendant is contractually obligated to pay them. Springstead v. Crawford State Bank, 231 U.S. 541 (1913); Farmers Ins. Co. v. McClain, 603 F.2d 821 (10th Cir. 1979); Nationwide Mut. Ins. Co. v. Rowles, 818 F. Supp. 852 (E.D. Pa. 1993).

⁶⁶ U.S. CONST. art. III, § 2.

⁶⁷ Aetna Life Ins. Co. v. Haworth, 300 U.S. 227, 240 (1937) (“A ‘controversy’ in this sense must be one that is appropriate for judicial determination. . . . A justiciable controversy is thus distinguished from a difference or dispute of a hypothetical or abstract character; from one that is academic or moot. . . . The controversy must be definite and concrete, touching the legal relations of parties having adverse legal interests”); *see also* Certain Underwriters at Lloyd's v. St. Joe Minerals Co., 90 F.3d 675 (2d Cir. 1996); Newton v. State Farm Fire & Cas. Co., 138 F.R.D. 76 (E.D. Va. 1991).

⁶⁸ Md. Vas. Co. v. Pac. Coal & Oil Co., 312 U.S. 270, 273 (1941).

resulting from the defendant's conduct, that the injury fairly can be traced to the challenged action, and that the injury is likely to be redressed by favorable court disposition.⁶⁹

In the typical fidelity claim, the threshold question is whether a claim ripens into a justiciable controversy upon the insured's submission of a proof of loss, or whether the insurer must formally deny coverage before it does so. Enforcing the principle that a justiciable controversy does not arise until there is a dispute, at least one court has held that an insurance coverage claim does not ripen into a justiciable controversy until, at a minimum, the insured gives its insurer notice of its claim because until the insured gives its insurer notice of the claim, neither the insured nor the insurer could not claim actual nor threatened injury.⁷⁰ Thereafter, a justiciable controversy ripens once the insurer denies coverage.⁷¹

In some instances, an insured may also seek indemnity under a fidelity bond for third party losses. Beyond the general requirements for justiciability, these claims (although they are rarely covered under a fidelity bond) also raise a distinct justiciability issue, namely whether the insured must have been held liable to the third party before its dispute ripens into a justiciable controversy. There is a split of authority on this issue. Some courts have held that an actual controversy does not exist until the judgment in the third party action has been entered and the liability for which indemnification is sought has accrued.⁷² Other courts have reached the opposite conclusion and ruled that such claims are justiciable before a judgment is entered if the third party suit has already been filed and there is a "real and substantial" possibility that an indemnification claim may arise.⁷³

⁶⁹ *E.g.*, Valley Forge College v. Ams. United, 454 U.S. 464, 472 (1982); Caulkins Indiantown Citrus Co. v. U.S. Fire Ins. Co., 931 F.2d 744, 747 (11th Cir. 1991).

⁷⁰ Atlanta Gas Light Co. v. Aetna Cas. & Sur. Co., 68 F.3d 409, 415 (11th Cir. 1995); *see also* Ind. Gas Co., Inc. v. Aetna Cas. & Sur. Co., 946 F. Supp. 627 (N.D. Ind. 1996), *rev'd on other grounds*, 141 F.3d 314 (7th Cir. 1998) (no claim or controversy exists until a third party claim is actually filed against the insured. Mere threat of a claim does not present a justiciable controversy).

⁷¹ *See, e.g.*, Transport Indem. Co. v. Home Indem. Co., 535 F.2d 232, 234 n.2 (3d Cir. 1976); Globe Indem. Co. v. St. Paul Fire & Marine Ins. Co., 369 F.2d 102, 104 (3d Cir. 1966); West Am. Ins. Co. v. Allstate Ins. Co., 295 F.2d 513 (10th Cir. 1961); County of Wyoming, N.Y. v. Erie Lackawanna Ry. Co., 360 F. Supp. 1212 (W.D.N.Y. 1973), *aff'd* 518 F.2d 23 (2d Cir. 1975); Vance Trucking Co. v. Canal Ins. Co., 243 F. Supp. 469 (W.D.S.C. 1965).

⁷² *See, e.g.*, Certain Underwriters at Lloyd's, London v. St. Joe Minerals Corp., 90 F.3d 671, 675 (2d Cir. 1996) (holding that a declaratory judgment action by excess insurers seeking an adjudication of their responsibilities to their insured for environmental claims did not present a justiciable controversy where "there was no practical likelihood that St. Joe's liability would reach the layers of its excess insurance"); Argento v. Vill. of Melrose Park, 838 F.2d 1483, 1492 (7th Cir. 1988) ("In this Circuit, an insurer ordinarily cannot obtain a declaratory judgment as to its liability prior to the insured first being found liable"); Providence Journal Co. v. Travelers Indem. Co., 938 F. Supp. 1066 (D. R.I. 1996) (same); U.S. Healthcare, Inc. v. O'Brien, 868 F. Supp. 607, 615 (S.D.N.Y. 1994) (same).

⁷³ *See, e.g.*, Marine Equip. Mgmt. Co. v. United States, 4 F.3d 643, 647 (8th Cir. 1993) (controversy exists where lawsuits are pending and a "real and substantial" possibility exists that indemnification will be sought); Assoc. Indem. Corp. v. Fairchild Indus., Inc., 961 F.2d 32 (2d Cir. 1992); Kunkel v. Cont'l Cas. Co., 866 F.2d 1269 (10th Cir. 1989); Am. Commercial Lines, Inc. v. Monsanto Co.,

3. Availability of Other Remedies

Although the FDJA is not intended to allow parties to seek duplicative relief for a breach of contract, the mere availability of alternative remedies or claims does not preclude an action for declaratory judgment. Under the express terms of the act, “[t]he existence of another adequate remedy does not preclude a judgment for declaratory relief where it is appropriate.” The “where it is appropriate” clause appears to leave the door open for an argument that declaratory relief may not always be “appropriate” where other remedies exist, but courts have rejected this notion and held that a party may seek declaratory relief, even if the claim is duplicative of other available remedies.⁷⁴

4. Joinder of Necessary Parties

While an insurer and its insured must obviously be parties to a declaratory judgment action, an issue commonly arises about whether other potentially interested third parties must also be joined in the action. For example, if a fidelity insurer and its insured are disputing whether a third party loss is covered under a fidelity bond, the injured third-party may be interested in the outcome of the declaratory judgment proceedings, but must it be joined as a party to the action?

While a plaintiff normally has discretion to decide who should be a party to a lawsuit, the Federal Rules of Civil Procedure requires all individuals or entities needed for a just adjudication of the controversy to be joined in an action for declaratory judgment. The issue of who are and are not necessary and proper parties to a declaratory judgment action is basically the same as with any other action.⁷⁵ Under Rule 19,

[a] person who is subject to service of process and whose joinder will not deprive the court of jurisdiction over the subject matter of the action shall be joined as a party in the action if (1) in the person’s absence complete relief cannot be accorded among those already parties, or (2) the person claims an interest relating to the subject of the action and is so situated that the disposition of the action in the person’s absence may (i) as a practical matter impair or impede the person’s ability to protect that interest or (ii) leave any of the persons already parties subject to a substantial risk of incurring double, multiple, or otherwise inconsistent obligations by reason of the claimed interest.⁷⁶

Analyzing this joinder under Rule 19 raises three issues: First, is the party to be joined a “necessary party” under Rule 19(a)? Second, will joinder deprive the court of

781 F.2d 114, 116 (8th Cir. 1985); *Nat’l R.R. Passenger Corp. v. Consolidated Rail Corp.*, 670 F. Supp. 424, 428 (D.D.C. 1987).

⁷⁴ See, e.g., *Truck Components, Inc. v. Beatrice Co.*, 1994 WL 520939 (N.D. Ill. Sept. 21, 1994) (motion to dismiss declaratory judgment claim as redundant “lacks merits” in light of Rule 57); see also Fed. R. Civ. P. 57 advisory committee’s notes (“the fact that another remedy would be equally effective affords no ground for declining declaratory relief”).

⁷⁵ See, e.g., *State Farm Mut. Auto Ins. Co. v. Mid-Continent Cas. Co.*, 518 F.2d 292, 294 (10th Cir. 1975) (no special rules as to parties needed for just adjudication in declaratory judgment action).

⁷⁶ Fed. R. Civ. P. 19(a) (2001).

subject matter jurisdiction? Third, if the party is necessary and the inclusion of that party does not deprive the court of subject matter jurisdiction, the issue becomes whether (1) that party is indispensable, such that a court cannot adjudicate the case in that party's absence and must dismiss the case, or (2) the action may go forward in equity and good conscience in that party's absence.⁷⁷ If the answer to any of these questions is no, joinder must be denied. Otherwise, the absentee constitutes a necessary party and must be joined in the action.

a. *Necessary Party*: Rule 19(a) prescribed three situations in which an absentee will be found to be a necessary party.⁷⁸ A party is deemed necessary, if (1) without joinder, "complete relief cannot be accorded among those already parties";⁷⁹ or (2) the absentee claims "an interest relating to the subject of the action" and is so situated that disposition of the case without its joinder "may as a practical matter impair or impede [the absentee's] ability to protect that interest";⁸⁰ or (3) absentee "claims an interest relating to the subject of the action" and is so situated that disposition of the case without its joinder "may leave any of the persons already parties subject to a substantial risk of incurring double, multiple, or otherwise inconsistent obligations . . ." without their joinder.⁸¹

The first test focuses on avoiding the entry of partial or "hollow" judgments -- judgments that do not effectively resolve the parties' entire controversy.⁸² In weighing this issue, however, "[c]ompleteness is determined on the basis of those persons who are already parties, and not as between a party and the absent person whose joinder is sought."⁸³ As such, courts have interpreted the first test narrowly and held that joinder is required only when the absentee's nonjoinder precludes the court from rendering complete justice among those already joined.

The second test reflects courts' interest in protecting the rights of unnamed parties. Rule 19, therefore, requires joinder of all parties if the action threatens to harm an absentee's "interest relating to the subject of the action." The absentee's interest, however, must be "legally protected, not merely a financial interest or interest of convenience."⁸⁴ The absentee must have a direct stake in the pending litigation. If the

⁷⁷ See, e.g., *Abbott Labs. v. Gardner*, 387 U.S. 136 (1967).

⁷⁸ Although Rule 19 requires joinder of all parties "needed for just adjudication," courts have interpreted this phrase as compelling only joinder of "necessary parties."

⁷⁹ Fed. R. Civ. P. 19(a)(1).

⁸⁰ *Id.* at (a)(2)(i).

⁸¹ *Id.* at 19(a)(2)(ii).

⁸² *A.J. Kellos Constr. Co. v. Baldoa Ins. Co.*, 295 F. Supp. 408, 414 (S.D. Ga. 1980), *rev'd on other grounds*, 661 F.2d 402 (5th Cir. 1981) ("Rule 19(a)(1) contemplates consummate rather than partial or hollow relief to parties before the court"); see also *Field v. Volkswagenwerk AG*, 626 F.2d 293, 301 (3d Cir. 1980) (same).

⁸³ See, e.g., *Angst v. Royal Maccabees Life Ins. Co.*, 77 F.3d 701, 705 (3d Cir. 1996); *Arkwright-Boston Mfrs. Mut. Ins. Co. v. City of N.Y.*, 762 F.2d 205 (2d Cir. 1985); *U.S. v. Country of Arlington*, 669 F.2d 925, 929 (4th Cir. 1982).

⁸⁴ See, e.g., *Northrop Corp. v. McDonnell Douglas Corp.*, 705 F.2d 1030, 1043 (9th Cir. 1983).

outcome of the litigation will have no practical effect on the absentee's interest, the absentee is not a necessary party.⁸⁵

The third test is primarily concerned with the threat posed to defendants by nonjoinder of an absentee. It is important to note, however, that the multiple liability clause compels joinder of an absentee to avoid inconsistent obligations, and not to avoid inconsistent adjudications. It is not triggered by the possibility of a subsequent adjudication that may result in an inconsistent judgment, but rather by the possibility of a double liability.⁸⁶

b. *Breaking of Jurisdiction:* Like all other joinder provisions, the compulsory joinder rule prescribes circumstances in which an absentee must be joined. Rule 19, however, only governs the procedural propriety of joinder and does not affect the jurisdiction or venue of the federal court. Therefore, regardless of whether an absentee is a necessary party, the underlying claim must be supported by federal subject matter jurisdiction. Courts, therefore, must determine if joinder is feasible without destroying subject matter jurisdiction.

Joinder is deemed feasible as long as the absentee is subject to service of process, or its joinder would not thwart diversity jurisdiction or venue.⁸⁷ If the joinder of a party will destroy subject matter jurisdiction, a court must consider whether the party is truly indispensable. If so, the court must dismiss the case. If not, the court may deny joinder and adjudicate the suit.

c. *Indispensability:* If a court determines that joinder of a necessary party is not feasible, the inquiry shifts to whether the necessary party is indispensable. The court must "determine whether in equity and good conscience the action should proceed among the parties before it, or should be dismissed, the absent person being thus regarded as indispensable."⁸⁸ In so doing, the court must consider four factors.

First, to what extent a judgment rendered in the person's absence might be prejudicial to the person or those already parties; second, the extent to which, by protective provisions in the judgment, by the shaping of relief, or other measures, the prejudice can be lessened or avoided; third, whether a judgment rendered in the person's absence will be adequate; fourth, whether the plaintiff will have an adequate remedy if the action is dismissed for nonjoinder.⁸⁹

In effect, a party is indispensable if its presence is required in order that the court may make an equitable adjudication of the dispute. It is not necessary that the absentee would be bound by the judgment in a technical sense. It is enough that as a practical

⁸⁵ *Janney Montgomery Scott, Inc. v. Shepard Niles, Inc.*, 11 F.3d 399 (3d Cir. 1993); *Eldredge v. Carpenters 46 N. Cal. Counties Joint Apprenticeship and Training Comm'n*, 662 F.2d 534 (9th Cir. 1981).

⁸⁶ *E.g.*, *Gwartz v. Jefferson Mem'l Hosp.*, 23 F.3d 1426 (8th Cir. 1994); *Angst*, 77 F.3d at 705-06.

⁸⁷ *Winklevoss Consultants, Inc. v. Fed. Ins. Co.*, 174 F.R.D. 416, 417 (N.D. Ill. 1997).

⁸⁸ Fed R. Civ. P. 19(b).

⁸⁹ *Id.*

matter his rights will be affected. Where such a community of interest exists that no decree can be rendered without affecting the interest of the absent party, that party is deemed indispensable.

Who constitutes a necessary party in an insurance coverage dispute depends, in large measure, upon the nature of the policy, and the circumstances underlying the claim. For example, an insured's primary carriers are generally considered necessary parties in a suit for coverage on an excess policy.⁹⁰ Courts have also held that third parties may be a necessary party to a declaratory judgment action regarding the scope of coverage under a liability policy, if they otherwise would have a claim against the insurer upon obtaining a judgment against the insured, because the action might adversely impact their rights.⁹¹

Although there are no cases specifically addressing this issue in the context of a fidelity claim, courts have recognized that a third party is not a necessary party to a breach of contract action, unless it is either a party to the contract or it has rights under the terms of the contract.⁹² Since fidelity bonds are not liability policies⁹³ and third parties do not have a right of indemnity under the bond,⁹⁴ they arguably do not constitute a necessary party within the meaning of Rule 19 because the resolution of the coverage action will not substantively impact their rights.⁹⁵

⁹⁰ See, e.g., *Schlumberger Indus. Inc. v. Nat'l Sur. Corp.*, 36 F.3d 1274, 1286- 87(4th Cir. 1994) (all insurers are necessary where insured could end up without full coverage even though it was legally entitled to full coverage); *City of Littleton*, 133 F.R.D. at 162-63 (in suit against excess carriers, absent primary insurers were necessary and indispensable parties); *Shell Oil Co. v. Aetna Cas. & Sur. Co.*, 158 F.R.D. 395, 399-404 (N.D. Ill. 1994) (excess insurance carriers are necessary and indispensable parties).

⁹¹ *Thoele v. Aetna Cas. & Sur.*, 39 F.3d 724 (7th Cir. 1994) (third party pursuing a claim against an insured is a necessary party to declaratory judgment action regarding scope of coverage under a homeowner's policy because upon securing a judgment against the insured, the third party would have a right to pursue recovery under the policy); *Franklin Life Ins. Co. v. Johnson*, 157 F.2d 653 (10th Cir. 1946) (beneficiary to a life insurance policy is a necessary party to coverage action regarding availability of coverage under a life insurance policy because action might impact beneficiary's rights).

⁹² *Davis Cos. v. Emerald Casino, Inc.*, 268 F.3d 477 (7th Cir. 2001); *ConnTech Dev. Co. v. Univ. of Conn. Educ. Properties, Inc.*, 102 F.3d 677 (2d Cir. 1996); *Fuller Co. v. Ramon I. Gil, Inc.*, 782 F.2d 306 (1st Cir. 1986); *Northrop Corp. v. McDonnell Douglas Corp.*, 705 F.2d 1030, 1044 (9th Cir. 1983) ("A nonparty to a commercial contract ordinarily is not a necessary party to an adjudication of rights under the contract").

⁹³ See, e.g., *Lynch Prop., Inc. v. Potomac Ins. Co. of Ill.*, 140 F.3d 622, 629 (5th Cir. 1998); *Travelers Ins. Co. v. P.C. Quote, Inc.*, 570 N.E.2d 614, 621 (Ill. App. Ct. 1991); *Central Nat'l Ins. Co. of Omaha v. Ins. Co. of N.A.*, 522 N.W.2d 39, 43-4 (Iowa 1994); *Aetna Cas. & Sur. Co. v. Kidder, Peabody & Co. Inc.*, 676 N.Y.S.2d 559, 566 (N.Y. App. Div. 1998).

⁹⁴ See, e.g., *Anderson v. Employers Ins. of Wausau*, 826 F.2d 777 (8th Cir. 1987); *Three Garden Village Ltd. P'ship v. U.S. Fid. & Guar. Co.*, 567 A.2d 85 (Md. 1989); *175 E. 74th Corp. v. Hartford Acc. & Indem. Co.*, 435 N.Y.S.2d 584, 587-88 (N.Y. App. Div. 1980). For a detailed explanation of why third parties do not have a right to seek recovery under a fidelity bond, see Scott L. Schmookler, *The Compensability of Third-Party Losses Under Fidelity Bonds*, VII FID. L.J. 115, 150-59 (2001).

⁹⁵ "When a person is not a party to the contract in litigation and has no rights or obligations under that contract, even though the absent party may be obligated to abide by the result of the pending action . . . , the absentee will not be regarded as an indispensable party in a suit to determine obligations under the disputed contract" " 7 CHARLES ALAN WRIGHT, ARTHUR R. MILLER & MARY KAY KANE, FEDERAL PRACTICE AND PROCEDURE CIVIL 3d, § 1613 at 197 (2001).

5. Discretionary Review and Abstention

Even if a federal court has subject matter jurisdiction over a dispute, the FDJA does not require the court to exercise jurisdiction. The FDJA is an enabling statute that grants discretion to the district courts to entertain declaratory relief actions, but it does not provide an absolute right to the litigant. Rather, it simply confers upon the court unique and substantial discretion to declare the rights of litigations.⁹⁶

A court may not, however, decline to exercise jurisdiction over an action for declaratory relief based upon a whim or personal disinclinations.⁹⁷ If a party raises an objection to the exercise of declaratory jurisdiction, the court must carefully weigh the issue and articulate the basis for declining to exercise its discretion. If the court does not do so, the appellate courts have shown no hesitation to remand the case to clarify the basis of the district court's decision, so the matter may be properly reviewed on appeal.

Whether a district court declines to exercise jurisdiction depends, in large measure, upon whether there is a prior state court action pending at the time of the filing of the federal action. If so, federal courts generally abstain from exercising federal jurisdiction, if the underlying state court action involves the same parties and issues. Conversely, if the federal action is "first in time" or there is not pending state court action, federal courts have been more reluctant to abstain from exercising jurisdiction.

a. *Deference to Prior State Court Action:* Application of the FDJA during the pendency of parallel state proceedings can prove particularly complex. Concerns of federalism, comity, and fairness require a balancing of competing values to determine whether to grant federal declaratory relief.⁹⁸ As a result, federal courts have adopted a doctrine of abstention to step aside in order to allow the state adjudicatory process to take its course.⁹⁹ Abstention, however, is controversial because it hampers a plaintiff's access

⁹⁶ *Wilton v. Seven Falls Co.*, 515 U.S. 277, 287 (1995) (district courts possess discretion to entertain action under the FDJA, even when subject matter jurisdictional requirements have been met); *Public Serv. Comm'n of Utah v. WyCoff Co.*, 344 U.S. 237, 241-43 (1952) (propriety of declaratory relief in particular case depends upon "a circumspect sense of its fitness informed by the teachings and experience concerning the functions and extent of federal judicial power").

⁹⁷ *Public Affairs Assocs., Inc. v. Rickover*, 269 U.S. 111, 112 (1962) (although FDJA gives federal courts competence to render declaratory judgments, court may not decline jurisdiction on a whim); *see also Gov't Employees Ins. Co. v. Dizol*, 133 F.3d 1220, 1223 (9th Cir. 1998) (court may not decline to entertain declaratory relief based of personal disinclination); *Nautilus Ins. Co. v. Winchester Homes, Inc.*, 15 F.3d 371, 375-76 (4th Cir. 1994) (same).

⁹⁸ The purpose of abstention is to preserve the balance between state and federal sovereignty, sometimes referred to as federalism or comity. "[Comity is] a proper respect for state functions, a recognition of the fact that the entire country is made up of a Union of separate state governments, a continuance of the belief that the National Government will fare best if the States and their institutions are left free to perform their separate functions in their separate ways." *Younger v. Harris*, 401 U.S. 37, 44 (1971).

⁹⁹ Although the abstention doctrines defy strict categorization, the cases relying on the abstention principle are commonly divided into several doctrinal groups. *First*, the Pullman abstention doctrine generally requires a lower federal court to stay its hand to permit state courts to resolve unsettled state law questions which may obviate the need to reach the federal questions presented in a case. *Second*, the Younger abstention doctrine holds that, absent specified circumstances, a federal court should not enjoin an ongoing state criminal proceeding. *Third*, the Burford abstention doctrine requires abstention to avoid

to a federal court, even though the federal court has jurisdiction over the parties and the case.¹⁰⁰

The seminal case addressing abstention in declaratory judgment actions is *Brillhart v. Excess Insurance Company*.¹⁰¹ In that case, the plaintiff's decedent died in an automobile collision involving a truck leased by Cooper-Jarrett and insured by Central Mutual Insurance Company. Excess Insurance Company reinsured Central Mutual for cash sums actually paid in settlement of losses. Before the conclusion of the Missouri state action regarding the automobile collision, a matter exceedingly local in character, Central Mutual was liquidated, and Cooper-Jarrett filed for bankruptcy protection. Ultimately, Brillhart obtained a default judgment and instituted state garnishment proceedings against Central Mutual and subsequently joined Excess Insurance.

Excess Insurance filed a declaratory judgment action in federal district court in Kansas seeking a declaration that Excess Insurance owed Brillhart nothing. The district court dismissed the declaratory action, and the Tenth Circuit reversed. Explaining that federal courts had no obligation to entertain all declaratory judgment actions, the Supreme Court affirmed.

Ordinarily it would be uneconomical as well as vexatious for a federal court to proceed in a declaratory judgment suit where another suit is pending in a state court presenting the same issues, not governed by federal law, between the same parties. Gratuitous interference with the orderly and comprehensive disposition of state court litigation should be avoided.¹⁰²

The court, therefore, held that a federal court should abstain from exercising jurisdiction if the "controversy between the parties to the federal suit, . . . which are not foreclosed under the applicable substantive law, can better be settled in the proceeding pending in the state court."¹⁰³

Since the district court had not considered this issue, the Supreme Court remanded the case for further proceedings. In so doing, the court established a three-prong balancing test to determine the appropriateness of abstention. Under the *Brillhart* test, federal courts must weigh the interest in avoiding needless determinations of state

federal court interference in complex state administrative schemes. *Fourth*, the Colorado River abstention doctrine, which is discussed in detail below, counsels federal court restraint when parallel state court proceedings and "exceptional circumstances" exist.

¹⁰⁰ Commentators almost uniformly condemn the Supreme Court's abstention doctrines. The critics suggest that the entire concept of abstention is antithetical to the federal courts' obligation to exercise the jurisdiction granted them. See generally Barry Friedman, *A Revisionist Theory, of Abstention*, 88 MICH. L. REV. 530 (1989); Linda S. Mullenix, *A Branch Too Far: Pruning the Abstention Doctrine*, 77 GEO. L.J. 99 (1986); Martin H. Redish, *Abstention, Separation of Powers, and the Limits of the Judicial Function*, 94 YALE L.J. (1984); David A. Sonenshein, *The Crooked Course of Colorado River*, 59 TUL. L. REV. 651 (1985).

¹⁰¹ 316 U.S. 491 (1942).

¹⁰² *Id.* at 495.

¹⁰³ *Id.*

law, forum shopping, and duplicative litigation when considering whether to accept jurisdiction over a declaratory judgment action.¹⁰⁴

Brillhart provided guidance for generations. A question, however, arose in 1976, when the Supreme Court addressed the issue of abstention in *Colorado River Water Conservation District v. United States*¹⁰⁵. In that case, Colorado, by state statute, divided itself into seven divisions for the determination of water rights. The state system, on a continuous basis, adjudicated water claims within each division. The United States filed an action in a federal district court in Colorado against one thousand water users, seeking a declaration of water rights in one of the state water rights divisions. One of the one thousand water users then joined the United States as a party in state proceedings to determine water rights for that same state division. The district court dismissed the federal action, citing the abstention doctrine, in an unreported oral opinion. The Tenth Circuit Court of Appeals reversed, holding that abstention was inappropriate.

On review, the Supreme Court emphasized that abstention is an extraordinary and narrow exception to the duty of a District Court to adjudicate a controversy properly before it. Abdication of the obligation to decide cases can be justified under this doctrine only in the exceptional circumstances where the order to the parties to repair to the state court would clearly serve an important countervailing interest.”¹⁰⁶ The Court, therefore, held that a federal court should decline jurisdiction over a matter when a concurrent state proceeding exists only if “exceptional” circumstances favor doing so.¹⁰⁷

To guide the analysis as to whether a federal court might refuse to hear a matter, the Colorado River court listed several factors as relevant indicators of the presence of exceptional circumstances that would justify a federal court’s refusal to hear a matter otherwise properly before it. The factors that the court listed were: “the court first assuming jurisdiction over property,” “the inconvenience of the federal forum,” “avoiding piecemeal litigation,” and “the order in which jurisdiction was obtained by the concurrent forums.”¹⁰⁸

At first glance, one might interpret *Colorado River* as having no impact on the viability of *Brillhart* because it did not involve a declaratory judgment action. However, the issue became muddled two years later, when the Supreme Court decided *Will v. Calvert Fire Insurance Company*.¹⁰⁹ In that case, a reinsurer brought a state action asking the trial court to declare an agreement enforceable. The defendant argued that the agreement was invalid because it violated federal and state securities laws. During the pendency of the state court suit, the defendant filed an action in federal district court

¹⁰⁴ *Id.* at 498.

¹⁰⁵ 424 U.S. 800 (1976).

¹⁰⁶ *Id.* at 813 (quoting *County of Allegheny v. Frank Mashuda Co.*, 360 U.S. 185, 188-89 (1959)).

¹⁰⁷ *Id.* at 817-18 (Given this obligation of the federal courts to hear matters before them, and the absence of weightier considerations of constitutional adjudication and state-federal relations, the circumstances permitting the dismissal of a federal suit due to the presence of a concurrent state proceeding for reasons of wise judicial administration are considerably more limited than the circumstances appropriate for abstention).

¹⁰⁸ *Id.*

¹⁰⁹ 437 U.S. 655 (1978).

seeking damages under the Securities Act of 1934. The district court stayed all aspects of the federal action.

The Supreme Court accepted an appeal from a writ of mandamus issued by the Seventh Circuit Court of Appeals, which had ordered the district judge to adjudicate the matter regarding the 1934 Act immediately. Though the case did not involve the FDJA, the Supreme Court relied on *Brillhart* for the proposition that “a district court is ‘under no compulsion to exercise (its) jurisdiction’” if a state court can settle that matter “more expeditiously.” The court, however, then quoted the¹¹⁰ Colorado River language concerning the “‘virtually unflagging obligation of the federal courts to exercise the jurisdiction given them’” as one “factor” that the district court should consider in what is, “in the last analysis, a matter committed to the district court’s discretion.”¹¹¹

After *Calvert*, the interrelationship of *Brillhart* and *Colorado River* was unclear. The Court then decided *Moses H Cone Memorial Hospital v. Mercury Construction Corporation*,¹¹² here the Supreme Court once again considered a related state litigation matter in a case not involving the federal declaratory judgment procedure. In that case, the Supreme Court clearly stated that the *Colorado River* analysis applied to a case that did not arise under the federal declaratory judgment statute, eliminating the confusion created by the problematic *Calvert* case. The court held “our task in cases such as this is not to find some substantial reason for the exercise of federal jurisdiction by the district court; rather, the task is to ascertain whether there exist ‘exceptional’ circumstances, the ‘clearest of justifications,’ that can suffice under *Colorado River* to justify the surrender of that jurisdiction.”¹¹³

Despite *Moses H Cone*, a split of authority in lower federal courts arose over the standard for determining whether to entertain a declaratory judgment action. Some courts applied *Colorado River* and held that a federal court could only refuse to hear a matter, even if there was related state litigation, if exceptional circumstances overcame the court’s “unflagging obligation” to exercise jurisdiction existed.¹¹⁴ Other courts applied *Brillhart* and found that federal jurisdiction in a declaratory judgment action is permissive, not mandatory, and thus exceptional circumstances need not justify abstention because there is no mandatory obligation to exercise jurisdiction.”¹¹⁵

This split of authority persisted until 1995, when the Supreme Court decided *Wilton v. Seven Falls Company*.¹¹⁶ In *Wilton*, London Underwriters petitioned the United States District Court for the Southern District of Texas for a declaration that their

¹¹⁰ *Id.* at 667.

¹¹¹ *Id.*

¹¹² 460 U.S. 1 (1983).

¹¹³ *Id.* at 25-26.

¹¹⁴ *BASF Corp. v. Symington*, 50 F.3d 555 (8th Cir. 1995); *De Cisneros v. Younger*, 871 F.2d 305, 307-08 (2d Cir. 1989); *General Reinsurance Corp. v. Ciba-Geigy Corp.*, 853 F.2d 78, 81-82 (2d Cir. 1988); *Nat’l R.R. Passenger Corp. v. Providence & W.R.R.*, 798 F.2d 8, 11 (1st Cir. 1986).

¹¹⁵ *See*, e.g., *Nationwide Ins. v. Zavalis*, 52 F.3d 689, 692-93 (7th Cir. 1995); *State Farm Fire & Cas. Co. v. Mhoon*, 31 F.3d 979, 982-83 (10th Cir. 1994); *Nationwide Mut. Fire Ins. Co. v. Willenbrink*, 924 F.2d 104, 105 (6th Cir. 1991); *Allstate Ins. Co. v. Mercier*, 913 F.2d 273, 277 (6th Cir. 1990).

¹¹⁶ 515 U.S. 277 (1995).

insurance policies did not cover an insured's liability for a state court judgment. Several weeks later the insured filed a state action against London Underwriters seeking a declaration of coverage, thus presenting a convergence of a federal declaratory judgment action and related state proceedings.

The district court stayed the declaratory judgment action to avoid piecemeal litigation and forum shopping, given that the issues in the state and federal actions were identical. The Fifth Circuit Court of Appeals affirmed, although it did not apply either the *Colorado River* analysis or the *Brillhart* analysis. Rather, the court, noting that the district court had "broad discretion . . . to grant (or decline to grant) declaratory judgment," held that the district court did not abuse its discretion.¹¹⁷

On appeal, the Supreme Court embraced *Brillhart* as the controlling precedent for a district court's decision whether to entertain a declaratory judgment action involving related state litigation. The Court analogized *Wilton* to *Brillhart*, stating that the circumstances were "virtually identical." Acknowledging that the FDJA carried "'no compulsion (for the court) to exercise (its) jurisdiction,'" the Court held that test for the district court to apply is "'whether the questions in controversy between the parties to the federal suit, and which are not foreclosed under the applicable substantive law, can better be settled in the proceeding pending in the state court.'"¹¹⁸ If so, the district court should abstain from exercising jurisdiction.

In response to the argument that *Colorado River* and *Moses H. Cone* had supplanted *Brillhart*, the Court stated that "[d]istinct features of the Declaratory Judgment Act, we believe, justify a standard vesting district courts with greater discretion in declaratory judgment actions than that permitted under the 'exceptional circumstances' test of *Colorado River* and *Moses H. Cone*."¹¹⁹ Thus, though a district court's ability to abstain under other doctrines has been referred to as an exercise of discretion, the *Wilton* court clarified that the discretion accompanying declaratory judgment actions is a greater than in other civil actions.

Although neither *Brillhart* nor *Wilton* set forth an exclusive list of factors governing the district court's exercise of that discretion, both decisions instruct that a district court should examine the scope of the pending state court proceedings and whether the claims of all parties in interest can satisfactorily be adjudicated in that proceeding. Accordingly, if the underlying state court action involves the same parties and same issues, courts have generally abstained from exercising federal jurisdiction.¹²⁰

¹¹⁷ *Wilton v. Seven Falls Co.*, 41 F.3d 934, 935 (5th Cir. 1994).

¹¹⁸ *Id.* at 2140 (quoting *Brillhart v. Excess Ins. Co. of Am.*, 316 U.S. 491, 494 (1942)).

¹¹⁹ *Id.* at 2142.

¹²⁰ *See, e.g.*, *State Auto Ins. Co. v. Summy*, 234 F.3d 131 (3d Cir. 2000); *Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Karp*, 108 F.3d 17 (2d Cir. 1997).

However, if the state court action does not involve the same parties and same issues, federal courts have distinguished *Wilton* and exercised jurisdiction.¹²¹

b. Deference to State Courts: If there is no state court action pending when a federal declaratory judgment action is filed, federal courts have greater latitude to accept jurisdiction and, as a practical matter, are more inclined to do so.¹²² In considering whether to exercise its discretion and accept jurisdiction, courts must determine whether the judgment “will serve a useful purpose in clarifying and settling the legal relationships in issue” and whether it “will terminate and afford relief from the uncertainty, insecurity, and controversy giving rise to the proceeding.”¹²³ To do so, courts generally consider whether (1) a judgment would settle the controversy and serve a useful purpose in clarifying the legal relations at issue; (2) action is being used merely for “procedural fencing” type purposes; (3) there is an overriding state court interest.¹²⁴

The primary factor considered by federal courts when determining whether to exercise jurisdiction over a declaratory judgment action is whether the judgment will serve a useful purpose in clarifying and settling the legal relations at issue, and terminate and afford relief from uncertainty, insecurity and controversy giving rise to the action.”¹²⁵ [W]here ‘the remedy sought is a mere declaration of law without implications for practical enforcement upon the parties, the case is properly dismissed.’”¹²⁶

The second factor is whether the declaratory judgment action is being used merely for “procedural fencing” purposes. Procedural fencing may provide an exception to the first-filed rule, such that plaintiffs’ choice of forum is not accorded deference when considering the appropriate venue. Even when the federal action is filed first, the court must determine whether the declaratory action was “anticipatory” of the declaratory defendant’s filing suit in state court.¹²⁷ The rationale for this rule is simple — it assures

¹²¹ See, e.g., *Agora Syndicate, Inc. v. Robinson Janitorial Specialists, Inc.*, 149 F.3d 371(5th Cir. 1998); *Exxon Corp. v. St. Paul Fire & Marine Ins. Co.*, 129 F.3d 781 (5th Cir. 1997); *Peerless Ins. Co. v. Disla*, 999 F. Supp. 261(D. Conn. 1998);

¹²² *Wilton*, 515 U.S. at 287 (district courts possess discretion to entertain action under FDJA, even when subject matter jurisdictional requirements have been met); *Public Serv. Comm’n of Utah*, 344 U.S. at 241-43 (propriety of declaratory relief in particular case depends upon “a circumspect sense of its fitness informed by the teachings and experience concerning the functions and extent of federal judicial power”).

¹²³ *Grand Trunk W. R.R. v. Consolidated Rail Corp.*, 746 F.2d 323, 326 (6th Cir. 1984).

¹²⁴ See, e.g., *State Farm Fire & Cas. Co. v. Mhoon*, 31 F.3d 979, 983 & n.6 (10th Cir. 1994); *Omaha Prop. & Cas. Ins. Co. v. Johnson*, 923 F.2d 446, 448 (6th Cir. 1991).

¹²⁵ *Cont’l Cas. Co. v. Coastal Savings Bank*, 977 F.2d 734, 737 (2d Cir. 1992).

¹²⁶ *S. Jackson & Son, Inc. v. Coffee, Sugar & Cocoa Exch. Inc.*, 24 F.3d 427, 431 (2d Cir. 1994) (quoting *Browning Debenture Holders’ Comm’n v. Dasa Corp.*, 524 F.2d 811, 817 (2d Cir. 1975)).

¹²⁷ *Northwest Airlines, Inc. v. Am. Airlines, Inc.*, 989 F.2d 1002, 1007 (8th Cir. 1993) (declaratory judgment actions may on occasion merit “a closer look” to ensure that the declaratory plaintiff is not motivated by forum-shopping concerns); *St. Paul Fire & Marine Ins. Co. v. Runyon*, 53 F.3d 1167, 1170 (10th Cir. 1995) (a district court may choose to avoid a declaratory judgment action because the plaintiff is using the action for procedural fencing).

that the federal declaratory action was not filed in an attempt to oust the state court of the opportunity to hear a case that would otherwise be properly before it.¹²⁸

The third factor is the existence of a compelling state court interest. A federal court may consider whether the state court has a compelling state interest in resolving the issues presented in the federal suit. For example, if state law exclusively governs a dispute, a state might have a compelling interest if the state law was undecided or if the issues are close, problematic or difficult.¹²⁹

c. Deference to Other Federal Courts: Beyond showing deference to state courts to resolve declaratory judgment actions, federal courts also maintain a system of comity among themselves.¹³⁰ Under the “first to file rule”¹³¹, federal courts will, absent compelling circumstances, defer and give priority to a prior-filed action over a later-filed action¹³² when the parties and issues in the two suits are substantively identical.¹³³

This is not, however, a *per se* rule. Rather, it simply gives either the first or the second court the discretion to dismiss, stay or transfer a duplicative suit pending before it upon learning of the existence of a similar suit between similar parties in another federal court. Since the rule is an instrument of deference and discretion (and is not intended to

¹²⁸ *Allendale Mut. Ins. Co. v. Bull Data Sys.*, 10 F.3d 425, 431 (7th Cir. 1993) (“a suit for declaratory judgment aimed solely at wresting the choice of forum from the ‘natural’ plaintiff will normally be dismissed”); *Pac. Employers Ins. Co. v. M/V Capt. W.D. Cargill*, 751 F.2d 801, 804 (5th Cir. 1985); *Wells’ Dairy Inc. v. Estate of Richardson*, 89 F. Supp. 2d 1042, 1060 (N.D. Iowa 2000); *State Farm Fire & Cas. Co. v. Taylor*, 118 F.R.D. 426, 430 (M.D.N.C. 1988) (a district court may consider the inequity of permitting a declaratory judgment plaintiff to gain precedence in time and forum by filing an anticipatory action).

¹²⁹ *Centennial Life Ins. Co. v. Poston*, 88 F.3d 255 (4th Cir. 1996); *Am. Home Assurance Co. v. Evans*, 791 F.2d 61 (6th Cir. 1986); *Zurich Ins. Co. v. Alvarez*, 669 F. Supp. 307 (C.D. Cal. 1987).

¹³⁰ *Brittingham v. Comm’n*, 451 F.2d 315, 318 (5th Cir. 1971) (“Comity dictates that courts of coordinate jurisdiction not review, enjoin, or otherwise interfere with one another’s jurisdiction”).

¹³¹ This rule, however, is not codified. Rather, it is a general principle of case management adopted by federal courts to avoid the issuance of rulings which might entrench upon the authority of sister courts. *Tingley Sys., Inc. v. Bay State HMO Management, Inc.*, 833 F. Supp. 882 (M.D. Fla. 1993) (describing the rule as “consistent with the doctrine of federal comity which requires the federal district courts to refrain from interfering with each other’s affairs in order to avoid duplication of judicial resources and conflicting decisions”).

¹³² Federal courts examine the date of filing, not of service, to determine which party filed first. *Allstate Ins. Co. v. Clohessy*, 9 F. Supp. 2d 1314, 1316 (M.D. Fla. 1998); *Fat Possum Records v. Capricorn Records*, 909 F. Supp. 442, 446 (N.D. Miss. 1995); *but see Pittman v. Triton Energy Corp.*, 842 F. Supp. 918, 923 (S.D. Miss. 1994) (finding that a suit served by mail to an expired mailing address did not qualify as the first-filed suit because the party to be served did not have sufficient notice of the suit). When the first-filed action was originally a state court suit that has been removed to federal court, the filing date with the state court remains the filing date for purposes of determining which action was filed first. *Mfr. Hanover Trust Co. v. Palmer Corp.*, 798 F. Supp. 161, 166 (S.D.N.Y. 1992).

¹³³ For the rule to come into play, the competing cases usually involve closely related questions, common subject matter, or substantial overlap of issues, but they need not be identical. *Texas Inst., Inc. v. Micron Semiconductor, Inc.*, 815 F. Supp. 994, 997 (E.D. Tex. 1993); *Mann Mfg., Inc. v. Hortex, Inc.*, 439 F.2d 403, 407 (5th Cir. 1971); *Fat Possum Records, Ltd.*, 909 F. Supp. at 445 (“a substantial overlap of the content of each suit is sufficient”); *but see Owens v. Blue Tee Corp.*, 177 F.R.D. 673, 679 (M.D. Ala. 1998) (finding the rule inapplicable where a prior filed suit involved certain identical claims, but where two of the three plaintiffs in the second suit were not parties to the first suit).

be applied rigidly, mechanically, or inflexibly), courts carefully analyze the procedural posture of the dispute to determine whether to give priority to the prior-filed action or the later-filed action.¹³⁴

As such, winning the race to the courthouse does not automatically preempt other suits. Federal courts have fashioned the “anticipatory suit exception” to prevent working an injustice upon the second-filing party. This exception is intended to discourage procedurally unfair suits filed to frustrate settlement discussions¹³⁵ and to eliminate the “race to the courthouse door in an attempt to preempt a later suit in another forum.”¹³⁶ The exception reflects the courts’ concern that a plaintiff should not lose his or her traditional choice of forum because the defendant anticipated the impending suit and preemptively struck by filing suit first in a different court.¹³⁷

When deciding whether the proponent of the anticipatory suit exception has overcome the presumption favoring the first-filed suit, courts inquire into the pre-filing history of the dispute. In inquiring into this history, courts often focus on pre-filing communications between the parties, examining both their content and their surrounding circumstances. In effect, courts evaluate the competing parties’ acts or omissions to try to determine if the party accused of committing an anticipatory filing really ‘jumped the gun.’”

The mere fact that the proponent of the exception sent his opponent a demand letter threatening to file suit does not itself, without more, establish the anticipatory nature of the suit. While a demand letter stating an intent to sue promptly if some condition is not met can be evidence that the recipient of the letter anticipated the suit threatened therein,¹³⁸ a combination of factors can create a synergy of evidence, making each factor appear more persuasive when combined than when presented apart as isolated proofs.

¹³⁴ *Kerotest Manf. Co. v. C-O-Two Fire Equip. Co.*, 342 U.S. 180 (1952) (in questions of priority between similar proceedings, “[a]n ample degree of discretion, appropriate for disciplined and experienced judges, must be left to the lower courts”); *Northwest Airlines, Inc.*, 989 F.2d at 1005; *Alltrade, Inc. v. Uniweld Products, Inc.*, 946 F.2d 622, 629 (9th Cir. 1991) (“The most basic aspect of the first-to-file rule is that it is discretionary”); *Texas Inst., Inc.*, 815 F. Supp. at 997 (opining that the rule gives the court presiding over the first-filed suit the responsibility to determine which suit should proceed, and that the sister court presiding over the second-filed suit may not usurp the role of the first court).

¹³⁵ *Columbia Pictures Indus., Inc. v. Schneider*, 435 F. Supp. 742, 747-48 (S.D.N.Y. 1977).

¹³⁶ *See Guthy-Renker Fitness, L.L.C. v. Icon Health & Fitness, Inc.*, 179 F.R.D. 264, 271 (C.D. Cal. 1998) (citing *Mission Ins. Co. v. Puritan Fashions Corp.*, 706 F.2d 599, 602 (5th Cir. 1983); *Ontel Products, Inc. v. Project Strategies Corp.*, 899 F. Supp. 1144, 1150 (S.D.N.Y. 1995) (“Where a party is prepared to file a lawsuit, but first desires to attempt settlement discussions, that party should not be deprived of the first-filed rule’s benefit simply because its adversary used the resulting delay in filing to proceed with the mirror image of the anticipated suit.”).

¹³⁷ The exception is applied widely, but not uniformly. There is a wide variation in the exception’s application because the discretionary nature of the rule allows a judge to focus on the facts of each case. Two courts reviewing similar facts can reach different conclusions when applying the exception, not because they use different criteria, but because courts in their discretion assign different weights to the criteria, effectively changing the application of the exception from district to district. This variation can occasionally result in differences in the application of the exception between jurisdictions.

¹³⁸ *Factors Etc., Inc. v. Pro Arts, Inc.*, 579 F.2d 215, 217-19 (2d Cir. 1978).

In other words, a court will weigh circumstantial evidence to determine if the suit was truly anticipatory. For example, when an accuser sends a grave demand letter demanding prompt compliance, and then waits months until filing suit after the accused files first, a court may construe the communicative and temporal elements together and conclude that the accuser's actual intent to sue was questionable.¹³⁹ Alternately, courts may consider an omission, such as a party's failure to respond to a demand letter or to pressure their accuser for an out-of-court resolution, prior to filing their lawsuit as evidence of intent to pursue legal recourse. It is, therefore, important for an insurer to document its diligence and the basis for its suit to ensure the viability of its action and application the anticipatory suit exception.

B. Uniform Declaratory Judgment Act

The amended version of the UDJA was originally proposed in 1922. With minor modifications, it has been adopted and enacted by forty-one states, the Virgin Islands, and the Commonwealth of Puerto Rico.¹⁴⁰ The remaining states have generally often have civil practice rules and evolved decisional law that, in effect, binds them to the letter and spirit of the UDJA.¹⁴¹ Therefore, while there may be subtle differences, this paper will use the UDJA as a model for the analysis of state declaratory judgment actions.

Since the UDJA and the FDJA were patterned after one another and drafted during the same period, they are substantively analogous. Like the FDJA, the UDJA provides courts with discretion to grant declaratory relief.

Any person interested under a deed, will, written contract or other writings constituting a contract, or whose rights, status or other legal relations are affected by a statute, municipal ordinance, contract or franchise, may have determined any question or construction or validity arising under the instrument, statute, ordinance, or franchise and obtain a declaration of rights, status or other legal relations thereunder.¹⁴²

That said, although the FDJA and UDJA are analogous in many respects, there are three substantive differences. *First*, the UDJA requires the plaintiff to join all interested parties, not only those parties who are necessary to the resolution of the claim. *Second*, the UDJA grants courts jurisdiction to grant declaratory relief before a breach of

¹³⁹ In effect, courts will scrutinize the content of a demand letter to determine whether it appears to be an expression of a genuine intent to file suit immediately, or merely a veiled threat, an instrument of leverage, or saber-rattling. *Northwest Airlines, Inc.*, 989 F.2d at 1007; *Guthy-Renker Fitness, L.L.C.*, 179 F.R.D. at 270-71; *Sweetheart Plastics, Inc. v. Ill. Tool Works, Inc.* 267 F. Supp. 938, 941-42 (S.D.N.Y. 1967).

¹⁴⁰ Although the states that have enacted the UDJA have generally incorporated the act as written, some states have drafted minor revisions to the act. It is, therefore, important to study the specific state act before filing a declaratory judgment action.

¹⁴¹ Alaska, California, Connecticut, Hawaii, Kentucky, Michigan, Mississippi, New Hampshire, New York and the District of Columbia have not enacted the UDJA. They all, however, have civil practice rules and evolved decisional law which is substantive analogous to the UDJA.

¹⁴² UNIFORM DECLARATORY JUDGMENT ACT, § 2 (amended 1922), 12A U.L.A. 3 (Supp. 1996).

the underlying contract. *Third*, the UDJA does not explicitly grant courts jurisdiction to grant declaratory relief when other legal alternatives are available.

1. Joinder of Interested Parties

The joinder provision incorporated into the IJDJA is much broader than Rule 19 of the Federal Rules of Civil Procedure. Unlike Rule 19, Section 11 of the UDJA does not limit joinder to only those parties who are necessary to the resolution of the dispute. Rather, to avoid prejudicing the insured's rights and/or a third-party claimant's rights and protect the integrity of the judicial process itself by avoiding the prospect of unnecessary or duplicative litigation, Section 11 requires joinder of all "parties who have or claim any interest which would be affected by the declaration."¹⁴³

That said, Section 11 obviously does not require joinder of any party with a mere curiosity about or concern over the outcome of a declaratory judgment action. On the contrary, a third party is only deemed an interested party under Section 11 if it "possess[es] a personal claim, status, or right which is capable of being affected."¹⁴⁴ In effect, the dispute must "touch the legal relations of parties who stand in position adverse to one another."¹⁴⁵

At first glance, Section 11 might not appear broader than Rule 19 because it appears to limit joinder to only those parties that have an interest in the declaratory judgment action. Courts, however, have interpreted Section 11 more liberally than Rule 19. For example, while some federal courts have generally held that an injured claimant is not a necessary party to a coverage action under Rule 19 because they are neither a necessary party nor an indispensable party,¹⁴⁶ courts interpreting Section 11 have reached the opposite conclusion, reasoning that these claimants are interested parties because their rights might be affected by the resolution of the coverage action.¹⁴⁷

2. Actual controversy

Like under the FDJA, the UDJA only gives courts discretion to grant declaratory relief when there is an actual controversy. However, while federal courts have strictly interpreted the case or controversy requirement in Article III as precluding declaratory relief before a breach of contract,¹⁴⁸ the UDJA authorizes courts to grant relief before a

¹⁴³ UNIFORM DECLARATORY JUDGMENT ACT § 2, 12 U.L.A. 516 (1994).

¹⁴⁴ See, e.g., *Underground Contractors Ass'n v. City of Chicago*, 362 N.E.2d 298, 301 (Ill. 1977).

¹⁴⁵ *Id.*

¹⁴⁶ *Winklevoss Consultants, Inc. v. Fed. Ins. Co.*, 174 F.R.D. 416 (N.D. Ill. 1997); *Hoosier Cas. Co. of Indianapolis, Ind. v. Fox*, 102 F. Supp. 214 (N.D. Iowa 1952).

¹⁴⁷ See, e.g., *Shapiro v. Republic Indem. Co. of Am.*, 341 P.2d 289 (Cal. 1959); *Flashner Med. P'ship v. Marketing Mgmt., Inc.*, 545 N.E.2d 177 (Ill. App. Ct. 1989); *Reagor v. Travelers Ins. Co.*, 415 N.E.2d 512 (Ill. App. Ct. 1980); *Updike Inv. Co. v. Employers' Liab. Assur. Corp.*, 258 N.W. 470 (Neb. 1935); *St. Paul Fire & Marine Ins. Co. v. Dept. of Natural Resources*, 265 N.E.2d 814 (Ohio 1970); *but see Monsanto Co. v. Aetna Cas. & Sur. Co.*, 565 A.2d 268 (Del. Super. Ct. 1989).

¹⁴⁸ See *supra* notes 66 to 73, and accompanying text.

breach of contract. Under Section 3, a “contract may be construed either before or after there has been a breach thereof.”¹⁴⁹

This difference substantially impacts when an insurance coverage dispute becomes justiciable. For example, while a coverage dispute may not be ripe for dispute under the FDJA until the insurer has denied coverage,¹⁵⁰ courts interpreting the UDJA have held that an insurer may seek declaratory relief before denying coverage, as long as there is a dispute about the compensability of the claim.¹⁵¹ Along these lines, although some federal courts have held that an insurance coverage dispute stemming from an insured’s potential liability to a third party does not become ripe until the insured’s liability accrues,¹⁵² courts have held that Section 3 of the UDJA permits adjudication of coverage disputes relating to third party claims before resolution of the underlying claim.¹⁵³

3. Availability of Alternative Relief

Unlike the FDJA, the UDJA does not expressly provide courts with discretion to grant declaratory relief when other legal alternatives are available. The UDJA is silent on this issue. This silence has created a split of authority about whether a plaintiff may seek declaratory relief when other legal alternatives exist.¹⁵⁴

The majority of states interpreting the UDJA have held that an action for declaratory relief may be maintained even though another remedy is available.¹⁵⁵ Although the UDJA does not expressly state that a litigant may maintain an action for declaratory judgment when other legal alternatives exist, these courts have reasoned that the absence of such a provision does not necessarily require a litigant to exhaust his legal alternatives before seeking declaratory relief because “while the Uniform Declaratory Judgments Act does not provide in specific terms, as do the Federal Rules, that the existence of other adequate remedies shall not bar declaratory relief,...the Uniform Act or similar state statutes...state that declaratory relief may be granted ‘whether or not further relief is or could be claimed.’”¹⁵⁶

Other courts, however, reached the opposite conclusion and held that declaratory judgment is not appropriate if another adequate remedy exists.¹⁵⁷ These courts have

¹⁴⁹ UNIFORM DECLARATORY JUDGMENT ACT, § 3 (amended 1922), 12A U.L.A. 266 (Supp. 1996).

¹⁵⁰ See *supra* notes 70 to 71, and accompanying text.

¹⁵¹ See, e.g., *Atlanta Cas. Co. v. Fountain*, 413 S.E.2d 450 (Ga. App. Ct. 1992); *Hartford Acc. & Indem. Co. v. Dana Corp.*, 690 N.E.2d 285 (Ind. App. Ct. 1997).

¹⁵² See *supra* notes 72 and 73, and accompanying text.

¹⁵³ See, e.g., *Pettit v. Erie Ins. Exch.*, 699 A.2d 550 (Md. App. Ct. 1997).

¹⁵⁴ *Rocky Mountain Oil & Gas Ass’n v. State*, 645 P.2d 1163 (Wyo. 1982).

¹⁵⁵ See, e.g., *Baughner v. Walker*, 362 N.E.2d 410 (Ill. Ct. App. 1977); *Katz Inv. Co. v. Lynch*, 47 N.W.2d 800 (Iowa 1951); *Schriber Sheet Metal & Roofers v. Shook*, 28 N.E.2d 699 (Ohio Ct. App. 1940); *Friestad v. Travelers Ind. Co.*, 306 A.2d 295 (Pa. 1973); *Neal v. Brockway*, 385 A.2d 1069 (Vt. 1978).

¹⁵⁶ *Rocky Mountain Oil & Gas Ass’n*, 645 P.2d at 1167.

¹⁵⁷ *El Capitan Club v. Fireman’s Fund Ins. Co.*, 506 P.2d 426 (Nev. 1973) (“We hold that, before a court may properly exercise its discretion to refuse declaratory relief on the ground that other remedies are available, it must clearly appear that the asserted alternative remedies are available to the plaintiff seeking the declaratory relief, and that such remedies are speedy and adequate or as well suited to the plaintiffs

rejected the notion that the clause giving courts authority to grant declaratory relief “whether or not further relief is or could be claimed” permits a court to grant declaratory relief when other legal alternatives exist. Rather, these courts have simply held that “[a] declaratory judgment remedy is not an alternative remedy in the sense that it is always available even though there may be grounds for full relief in equity or at law.”¹⁵⁸

IV. Strategic Considerations When Deciding Whether to Pursue a Declaratory Judgment Action

The strategic decision of whether to file a pre-emptive declaratory judgment action against an insured is often difficult. While it may be to the carrier’s advantage in some cases to file a pre-emptive action so the carrier can choose the venue and craft the pleadings to define the dispute, it may be to the carrier’s advantage in other cases to defer filing suit, so the carrier can attack the insured’s claim with a dispositive motion. Deciding this delicate issue requires a fidelity insurer to weigh both venue and pleading considerations, because the combination of these factors can create a synergy, making a given factor more persuasive in a given claim than it otherwise would be in a normal civil dispute.

A. FORUM AND VENUE CONSIDERATIONS

The strategic decision of where to file suit is often a key consideration in deciding whether to file a pre-emptive action against an insured. Beyond the obvious comfort factor (most litigators prefer to appear in their nearest court before judges they know), an insurer must carefully consider both the tangible and intangible benefits and detriments of a given forum because different venues can bring different juror demographics, docket speeds and judicial dispositions on issues of substantive law.

1. Judicial Demeanor

As most coverage lawyers will attest, the disposition of the trial judge can have as much of an impact on the resolution of the claim, as the merits of the case itself. The general demeanor, style of interpretation, and approach to litigation of a given trial judge may substantively impact his view of the dispute, and interpretation of the law. For example, if the trial judge does not favor rescission of insurance policies, an insurer will have an uphill battle seeking rescission in his courtroom, regardless of the merits of the insurer’s position, because the judge may, by his very nature, strictly construe the law against an insurer seeking rescission. As a result, since the judge presides over the case and a litigant may not normally appeal an interlocutory ruling, an insurer should carefully consider both the demographics of the local judiciary and any substantive decisions relating to the coverage dispute when selecting a venue.

needs as is declaratory relief”); *see also* *Mascarin Prof 1 Pharmacy v. Hart*, 91 Cal. Rptr. 560 (Cal. Ct. App. 1970); *Miller v. Siden*, 242 N.W. 823 (Mich. 1932); *State ex rel. Miller v. McLeod*, 605 S.W.2d 160 (Mo. Ct. App. 1980); *King County v. Boeing Co.*, 570 P.2d 713 (Wash. Ct. App. 1977); *Anderson v. Wy. Dev. Co.*, 154 P.2d 318 (Wyo. 1944).

¹⁵⁸ *Schaefer v. First Nat’l Bank of Findlay*, 18 N.E.2d 263, 267 (Ohio Ct. App. 1938).

While the best source of information on the local judiciary is normally local counsel because they can provide a frank and candid assessment of the local judiciary, and an overview of local custom and procedure, there are also publications which rate and review judges. For federal judges, the best source of information on federal judges is the Almanac of the Federal Judiciary and the Judicial Yellow Book, which provides a background summary on every federal judge and a brief review by local attorneys.¹⁵⁹ For state court judges, local legal publications often publish short biographies on the local judiciary, which can often be a valuable source of information. In addition, The American Bench also provides a brief background summary on state court judges.¹⁶⁰

In addition, an insurer should also research any local law addressing the disputed issues in the claim because recent coverage decisions can impact a fidelity carrier's choice of venue. If, for example, the local judiciary has recently published a string of decisions rejecting the insurer's position, the insurer might strongly consider selecting an alternative forum because, regardless of what law technically governs the dispute, a court may be more apt to apply its local law, as opposed to the law of another state, especially if the choice-of-law factors do not weigh strongly in favor of one state. Thereafter, after identifying the key issues in dispute, an insurer should research how the specific judges in the forum the insurer anticipates filing its suit have ruled on these issues to evaluate potential pitfalls before choosing a venue.

2. Choice of Law

Insurers should also consider choice of law issues. Although the bond will likely be governed by the law of the state with the most substantial contacts to the policy,¹⁶¹ it may be easier, from a psychological perspective, to convince a court to apply local law (with which it is likely more familiar), as opposed to the law of another state, especially if the choice of law factors do not strongly favor one forum over another. This is especially important if the law of one state favors an insurer's coverage position or there is a split of authority over the scope of coverage afforded under a fidelity bond.

Choice of law may also be an important consideration when faced with allegations of bad faith. Regardless of the thoroughness of an insurer's investigation or the correctness of its coverage decisions, many insured threaten bad faith suit as a means of negotiating a favorable settlement. Since the law of the state governing the underlying claim generally governs a bad faith claim, an insurer should carefully consider choice of

¹⁵⁹ JAMIE SUPEK, *JUDICIAL YELLOW BOOK*, (Leadership Directories, Inc. 2002); MEGAN CHASE, *ALMANAC OF THE FEDERAL JUDICIARY* (Aspen Law & Business 2002).

¹⁶⁰ DIANA R. IRVINE, *THE AMERICAN BENCH — JUDGES OF THE NATION* (Forster-Long, Inc. 2002).

¹⁶¹ For a detailed discussion of choice of law rules and their application to fidelity claims, see Dennis J. Bartlett, *A Review of Choice of Law and Forum Selection Rules for the Fidelity and Surety Practitioner* (an unpublished paper presented at the annual meeting of the National Bond Claims Association, Pinehurst, North Carolina. October 2000).

law issues because some states are lenient (both in terms of the elements for recovery and cognizable damages) than other states with respect to bad faith actions.¹⁶²

3. Juror Demographics

One might assume that a court in a metropolitan area would draw its venire from the area immediately surrounding the court. While technically true, the potential juror pool for a given court may expand well beyond the area immediately surrounding the court. Under 28 U.S.C. § 1863, a federal district court may draw jurors from anywhere within the district, so a court might draw potential jurors from a variety of surrounding counties, resulting in a wide juror demographic. For example, although the United States District for the Northern District of Illinois is physically located in Chicago, it draws its jury pool from the seven surrounding counties, including rural counties bordering Wisconsin. It is, therefore, important to understand the juror demographics of a given court, especially if the dispute involves factual issues.

B. PLEADING CONSIDERATIONS

In deciding whether to pursue a claim for declaratory judgment, many fidelity practitioners focus on the forum and venue considerations and do not give ample consideration to pleading issues. Depending upon the nature of the claim and the disputed coverage issues, a fidelity carrier may be able to gain at least two tactical advantages depending upon the procedural posture of the claim.

If an insurer elects to pursue a pre-emptive action, it may be able to gain a significant advantage by framing the dispute in its pleadings. By drafting the complaint, the carrier can explain the nature of the claim, detail the factual circumstances underlying the claim, explain its coverage position, and introduce potentially relevant documents (e.g., the proof of loss, the bond, correspondence regarding denial of the claim). By doing so at the outset of the claim, the insurer can assure that the court fully understands both the nature of the dispute, the carrier's coverage position and the reasons for its position. The insured then bears the burden of contradicting the insurer's allegations and overcoming the court's initial impressions of the claim.

Conversely, a fidelity carrier may also be able to seize a significant pleading advantage by allowing the insured to sue it for coverage because doing so allows the insurer to immediately attack the claim by a motion to dismiss. Although many fidelity claims are not amenable to disposition through a motion to dismiss (especially if they involve disputed factual issues), courts have, in recent years, become more receptive to resolving purely legal issues through a motion to dismiss. For example, courts in recent years have granted motions to dismiss third-party loss claims because, regardless of the

¹⁶² See, e.g., *Levanios v. State Farm Mut. Auto. Ins. Co.*, 1995 WL 612885 (E.D. Pa. 1995); *Silvest v. Monumental Gen. Ins. Co.*, No. 92-3336, 1993 WL 262012, at *4-5 (7th Cir. July 9, 1993), *aff'd*, 998 F.2d 1016 (7th Cir. 1993).

factual circumstances underlying the claim, third party losses are not covered under fidelity bonds.¹⁶³

The one potential downside to this tactic is that an insured, expecting a motion to dismiss, may try to prevent summary disposition by pleading conclusory allegations, thereby potentially eliminating any factual basis for a motion to dismiss and if nothing else, forcing a court to grant a dispositive motion on a bare factual record, which many courts are reluctant to do. Although a common tactic, fidelity insurers can avoid this pitfall by considering this issue when investigating the claim, and draft its communications with the insured with an eye toward relying upon them in support of its motion to dismiss, because although a court may not normally consider materials outside the record on a motion to dismiss, there are two exceptions.

First, a court can take judicial notice of public records, including pleadings from other related actions, in ruling on a motion to dismiss. If the insured has filed another related action, the court may take judicial notice of the pleadings from that action and may consider those pleadings in ruling on the insurer's motion to dismiss.¹⁶⁴ Therefore, for example, if an insured admits in a complaint against the principal that the principal was not an employee of the insured, an insurer may rely upon the complaint to support a motion to dismiss.

Second, although a plaintiff is under no obligation to attach to its complaint documents upon which the action is based, a defendant may introduce certain relevant documents if the plaintiff fails to do so.¹⁶⁵ Documents referenced in the complaint, but not attached thereto, are considered part of the pleadings if they are referred to in the complaint and are central to the claim, meaning that if an insured references the insurer's denial of coverage in its complaint (which it must almost always do to establish a case in controversy), an insurer may be able to rely upon its denial letter and documents attached thereto to support its motion to dismiss.¹⁶⁶ Therefore, if an insurer uncovers documents refuting the insured's claim during discovery, it should consider attaching them to its denial letter because it may be able to rely upon those documents to support a motion to dismiss.

¹⁶³ Williams Elec. Games v. Barry, No. 97 C 2743, 2000 WL 106672, at *1 (N.D. Ill. Jan. 13, 2000).

¹⁶⁴ See, e.g., Henson v. CSC Credit Serv., 29 F.3d 280, 284 (7th Cir. 1994); Pension Benefit Guar. Corp. v. White Consolidated Indus., 998 F.2d 1192, 1196-97 (3rd Cir. 1993); Westpoint-Pepperell, Inc., 945 F.2d 40, 44 (2d Cir. 1991) ("In determining the adequacy of a claim under Rule 12(b)(6), consideration is limited to the facts stated on the face of the complaint ... and to matters of which judicial notice may be taken"); United States v. Wood, 925 F.2d 1580, 1582 (7th Cir. 1991); MGIC Indem. Corp. v. Weisman, 803 F.2d 500, 504 (9th Cir. 1986) ("On a motion to dismiss, we may take judicial notice of matters of public record outside the pleadings").

¹⁶⁵ Romani v. Shearson Lehman Hutton, 929 F.2d 875, 879 n.3 (1st Cir. 1991) (quoting CHARLES A. WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1327 at 762-63 (2d ed. 1990)).

¹⁶⁶ Venture Assoc. v. Zenith Data Sys., 987 F.2d 429, 431 (7th Cir. 1993); Ed Miniati, Inc. v. Globe Life Ins. Group, Inc., 805 F.2d 732, 739 n. 12 (7th Cir. 1986); Field v. Trump, 850 F.2d 938, 949 (2d Cir. 1988); Fudge v. Penthouse Inter., Ltd., 840 F.2d 1012, 1015 (1st Cir. 1988).

IV. Conclusion

A fidelity insurer faced with the prospect of litigation should carefully consider how to best position the dispute to maximize its chances for a successful result, whether through litigation or settlement. This delicate issue requires an insurer to consider more than simply whether one forum is more favorable than another forum. This consideration might be important, but an insurer must also consider other intangible factors (including venue and pleading considerations), because they weigh heavily upon this issue and may have a substantial impact on an insurer's ability to successfully resolve a claim.