



1994

Recent Developments: Nautilus Insurance Co. v. Winchester Homes, Inc.: Pendency of a Related Action in State Court Is an Insufficient Reason Alone to Decline Consideration of a Federal Declaratory Judgment Action

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Recommended Citation

Ivory Orem, Vicky L. (1994) "Recent Developments: Nautilus Insurance Co. v. Winchester Homes, Inc.: Pendency of a Related Action in State Court Is an Insufficient Reason Alone to Decline Consideration of a Federal Declaratory Judgment Action," *University of Baltimore Law Forum*: Vol. 24 : No. 3 , Article 17.

Available at: <http://scholarworks.law.ubalt.edu/lf/vol24/iss3/17>

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***Nautilus Insurance Co.
v. Winchester Homes,
Inc.:***

***PENDENCY OF A
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CONSIDERATION OF
A FEDERAL
DECLARATORY
JUDGMENT ACTION.***

In *Nautilus Insurance Co. v. Winchester Homes, Inc.*, 15 F.3d 371 (4th Cir. 1994), the United States Court of Appeals for the Fourth Circuit resolved the question of when a federal district court may decline to entertain a declaratory judgment action properly within its jurisdiction. The court held that a federal district court should normally entertain a declaratory judgment action unless traditional concerns of federalism, efficiency, and comity outweigh the utility of declaratory relief. Thus, the court held that deference to the pendency of a related action in state court is an insufficient reason by itself to justify declining to entertain a federal declaratory action.

Nautilus Insurance Company undertook to indemnify and defend Reliance Wood Preserving, Inc. ("Reliance"), a Maryland corporation, against claims arising from the production and manufacture of its fire retardant plywood. Winchester Homes, Inc. ("Winchester"), a Delaware corporation, filed two claims in separate state courts against Reliance, and thirteen other entities, for damages suffered by the use of their products in constructing residential buildings. Winchester claimed Reliance's plywood deteriorated shortly after installation.

Four months after Winchester filed its state claims, Nautilus filed a declaratory judgment action in the United States District Court for the District of Maryland asserting that it had no duty to defend or indemnify Reliance. Nautilus claimed that Reliance misrepresented and omitted material facts when applying for the insurance policy. Nautilus also argued that the policy did not cover the product liability claims. Reliance, Win-

chester, and two liability insurers for Reliance, Pennsylvania Lumbermen's Mutual Insurance Company ("PLMIC") and Great American Insurance Company ("GAIC"), were named as defendants in the declaratory judgment action commenced in the United States District Court for the District of Maryland. Reliance counterclaimed seeking *inter alia* a declaration that Nautilus was required to defend and indemnify it under the terms of the insurance policy.

Reliance later filed for bankruptcy protection. During the bankruptcy proceedings, Reliance assigned its interest in the Nautilus insurance policy to Winchester, thereby preserving Winchester's interest in obtaining judgment in the pending tort actions. One week prior to trial, GAIC moved to dismiss the federal declaratory action due to the pendency of the state tort actions. Over Nautilus' and Winchester's objections, the federal district court dismissed the action. Winchester appealed, alleging that the district court erred in declining to entertain the declaratory judgment action. Contending that Winchester did not have standing to bring the appeal because it was not sufficiently aggrieved, GAIC, joined by PLMIC and Nautilus, moved to dismiss the appeal.

On review, the court of appeals first determined that Winchester, as Reliance's assignee in the Nautilus insurance policy, was sufficiently aggrieved to appeal the judgment of the district court. Next, the court examined the statutory language of the Federal Declaratory Judgment Act ("FDJA") and related case law, and concluded that the district court erred in declining to entertain the declaratory judgment action.

The FDJA gives a federal district court power to review a declaratory action in any “case of actual controversy within its jurisdiction” and to “declare the rights and other legal relations of any interested party seeking such declaration, *whether or not further relief is or could be sought.*” *Nautilus Insurance Co.*, 15 F.3d at 375 (quoting 28 U.S.C. § 2201) (emphasis added).

Further, the court found that a federal district court must not decline review of a declaratory judgment action out of “whim or personal disinclination,” but must have “good reason.” *Nautilus Insurance Co.*, 15 F.3d at 375 (citations omitted). The court must consider whether the declaratory action will serve a useful purpose in clarifying and settling the legal relations at issue, and terminate and afford relief from the uncertainty, insecurity, and controversy giving rise to the proceeding. *Nautilus Insurance Co.*, 15 F.3d at 375 (quoting *Aetna Cas. & Sur. Co. v. Quarles*, 92 F.2d 321, 324-25 (4th Cir. 1937)).

The court also remarked that federal declaratory actions are often used to resolve disputes over liability insurance coverage even when judgment is pending on the underlying obligation in state court. *Nautilus Insurance Co.*, 15 F.3d at 375-76. Moreover, the court determined that indemnity disputes are suitable for declaratory resolution because early determination of the rights and obligations of the parties identifies the bearer of liability on the underlying claim. *Id.* at 376.

The district court relied on the recent decision in *Mitcheson v. Harris*, 955 F.2d 235 (4th Cir. 1992) as authority for dismissing the declaratory action. However,

in *Nautilus Ins. Co.*, the court held that *Mitcheson* did not announce a *per se* rule forbidding a federal court from entertaining a declaratory action in an indemnity dispute during the pendency of related litigation in state court. *Nautilus Insurance Co.*, 15 F.3d at 376. Rather, *Mitcheson* held that when a party seeks a declaratory judgment action under these circumstances, the court must balance concerns of federalism, efficiency, and comity, with the usefulness of entertaining the declaratory action. *Id.* The *Mitcheson* court also suggested consideration of the following factors when addressing these concerns: 1) the strength of the state’s interest in having the issues decided in state court; 2) whether the issues underlying the federal action can be more efficiently resolved in the pending state action; and 3) whether proceeding with the federal action would result in unnecessary “entanglement” due to “overlapping issues of fact or law.” *Id.* at 376-77 (citing *Mitcheson* 955 F.2d at 237-40). The court in *Nautilus Insurance Co.* added an additional factor: 4) whether the declaratory judgment action is being used as a device for “procedural fencing.” *Nautilus Insurance Co.*, 15 F.3d at 377. The court defined “procedural fencing” as a maneuver by a party in a race for *res judicata* or an attempt to achieve a federal hearing in a case otherwise not removable to federal court. *Id.*

The *Mitcheson* court held that entertaining the declaratory action would not serve judicial efficiency or comity. *Id.* at 377. That court also held that the state’s interest in having the issues decided in state court outweighed the federal court’s exercise of jurisdiction over the declaratory action. *Id.* at 377. In

reaching its decision, *Mitcheson* considered that the pending litigation in state court was governed by unsettled state law and the parties and issues were the same as in the declaratory action. *Id.*

In the present case, the court of appeals found no compelling state interest in having the declaratory action decided in state court. The court reasoned that although all the issues raised in the federal action were governed by state law, the state issues were not close, difficult, or problematic. *Id.* at 378. The state questions involved routine application of settled principles of law to particular disputed facts. *Id.* Therefore, the exercise of federal jurisdiction would not interfere with the state’s interest in having those issues decided in state court.

Guided by the Supreme Court decision in *Brillhart v. Excess Ins. Co.*, 316 U.S. 491 (1942), the court of appeals concluded that the federal district court could have resolved the controversy more efficiently than the state court. *Id.* *Brillhart* espoused that a court must consider whether the questions in controversy between the parties to a federal suit can be better settled in the proceedings pending in state court. *Id.* at 378-79 (citing *Brillhart*, 316 U.S. at 495). To answer these questions, a court must carefully review the scope of the pending state court litigation. This includes a determination as to whether all the claims can be satisfactorily adjudicated in the federal proceeding and if all parties have been joined and are amenable to the federal proceedings. *Id.* In *Nautilus Insurance Co.*, the court found that judicial efficiency would not be served by dismissing the federal declaratory action because the indemnity dis-

pute raised in the federal action was not raised in either of the two pending state actions and not all the parties in the indemnity dispute were joined as parties in the pending state actions. *Nautilus Insurance Co.*, 15 F.3d at 379.

Another factor in the court's analysis was whether the state court remedy could provide a "more effective or efficient" means of resolving the case. *Id.* When the motion to dismiss was made, the trial was less than a week away and substantial issues had already been resolved by the district court. Consequently, the court stated that pursuing a remedy in state court would not be the most "effective or efficient" means of resolving the case. Further, dismissing the case would create delay and unnecessary cost by requiring the parties to start over in a different court. *Id.*

Finally, the court noted that

allowing the action to proceed in federal court would not involve unnecessary entanglement between the federal and state court systems because the issues involved separate and independent legal controversies. *Id.* The court further pointed out that the declaratory action was not being used as a device for procedural fencing because the parties were not seeking to invoke *res judicata* or attempting to obtain a federal hearing in a non-removable case. The parties merely sought relief to clarify the obligations under the indemnity insurance policy. *Id.* at 380. Thus, the court held that the concerns of federalism, efficiency, and comity, did not sufficiently outweigh the utility of awarding the declaratory judgment. Accordingly, the Fourth Circuit reversed the federal district court's dismissal of the declaratory judgment action. *Id.*

The court of appeals' decision clarifies the circumstances under which a federal court may decline to entertain a declaratory action properly within its jurisdiction. Courts must balance the utility of entertaining the action with concerns of federalism, efficiency, and comity. Where there is a pending state action and a subsequent request for federal declaratory judgment, the court must carefully review both the pending state and federal issues to adequately weigh these concerns. If, after review, the court finds that those considerations do not outweigh the utility of awarding the declaratory judgment, the court must then entertain the action. Consequently, the mere existence of related pending state litigation is insufficient by itself to justify a refusal to entertain a federal declaratory action.

- Vicky L. Ivory Orem

