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D& O Insurance

Court's Decision in Stanford Proceedings Signals Importance of D& O Policy Wording

The Fifth Circuit's recent ruling in *Pendergest-Holt v. Certain Underwriters at Lloyd's of London* underscores the importance of the wording of the prerequisite provisions in the conduct exclusions in directors and officers insurance policies, corporate insurance attorneys told BNA in recent interviews.

An insurer's duty to advance the ongoing defense costs of corporate directors and officers accused of participating in financier Allen Stanford's alleged Ponzi scheme must be determined in a civil suit parallel to the criminal trial, the U.S. Court of Appeals for the Fifth Circuit held March 16 (*Pendergest-Holt v. Certain Underwriters at Lloyd's of London*, 5th Cir., No. 10-20069, 3/15/10, revised 3/16/10).

The case highlights the challenges companies and their insurers face in advancing defense costs under D& O policies that they may have difficulty recouping later if defendants are found guilty. In a March 24 e-mail to BNA, Robert D. Chesler, chair of the insurance practice group at the Roseland, N.J., office of Lowenstein Sandler LLP, said that the decision in *Pendergest-Holt* is a "major victory for policyholders."

The ruling "clarifies the importance of the distinction between 'in fact' wording and 'after adjudication' wording," Kevin M. LaCroix, a partner at OakBridge Insurance Services in Beachwood, Ohio, said in a March 24 e-mail to BNA. "Many D& O policy exclusions that preclude coverage based on conduct or events specify that the exclusion does not apply unless certain prerequisites are met," he said.

Case Began With SEC Civil Action

In February 2009, the Securities and Exchange Commission commenced a civil action alleging that Stanford and four other executives of his companies sold billions of dollars worth of sham certificates of deposit to investors, the proceeds of which were not invested as represented, but were instead used to pay CD interest and redemption payments to existing investors, as well as commissions, bonuses, and loans to Stanford financial advisers—a "classic Ponzi scheme," the court said.

In June 2009, the government brought a parallel criminal case against the same executives, alleging various fraud counts, obstruction of an SEC investigation, and money laundering. One executive pleaded guilty and stated under oath in open court that he and the others had engaged in various acts in furtherance of a Ponzi scheme.

The other defendants, however, pleaded not guilty; jury selection in their criminal trial is scheduled for January 2011. The SEC's civil suit has been stayed pending resolution of the criminal trial.

Exclusion in D& O Policy Lacked Clarity

Lloyd's issued a \$100 million D& O policy to certain Stanford companies, covering losses for any claims during the policy period for wrongful acts. "Loss" includes "necessary legal fees and expenses incurred in defending any judicial or administrative proceeding against a director or officer," the court said. The policy does not impose a duty to defend, but requires the executives to defend themselves, and Lloyd's to pay their defense costs upon prior notice every 60 days.

An exclusion in the directors' and officers' insurance policy covering the defendants provides that insurer Lloyd's of London is not liable for any loss, including defense costs, "arising ... in connection with" acts or alleged acts of money laundering, but requires Lloyd's to pay the insureds' costs "in the event of an alleged act ... until such time that it is determined that the alleged act ... did in fact occur." Judge Patrick E. Higginbotham read the exclusion's phrases "it is determined" and "in fact" to signal a judicial determination of coverage in a proceeding separate from the criminal trial, as opposed to the insurer's unilateral determination or a judicial determination at the close of the criminal trial as urged by the respective parties.

On Nov. 16, 2009, Lloyd's advised the executives that it would cease D& O policy coverage for all of them as of the date of the one executive's guilty plea because it had determined, based on his plea and the preliminary injunction in the SEC action, among other things, that money laundering had occurred. The policy broadly defines "money laundering" to include use or possession of property that the insured reasonably should have known was a benefit obtained in connection with criminal conduct.

The executives argued that the money laundering exclusion did not allow cutoff of defense costs until a judicial determination of coverage. The district judge assigned to try the criminal case granted them a preliminary injunction, requiring continued payment of defense costs pending further order.

Texas Court Adopts Insured's Perspective

The Fifth Circuit affirmed in part. It said that under governing Texas law, when an insurance policy exclusion is ambiguous, the court must adopt the construction urged by the insured if it is reasonable, even if the insurer's construction appears to be more reasonable or to better reflect the parties' intent.

The executives, who previously had argued that the money laundering exclusion prevented any determination of its applicability until a final adjudication in the criminal proceeding, in oral argument "prudently" conceded that the determination could be made in a parallel proceeding prior to judgment in either the SEC suit or criminal trial, the court said. Lloyd's, for its part, retreated from its assertion of unilateral authority to determine coverage to concede that the determination is at least judicially reviewable, the court said.

The court agreed with the statement in *Associated Elec. & Gas Ins. Servs. v. Rigas*, 382 F.Supp.2d 685 (E.D. Pa. 2004), that if an insurer "wants the unilateral right to refuse a payment called for in its policy, the policy should clearly state that right." The insurer should say so explicitly, "rather than leaving the reader to ponder the word 'it,'" the court here said, referring to the exclusion's provision that defense costs payments may cease when "it is determined that the alleged act ... did in fact occur." It concluded that requiring a judicial determination was the most reasonable construction, despite Lloyd's urging that "it is determined" be contrasted with the phrase "final adjudication" used in the policy's fraud exclusion, which it said clearly contemplated a judicial determination.

Timing, Scope of Determination Are Key Issues

The next issue was when the judicial determination should occur. "When a D& O policy requires a 'final adjudication' to trigger an exclusion, 'courts have consistently held that the adjudication must occur in the underlying D& O proceeding,' rather than in a parallel coverage action or other lawsuit," the court said. In contrast, cases construing policies with the "in fact" language present in the exclusion here have construed it to allow adjudication "in either the underlying case or a separate coverage case, or an admission by the insured," the court said. It found that the "weight of the case law" favored determination in a parallel proceeding, and that, as a reasonable construction favoring coverage, it controlled.

The executives argued that in making the "in fact" determination, the court should be governed by Texas's "eight corners" rules, which requires courts to gauge an insurer's duty to defend by examining only the

policy's provisions and the underlying complaint's factual allegations, without reference to those allegations' truth or falsity. The district court agreed. But the appeals court said that the "eight corners" rule has only been applied in the duty-to-defend context, not in cases like this one involving a duty to advance defense costs. The money laundering exclusion's "in fact" element requires "recourse to something more than allegations," and thus contemplates use of extrinsic evidence in making the coverage determination, the court said.

The preliminary injunction should remain in force until a district court judge other than the one presiding in the criminal trial makes the coverage determination "as expeditiously as is feasible under the circumstances," the court ruled. That determination may be reconsidered "should the executives be exonerated in either the criminal or SEC proceeding," it added.

Judges Edith Brown Clement and Leslie Southwick joined the opinion.

Rex S. Heinke, Akin Gump Strauss Hauer & Feld, Los Angeles, argued for Lloyd's. Lee H. Shidlofsky, Visser Shidlofsky, Austin, Texas, argued for the executives.

Decision Depended on Specific Wording

According to LaCroix, "the ruling in *Pendergest-Holt* is case specific in many ways, because it turns on the wording of an exclusion that is not found in many policies, and that also was awkwardly worded."

"The exclusion essentially does not apply until 'it is determined'—wording that manages to omit who is actually to do the determining," LaCroix said.

The wording used in D& O policies can specify whether or not the insurer can obtain a determination that would eliminate the coverage in a collateral proceeding of whether the determination must be made in the proceeding underlying the claim, LaCroix said. "In this case, the Fifth Circuit held that the insurers can obtain a determination in a collateral proceeding," he said.

The holding in *Pendergest-Holt* provides insureds with "much greater certainty that they will receive the defense costs from their D& O insurance carriers to which they are entitled, pending actual proof found by a court of law that the insured acted in a knowingly wrongful manner," Chesler said.

"In this case, the insurer argued that sufficient facts had been adduced in the underlying trial to establish wrongdoing in fact to the insurer's satisfaction," Chesler said. The court disagreed and found that in the policy, "in fact" meant that a finding by a court of actual wrongdoing by the insured was necessary before an insurer could stop paying defense costs, he said. "The insurer could not decide on its own when it had acquired sufficient facts," he said.

On the one hand, insurers do not want to pay defense costs for obviously guilty individuals, Chesler said. "On the other hand, insureds want to make certain that if they are sued, the insurance company will be there for them, regardless of the allegations in the underlying complaint. In order to make their D& O policies attractive to purchasers, insurers have met their customers more than half way on this issue," he said.

According to Chesler, one formulation by the insurance industry is to pay for the insured's defense until there is a finding "in fact" of wrongdoing. "While policyholders assumed that this language meant a finding by a court of facts that constitute wrongdoing, insurers have argued for a far less stringent standard," he said.

Insureds Should Carefully Inspect Policies

In order to ensure that the carrier cannot pursue a collateral proceeding to determine that coverage does

not apply, “insureds would be well advised to make sure that the conduct exclusion in their policy not only required an adjudication, but also specify that the adjudication must take place in the underlying proceeding,” LaCroix said.

D& O policyholders should strongly consider working with experienced brokers when dealing with D& O policies, Scott N. Godes, of counsel in the insurance coverage practice group at Dickstein Shapiro LLP in Washington, told BNA in a March 24 interview. “Policyholders should also consider seeking attorneys who work exclusively with insureds and policyholders, and not insurance companies,” he said.

“Attorneys who represent insurance policyholders and insureds in coverage actions can better explain and advise—both immediately at the time of claim and at the time a company is purchasing or renewing policies—how courts have interpreted various clauses and what the implications are,” Godes said.

Insureds should also keep in mind that when they want to make a claim under an insurance policy, any “high-dollar” potential loss, claim, or actual claim will likely cause the insurance company to seek opinions from sophisticated coverage counsel that represent insurance companies, Godes said. “These insurance attorneys will advise in terms of what provisions and exclusions may apply,” he said.

Thus, “insureds and policyholders are well advised to take the same approach as these insurance companies and have counsel involved early so that they can better protect their own rights,” Godes said.

By Tom Edmondson and Tina Chi

A full text of this case is available at <http://op.bna.com/car.nsf/r?Open=tchi-83tq6x>.