OUTSIDE PERSPECTIVES

D&O Insurance: Don't Let The Insurance Companies Stop Payment of Your Defense Costs

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Advancement of defense costs, on a monthly or quarterly basis, is one of the most important rights of any policyholder in a Directors and Officers insurance policy. Recently, however, insurance companies have been attempting to block such payments based solely upon their allegation that the policyholder made a misrepresentation in the policy application (that you as an outside director neither saw, reviewed or signed). Can the insurance companies negate such payments based upon mere allegations alone?

Insurance Companies Must Advance D&O Defense Costs Despite Pending Rescission Actions

All of the Courts that have specifically addressed the issue have held that an insurance company must continue to advance defense costs to its Director and Officer policyholders – and must continue to do so until a *final adjudication* is reached in the insurance company's action for rescission of the insurance policy. Several Appellate Courts have held that lower Court rulings to this effect were equivalent to "injunctions," which would last until there was a final determination of the rescission action. No United States Court has ever held that it was improper to require an insurance company to advance defense costs to its D&O policyholders, despite a pending rescission action.

Florida Courts Lead The Charge To Protect D&O Policyholders

Several Florida cases have addressed the issue of advancing D&O defense costs during the pendency of a rescission action. In *National Union Fire Ins. Co. of Pittsburgh, PA. v. Brown*, 787 F. Supp. 1424, 1427 (S.D. Fla. 1991), an insurance company that sold a D&O policy attempted to rescind the policy based upon alleged fraud in the insurance application. The policyholders filed a counterclaim seeking a declaration that the insurance company was required to advance defense costs as they were being incurred in underlying civil and criminal suits against the policyholders. *Id.* The Court clearly stated that during the pendency of the rescission action, the "D&O Policy remains in effect." *Id.* at 1428. The *Brown* Court then held that the insurance company was required to advance its policyholders' defense costs as they were incurred, rather than waiting for the adjudication or settlement of the underlying actions, and despite the pending rescission claim. *Id.* at 1430.

In *National Union Fire Ins. Co. of Pittsburgh, PA. v. Sahlen*, 999 F.2d 1532, 1535 (11th Cir. 1993), the Eleventh Circuit held that an order issued by the District Court, which held that the insurance company was required to pay its D&O policyholders' defense costs in the underlying suits until its claim for rescission was resolved, constituted an injunction. Although the insurance company ultimately was held entitled to rescission of the policy in *Sahlen*, the effect of this finding was merely to dissolve the injunction. *Id.* Thus, the Eleventh Circuit did not dispute the propriety of the District Court's "injunction," which mandated that the insurance company advance defense costs during the pendency of the rescission action.

In *Pacific Ins. Co. v. General Development Corp.*,1992 U.S. Dist. LEXIS 22057 (S.D. Fla. 1992) ("GDC"), the Court decided the precise issue relevant here: whether the insurance company was required to advance its D&O policyholders' defense costs despite a pending rescission action. Specifically, the insurance company claimed that the policy should be rescinded and held void *ab initio* due to alleged false statements made by the policyholders on the policy application. *Id.* at *4. The Court held that "[the insurance company] cannot avoid the fact that the policy is effective unless and until a final adjudication of

rescission is reached," and that the insurance company was thus bound by its contractual obligation to advance its policyholders' defense costs under the terms of the D&O policy at issue. *Id.* at *6-7.

The *GDC* case was appealed by the insurance company to the Eleventh Circuit. *Pacific Ins. Co. v. General Development Corp.*, 28 F.3d 1093 (11th Cir. 1994). As in *Sahlen*, the Eleventh Circuit found the District Court's ruling in *GDC* to be an injunction, which was ultimately dissolved when the policyholder was convicted on criminal counts of fraud and conspiracy. *Id.* at 1096. However, the Eleventh Circuit again found no fault with the District Court's decision to enjoin the insurance company and mandate the advancement of defense costs. *Id.* In fact, the policyholder's criminal convictions were insufficient to guarantee a right to reimbursement of the defense costs the insurance company already had advanced, as the Eleventh Circuit found that the ability to obtain restitution ultimately was dependent upon the resolution of the rescission action. Id. at 1097. Accordingly, though the appeal was rendered moot, the Eleventh Circuit's decision only confirms the propriety of requiring an insurance company to advance defense costs while its action for rescission is pending.

New York Law Follows Florida's Protection Of D&O Policyholders' Rights

New York has followed Florida on the issue of advancing defense costs during the pendency of a rescission action. In *Wedtech Corp. v. Federal Ins. Co.*, 740 F. Supp. 214 (S.D.N.Y. 1990), the plaintiff sought a declaratory judgment that its D&O policies were not void *ab initio* due to possible material misrepresentations made by some directors and officers. The Court held that where the insurance company sought rescission, it was still required to advance defense costs so long as the mere possibility of coverage remained. *Id.* Accordingly, until the pending rescission actions were fully adjudicated, the Court's holding required that the insurance company advance defense costs to its D&O policyholders. *Id.*

The reasoning behind these decisions is simple and logical: if an insurance company were permitted to deny its obligation to advance defense costs based upon mere allegations alone (as compared to the final adjudication of an action for rescission of the policy), the requirement to advance defense costs would be rendered in substantial part illusory. Therefore, the Courts that have addressed this issue are in agreement that, until there is a final adjudication of the underlying litigation or the rescission claim, insurance companies must advance defense costs to their policyholders.

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