

Insurers Must Advance Defense Costs under Unilaterally Rescinded D&O Policy

April 2004

The United States District Court for the Eastern District of Pennsylvania, applying Pennsylvania law, has held that insurers are required to advance defense costs to directors and officers insured under a D&O policy issued to Adelphia Communications Corporation, which the insurers unilaterally rescinded, pending judicial determination of rescission and other coverage issues in an action stayed by a bankruptcy court. *Assoc. Elec. & Gas Ins. Servs., Ltd. v. Rigas*, 2004 WL 540451 (E.D. Pa. Mar. 17, 2004).

The insurers issued D&O policies to Adelphia. The primary policy provided that the insurer would "pay on behalf of the directors and officers any and all sums which they become legally obligated to pay as Ultimate Net Loss for which the Company has provided reimbursement by reason of any Wrongful Act." The policy defined Ultimate Net Loss as "the total Indemnity and Defense Cost with respect to each Wrongful Act to which the policy applies, provided that Ultimate Net Loss does not include any amount allocated pursuant to Condition (T), to Claims against persons other than directors and officers or to non-covered matters." Condition T provided for an allocation to the extent that a claim involved "both covered and non-covered matters." Additionally, the policy contained two relevant exclusions. The "Fraud Exclusion" barred coverage for a claim against a director or officer arising from the "dishonest, fraudulent, criminal or malicious act or omission of such Director or Officer if a final adjudication establishes that acts of active and deliberate dishonesty were committed or attempted with actual dishonest purpose and intent and were material to the cause of action so adjudicated." The "Prior Knowledge Exclusion" barred coverage for any claim "where at the inception of the Policy Period the Director and Officer had knowledge of a fact or circumstance which was likely to give rise to such Claim and which such Director and Officer failed to disclose or misrepresented in the application...."

Adelphia disclosed that its past financial statements contained false and misleading information. The company filed for bankruptcy in June 2002. Numerous suits were brought against the directors and officers of the company, who then sought the advancement of defense costs by the insurers. The insurers refused to advance defense costs, rescinded the D&O policies and advised the defendants that absent rescission there was no coverage under the D&O policies for the suits filed based on several exclusions in the policies. The insurers then filed a declaratory judgment action in the district court seeking a judicial determination concerning rescission and coverage. Thereafter, the bankruptcy court stayed the coverage litigation "in so far as it relates to the Carriers' request for rescission, any factual findings, and all deposition discovery." However,

the bankruptcy court lifted the automatic stay to permit the directors and officers to seek access to up to \$300,000 per insured for defense costs from the insurers.

The district court held that the insurers were required to advance defense costs. First, the court determined that the insurers could not refuse to advance defense costs based on their unilateral rescission of the policies. The court explained that it could not engage in fact finding to determine whether rescission was proper because of the stay issued by the bankruptcy court. The court further noted that "the black letter law of Pennsylvania supports the view that rescission is available to a defrauded party without a judicial determination if the party repudiates the contract and provides restitution," which, for an insurance contract, requires return of the premium. In this case, however, the court noted that the carriers had not returned the premiums and could no longer do so because of the bankruptcy stay. The court concluded that, under Pennsylvania law, a contract remains in full force and effect pending rescission and therefore the insurers would have to advance defense costs pending the outcome of the insurers' rescission claim.

The court then addressed whether the policy provided for the advancement of defense costs. The court found that based on the "legally obligated to pay" language in the insuring clause of the policy, the insurers' duty to pay defense costs arose contemporaneously with the director's and officer's obligation to pay those costs. The court rejected the insurers' contention that the allocation clause of Condition T of the policy rendered the advancement of defense costs discretionary on the part of the insurers. The court noted that Condition T allowed for allocation only if a "claim...includes both covered and non-covered matters" and that, in the present case, the insurers had taken the position that all of the insureds' claims were not covered. Next, the court determined that the "Fraud Exclusion" was inapplicable because there had been no judicial determination that the directors and officers engaged in active fraud or deliberate dishonesty. However, the court noted that in the event that there was such a later judicial determination, the insureds would be required to reimburse the insurers for the defense costs advanced.

Finally, the court addressed the applicability of the "Prior Acts Exclusion." The court found that unlike the "Fraud Exclusion," the "Prior Acts Exclusion" did not on its face require a final adjudication to take effect. However, the court also noted that the exclusion did not state how a determination regarding whether the insured had knowledge of claims prior to the policy period should be made. The court found that the exclusion could "reasonably be read" to permit the insurer to determine whether the exclusion applies or to require a judicial determination that the exclusion applies. The court also indicated that it could not itself make findings of fact as to whether the "Prior Acts Exclusion" applied because of the bankruptcy stay. Accordingly, the court held that the exclusion was ambiguous and construed it in favor of the insureds. Moreover, the court again noted that the insurers would be entitled to reimbursement of defense costs if they ultimately prevailed on this defense.

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