

Insurer Seeking Declaration of No Coverage Must Advance Defense Expenses

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The United States District Court for the Southern District of New York has held that an insurer that denied coverage must continue to advance defense costs to its insureds facing civil and criminal actions until the insurer obtains a declaration of no coverage. The court held that a decision to stop advancement would cause the insureds to suffer “extreme or very serious damage” and that the balance of hardships tipped “lopsidedly” in favor of the insureds. *XL Spec.Ins. Co. v. Level Global Investors, L.P.*, 2012 WL 2138044 (S.D.N.Y. June 13, 2012).

In 2010, as part of a broad criminal investigation into insider trading, the FBI executed a search warrant on the insured hedge fund's offices, and the United States Attorney's Office issued subpoenas to the fund. The SEC also subpoenaed records from the fund as part of a parallel investigation. The hedge fund and certain individuals sought coverage for the investigations under an investment fund management and professional liability policy, and the insurer began advancing defense expenses. In January 2012, a co-founder of the fund was indicted on charges of securities fraud and conspiracy to commit securities fraud. The following day, the fund and the co-founder were named as defendants in an action brought by the SEC. In addition, in January 2012, it was publicly revealed that a former research analyst at the hedge fund had pleaded guilty to securities fraud and conspiracy to commit securities fraud, admitting to obtaining inside information and providing that information to others at the hedge fund.

In March 2012, the insurer informed its insureds that it was denying coverage for the underlying matters based on the analyst's guilty plea and a prior knowledge exclusion in the application. The application asked: “is any person(s) or entity(ies) proposed for this insurance aware of any fact, circumstance or situation which might afford valid grounds for any claim such as would fall within the scope of the proposed insurance?” The insured had marked “no.” The application then stated that “without prejudice to any other rights and remedies of the Insurer, any Claim arising from any claims, facts, circumstances or situations required to be disclosed . . . is excluded from the proposed insurance.” The insurer also stated that it would no longer advance defense expenses. The insurer filed a declaratory judgment action seeking a declaration of no coverage and recoupment of amounts already advanced as defense costs. The insureds filed a motion for a preliminary injunction requiring the insurer to continue to advance defense expenses.

The court granted the insureds' motion, finding that the insureds would suffer serious harm in the absence of advancement. First, the court noted that the insureds faced criminal investigations and/or charges, presenting a risk "not only of monetary liability, but of prosecution and a loss of liberty." Second, the court opined that the alleged securities violations would be expensive to defend and that the "potential damage from interrupting and destabilizing ongoing defense efforts is multiplied" in light of joint defense arrangements among co-defendants. Third, the court asserted that the insurer's decision potentially jeopardized the insureds' ability to access excess layers of insurance to the extent the excess insurers took the position that coverage under their policies were not triggered until the primary policy was exhausted. The court held the balance of hardships therefore tipped in favor of the insureds on the grounds that the primary insurer faced "at most the loss of an additional \$2.7 million."

Turning to the likelihood of the insureds' success on the merits, the court held that the insureds raised "sufficiently serious claims going to the merits" of the insurer's prior knowledge exclusion defense. The insureds cited an application provision stating that "the undersigned authorized agent of the person(s) and entity(ies) proposed for this insurance declares that to the best of their knowledge and belief after reasonable inquiry, the statements herein are true and complete." Based on this provision, the insureds argued that the application, including the prior knowledge question, only required disclosure of facts known to the application signer (the fund's general counsel and COO) upon "reasonable inquiry," and the application signer could not have uncovered the analyst's insider trading upon reasonable inquiry. The court held that the insureds had raised a "sufficiently serious claim" that the application was ambiguous as to whether the prior knowledge exclusion applied based on the analyst's guilty plea.

The insureds also contended that, even if the application required disclosure of the analyst's knowledge, a severability provision in the policy would apply. The severability provision stated, in relevant part: "in the event that any of the particulars or statements in all material respects in the Application are untrue, this Policy will be void with respect to any Insured who had actual knowledge of the untruth." The court rejected this argument. It held that the prior knowledge exclusion does not depend on imputation of knowledge among the insureds. The court also held that the severability provision, which stated the policy would be "void," applied only to rescission, not to a coverage denial.

The court also rejected the insureds' argument that an insurer that has denied coverage nevertheless has a general duty at law to advance defense costs until a court has determined that there is no coverage. The court stated that accepting the insureds' argument would "invite abuse" and "would permit an insured to gain advancement . . . even where the insured's claim to coverage was sketchy or even risible." The court reasoned that insureds had sufficient protection because they could seek relief through a preliminary injunction, as the insureds in this case had done.