

D&O Insurer Must Advance Defense Costs if There Is Reasonable Potential for Coverage

November 2004

The U.S. District Court for the District of Massachusetts, applying Kentucky law, has held that a D&O insurer must advance defense costs to two directors of an insured company who were named as defendants in a lawsuit because there was a reasonable potential for coverage for the suit. *Brown v. Amer. Int'l Group, Inc.*, 2004 WL 2358290 (D. Mass. October 19, 2004).

The D&O policy at issue stated that "[t]he Insurer does not assume any duty to defend. The Insureds shall defend and contest any Claim made against them. Notwithstanding the foregoing, the Insureds shall have the right to tender the defense of the Claim to the Insurer...When the insurer has not assumed the defense of a Claim pursuant to [this provision] the Insurer shall advance nevertheless, at the written request of the Insured, Defense Costs prior to the final disposition of a Claim." However, "[o]nly those settlements, stipulated judgments and Defense Costs which have been consented to by the Insurer shall be recoverable as Loss under the terms of the policy."

The policy further provided that "in all events the Insurer may withhold consent to any settlement, stipulated judgment or Defense Costs, or any portion thereof, to the extent such Loss is not covered under the terms of this policy." The policy also contained a prior acts exclusion, providing that the Insurer is not liable to make any payment for "Loss arising from any Claim(s) alleging Wrongful Act(s) which occurred prior to the inception date of the Policy Period or after the end of the Policy Period...Loss(es) arising out of the same or Related Wrongful Act(s) shall be deemed to arise from the first such same or Related Wrongful Acts."

After the company filed for bankruptcy, the company's trustee in bankruptcy filed an adversary complaint against the company's former officers and directors, alleging that they drove the company into bankruptcy by misdirecting client funds, distributing improper bonuses and orchestrating a fraudulent spin-off transaction. Two of the company's directors provided the company's D&O insurer with timely notice of the trustee's complaint. The directors sought coverage under the policy, including the assumption of their defense. The insurer declined to assume the director's defense based on the prior acts exclusion, explaining that the alleged wrongful acts either occurred prior to the inception of the policy, or were the "same as," "related to" or "continuous with" such prior acts.

The court held that the insurer was required to advance defense costs to the directors subject to its right to repayment in the event that the trustee's claims were later found not to be covered losses under the policy. The court first addressed the policy's defense provisions, concluding that the insurer was required to advance defense costs to the directors only if the trustee's claim suggested a "reasonable potential for coverage." In reaching this decision, the court rejected the director's contention that the insurer had an absolute duty to provide defense costs, finding that such an interpretation would render the policy's consent provisions a nullity. The court explained that although the insurer would eventually be repaid for defense advances if the claim was not covered, the value of such payments would be diminished based on the time value of money. The court also reasoned that if the insurer were simply required to advance all costs subject only to the right of ultimate repayment, the insurer would be unable to incrementally address the reasonableness of such costs. "It would thus be denied a primary benefit of advancing rather than reimbursing defense costs."

After addressing the standard for advancing defense costs, the court determined that at least some of the wrongful acts alleged by the trustee created the "reasonable potential for coverage." In reaching this decision, the court explained that the burden was on the insurer to show that each of the wrongful acts alleged by the trustee was "the same, related or continuous" with a prior wrongful act. The court found that these terms should be narrowly construed in the context of a policy exclusion, and that at least some of the wrongful acts—those related to the orchestrated spin-off transaction—were unrelated to acts occurring prior to the inception of the policy.

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