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NEWSLETTER

Excess Insurer Must Advance Defense Costs under Unilaterally Rescinded D&O Policy

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The United States District Court for the Southern District of New York, applying New York law, has granted a former WorldCom, Inc., director's motion for a preliminary injunction requiring an excess insurer to advance defense costs under an excess D&O policy issued to WorldCom, which the insurer unilaterally rescinded, pending judicial review of the excess insurer's rescission of its policy. *In re WorldCom, Inc., Sec. Litig.*, 2005 WL 254684 (S.D.N.Y. Feb. 3, 2005).

The insurer participated in WorldCom, Inc.'s D&O insurance program as an excess carrier. The primary policy, to which the excess carrier's policies followed form, included a notice that "the insurer must advance defense costs payments pursuant to the terms herein prior to the final disposition of a claim." The primary policy further stated that "[t]he Insurer shall, in accordance with and subject to Clause 8, advance Defense Costs of such Claim prior to its final disposition." Clause 8 of the primary policy obligated the insurer to "advance, at the written request of the Insured, Defense Costs prior to the final disposition of a Claim" but provided that "[s]uch advanced payments by the Insurer shall be repaid to the Insurer by the Insureds or the Company severally according to their respective interests, in the event and to the extent that the Insureds or the Company shall not be entitled under the terms and conditions of this policy to payment of such Loss."

Following WorldCom's disclosure that its past financial statements contained false and misleading information necessitating restatement, the company filed for bankruptcy in July 2002. In a settlement with the primary carrier that was approved by the bankruptcy court, WorldCom agreed that its policy was rescinded and void *ab initio* as to the company. The settlement expressly stated that the primary policy was not rescinded with respect to WorldCom's directors and officers; however, numerous suits were brought against the directors and officers of the company following its disclosure and subsequent collapse. The directors and officers sought the advancement of their defense costs under the D&O policies, and the primary insurer agreed to defend the directors. Upon exhaustion of the limits of the primary policy, the excess insurer unilaterally rescinded its policy and refused to advance defense costs. Thereafter, the excess insurer filed a declaratory judgment action seeking a judicial determination that its policy was rescinded.

The court determined that the insurer's declaratory judgment action, along with a parallel action filed by another excess carrier, could not be maintained because the insurer failed to seek relief from the automatic stay from the bankruptcy court prior to filing the rescission action. WorldCom then filed an adversary

proceeding in the bankruptcy court seeking a declaration of rights on behalf of itself and its officers. WorldCom emerged from bankruptcy before the conclusion of the adversary proceeding, however, and the bankruptcy court declined to rule in the matter based on the *de minimis* effect the case would have on the estate.

The instant action was subsequently filed by one of the former WorldCom directors seeking a declaration of rights, duties and responsibilities of the insurer and WorldCom's other excess insurers. The director also sought injunctive relief compelling the advancement of defense costs in the interim.

The district court held that the insurer was required to advance defense costs while the rescission action was pending. The court determined that the insurer could not refuse to advance defense costs based on its unilateral rescission of the policies because "[t]he [primary] policy imposes the obligation upon [the primary insurer], and through its follow form policy upon [the excess insurer], to pay [the director] the costs of his defense as those costs are incurred." Relying on *Federal Insurance Co. v. Tyco,* 2004 WL 583829 (N.Y. Sup. Ct. Mar. 5, 2004), *Wedtech Corp. v. Federal Insurance Co.,* 740 F. Supp. 214 (S.D.N.Y. 1990) and *Associated Electric & Gas Insurance Service Ltd. v. Rigas,* 2004 WL 540451 (E.D. Pa. Mar. 17, 2004), the court held that "[u]ntil the issue of rescission is adjudicated, a contract of insurance remains in effect and the duty to pay defense costs is enforceable." In so holding, the court distinguished the precedents relied upon by the excess insurer on the basis of the specific policy language at issue in those cases.

The court also rejected the excess insurer's argument that the director had failed to show a sufficient likelihood of success on the merits (i.e., of defeating the excess insurer's rescission claim). The court reasoned that the director needed only to show that "under the terms of the policies, he is entitled to payment of defense costs as they are incurred, and that as a matter of law, that obligation exists until the rescission issues have been litigated and resolved." The court found that the director had met his burden. Moreover, the court observed that its repeated offers to "resolve the rescission issue on an expedited basis" in the current action were ignored by the insurers.