

Insurer Must Advance Defense Costs Despite Fraud Exclusion

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The United States District Court for the Eastern District of Virginia has granted a preliminary injunction in favor of insureds under a D&O policy, obligating the insurer to continue to pay defense costs in numerous underlying actions notwithstanding the officers' and directors' pleading guilty to fraud in a related criminal action and the fraud exclusion in the applicable policy. *Great Am. Ins. Co. v. Gross*, 2005 WL 1048752 (E.D. Va., May 3, 2005).

The policy at issue obligated the insurer to "advance Costs of Defense for any payments made on behalf of the Directors and Officers . . . prior to the final disposition of any Claim . . . on the condition that the Directors and Officers . . . provide a written undertaking satisfactory to the Insurer providing that in the event it is finally established that the Insurer has no liability under [the] Policy to Directors and Officers . . . for such Claim, such Directors and Officers . . . agree to repay the Insurer upon demand all Costs of Defense advanced on their behalf by virtue of this provision." The policy also contains a fraud exclusion, which stated that "[the insurer] shall not be liable to make any payment for Loss in connection with any Claim made against the Directors or Officers . . . brought about or contributed to by the fraudulent, dishonest, or criminal acts of the Directors or Officers or Company; provided, however that this exclusion shall not apply unless a judgment or final adjudication established in fact that such conduct did occur."

The directors and officers of the company were named as defendants in 13 separate lawsuits pending in a multi-district litigation action in the United States District Court for the Western District of Tennessee and in two Alabama state courts. The individuals tendered these actions to the insurer and the insurer advanced approximately \$2.87 million in defense costs pursuant to the policy. The insurer subsequently filed the instant action to rescind and/or determine its obligations under the policy. In February 2005, two of the directors and officers pled guilty to conspiracy to commit insurance fraud and mail fraud in a proceeding in the United States District Court for the Eastern District of Virginia. The insurer subsequently stopped advancing defense costs to the two directors and officers who pled guilty to criminal acts. The two directors and officers then filed the instant motion for a preliminary injunction, seeking to force the insurer to continue advancing their defense costs.

The court first considered whether a preliminary injunction was the appropriate form of relief in this case and rejected the insurer's argument that an injunction was improper because the defendants' claims were based on alleged breach of contract, which can be quantified and remedied by monetary awards. The court stated that in this case "there is more at stake than the award of monetary damages due to breach of contract" because the moving defendants "face the potential of irreparable harm due to the massive and complex civil lawsuits pending against them and the risk of losing the benefit of long-standing counsel in those cases." The court also declined to apply the stricter mandatory injunction standard that is applicable when a party seeks an injunction that modifies the status quo. Here, the court held that it was the insurer that changed the status quo by ending its advancement of defense costs and that the moving defendants were not seeking a complete adjudication of their rights under the policy at the injunction stage. The court also held, relying on *In re Worldcom, Inc.*, 354 F.Supp.2d 455, 463 (S.D.N.Y.2005), that the plain language of the policy obligated the insurer to advance defense costs and ordering a party to perform its contractual obligations is not a modification of the status quo.

The court then proceeded to analyze the applicable preliminary injunction factors. The court found that the moving defendants had satisfied their burden of establishing the likelihood of irreparable harm if the motion were denied because moving defendants would be unable to pay for their defense absent advancement from the insurer and thus "denial of a preliminary injunction would essentially cripple Moving Defendants' defense and leave them with no ability to defend their interests in the [underlying] litigation." Notwithstanding its finding that the insureds would be unable to pay the costs of their own defense, the court downplayed the likelihood of irreparable harm to the insurer from an injunction, reasoning that "[the insurer] cannot be irreparably harmed by doing that which it agreed to do under the plain language of the Policy or by doing what it was contractually obligated to do." The court also noted that if the insurer were successful in its coverage/rescission action it would be able to seek reimbursement of the funds it advanced to cover the defense of the underlying actions from those same insureds.

With respect to the moving defendants' likelihood of success on the merits, the court noted that a moving party is not required to make a strong showing that it is likely to succeed on the merits where the balance of harms tips in its favor. Here, the court held that the moving defendants "have demonstrated that the balance of the hardships tilts decidedly in their favor because they face serious, imminent, and irreparable harm as a result of Plaintiff withholding the costs of defense." Moreover, the court noted that it had not decided the full effect of the guilty pleas and thus it was unclear whether the insurer would prevail on its fraud exclusion defense. The court also held that "[p]ublic policy is served by requiring Plaintiff to continue forwarding the costs of defense to Moving Defendants because it is in the public interest to see parties abide by their contractual obligations."

Finally, the court waived the requirement under *Fed. R. Civ. P.* 65 that the insureds post a bond prior to issuance of the preliminary injunction because the insureds filed affidavits indicating "that they lack the financial resources to pay for the costs of their defense in the [underlying] litigation." Based on these affidavits, the court concluded "it is clear that Moving Defendants lack the financial resources and assets to post a bond in a meaningful amount," and that "a bond of zero dollars is appropriate in this case."

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