

D&O Insurance: Don't Let Insurance Companies Stop Payment of Defense Costs

By R. Mark Keenan and Cort Malone

Advancement of defense costs, on a monthly or quarterly basis, is one of the most important rights provided to any policyholder in a Directors and Officers insurance policy.

Recently, insurance companies have been attempting, however, to block such payments based solely upon the assertion that the policyholder made a misrepresentation in the policy application (which you as an outside director did not see, review or sign). Can D&O insurance companies negate such payments based upon mere assertions alone?

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Insurance Companies Must Advance D&O Defense Costs Despite Pending Rescission Actions

All of the courts that have specifically addressed the issue have held that an insurance company must first advance defense costs to its Director and Officer policyholders - and must continue to do so until a final adjudication of rescission is reached. Several appellate courts have even held that court rulings requiring “pay first” are the equivalent of “injunctions,” which would last until there was a final determination of the rescission action.

Florida Courts Lead The Charge to Protect D&O Policyholders

In *National Union Fire Ins. Co. of Pittsburgh, PA. v. Brown*, 787 F. Supp. 1424, 1427 (S.D. Fla. 1991), an insurance company that sold a D&O policy attempted to rescind the policy based upon alleged fraud in the insurance application. The policyholders filed a counterclaim seeking a declaration that the insurance company was required to advance defense costs as they were being incurred in underlying civil and criminal suits against the policyholders. *Id.* The Court held that during the pendency of the rescission action, the “D&O Policy remains in effect.” *Id.* at 1428.

In *National Union Fire Ins. Co. of Pittsburgh, PA. v. Sahlen*, 999 F.2d 1532, 1535 (11th Cir. 1993), the Eleventh Circuit held that an order issued by the District Court, which held that the insurance company was required to pay its D&O policyholders’ defense costs in the underlying suits until its claim for rescission was resolved, constituted an injunction.

In *Pacific Ins. Co. v. General Development Corp.*, 1992 U.S. Dist. LEXIS 22057 (S.D. Fla. 1992) (“GDC”), the insurance company asserted that the D&O

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policy should be rescinded and held void ab initio due to alleged false statements made by the policyholders on the policy application. *Id.* at *4. The Court held that “[the insurance company] cannot avoid the fact that the policy is effective unless and until a final adjudication of rescission is reached,” and that the insurance company was thus bound by its contractual obligation to advance its policyholders’ defense costs under the terms of the D&O policy at issue. *Id.* at *6-7.

The *GDC* case was appealed by the insurance company to the Eleventh Circuit. *Pacific Ins. Co. v. General Development Corp.*, 28 F.3d 1093 (11th Cir. 1994). As in *Sahlen*, the Eleventh Circuit found the District Court’s ruling in *GDC* to be an injunction.

New York Law Follows Florida’s Protection of D&O Policyholders’ Rights

New York has followed Florida on this issue in *Wedtech Corp. v. Federal Ins. Co.*, 740 F. Supp. 214 (S.D.N.Y. 1990), where the plaintiff sought a declaratory judgment that its D&O policies were not void ab initio due to possible material misrepresentations made by some directors and officers. The Court held that where the insurance company sought rescission, it was still required to advance defense costs so long as the mere possibility of coverage remained. *Id.* Accordingly, until the pending rescission actions were fully adjudicated, the Court’s holding required that the insurance company advance defense costs to its D&O policyholders. *Id.*

The reasoning behind these decisions is simple and logical: if an insurance company were permitted to deny its obligation to advance defense costs based upon mere assertions of misrepresentations alone (as compared to final adjudication) the requirement to advance defense costs would be rendered in substantial part illusory. Until there is a final adjudication of the underlying litigation or the rescission claim, insurance companies must advance defense costs. ■

For more information on these or other executive insurance matters, please contact one of the lawyers listed, each of whom practice in the area.

The information appearing in this newsletter does not constitute legal advice or opinion. Such advice and opinion are provided by the Firm only upon engagement with respect to specific factual situations.

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