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Recent Decisions Explore Limitations on D&O Coverage and Coverage Defense

By Randall W. Bodner and Peter L. Welsh

Several recent bankruptcy and district court decisions, many of which stem from recent high-profile corporate meltdowns, help to inform the matter of whether and when D&O coverage will be available, particularly following a corporate bankruptcy filing or a significant restatement by an issuer. In particular, several recent decisions concerning the Adelphia D&O program, as well as the Tyco, HealthSouth and Cutter & Buck D&O programs, provide important guidance on significant threats to coverage and, therewith, strengthen the ability of directors and officers to protect themselves effectively from a rescission claim by their D&O carrier or from the risk that amounts payable under their D&O policy will be frozen in bankruptcy. Directors and officers need to be aware of the issues raised by these decisions and need to consider available measures for responding to coverage risks, although a certain measure of coverage risk unfortunately is simply unavoidable in the current legal environment.

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Policies, Proceeds and Estate Property in Bankruptcy

Recent decisions from the United States Bankruptcy Court for the Southern District of New York in the *Adelphia* bankruptcy case have raised important questions concerning the availability of D&O insurance coverage in bankruptcy and, moreover, about the ability of directors and officers to protect themselves against the risk that their policy will be deemed an asset of their corporation's bankruptcy estate and thereby restricted by the automatic stay. Three recent decisions in the Adelphia Communications bankruptcy case—two of which the authors discussed in prior issues of this publication—have raised several important questions concerning the circumstances under which a D&O policy will respond in bankruptcy:

- ***Adelphia III*** (Bankr. S.D.N.Y. December 5, 2003)—In November of 2002, in the first of three decisions from the Adelphia bankruptcy case, the bankruptcy court held that the Adelphia D&O policy and amounts payable to the insureds under the D&O policy were assets of the Adelphia bankruptcy estate. *Adelphia Communications, Inc.* v. *Associated Electric & Gas Ins. Services (In re Adelphia Communications Corp.)*, 285 B.R. 580, 590 (Bankr. S.D.N.Y. 2002) ("*Adelphia I*"). In so holding, the court noted that, unlike in the case of the Enron D&O insurance program, in which the same bankruptcy court had allowed the directors and officers unfettered access to amounts payable under the policies, the Adelphia D&O policy did not have a "priority of payments" endorsement entitling the individual directors and officers to a priority interest, ahead of the debtor corporation, to amounts payable under the policy. *Id*. at 597, n.25. On August 25, 2003, in the second decision from the Adelphia bankruptcy, the United States District Court for the Southern District of New York reversed the Adelphia bankruptcy court in a relatively terse decision that held simply that, "[n]o cognizable equitable and legal interest [in the policy proceeds] has arisen here." *Adelphia Communications, Inc.* v. *Associated Electric & Gas Ins. Services (In re Adelphia Communications Corp.)*, 2003 WL 11005944, *1-2 (S.D.N.Y.). On December 5, 2003, on remand from the district court, the bankruptcy court employed a slightly different procedural approach to reach essentially the same result as in *Adelphia I* and froze the proceeds of the Adelphia D&O policy, limiting the amounts available to the Adelphia directors to an agreed-upon $300,000 per director. *Adelphia Communications, Inc.* v. *Associated Electric & Gas Ins. Services (In re Adelphia Communications Corp.)*, 302 B.R. 439, 452-53 (Bankr. S.D.N.Y. 2003) ("*Adelphia III*"). The court held, in particular, that regardless of whether the *proceeds* were estate assets, the *policies* unquestionably were, and any substantial payments of proceeds under the D&O policy could threaten the *policies* themselves. *Id*. at 445. On this basis, the bankruptcy court in *Adelphia I* had previously barred any payments of proceeds under the D&O policies in excess of $300,000, or roughly 5% of the policy limits. *Adelphia I*, 285 B.R. at 590. The *Adelphia III* decision reiterated the bankruptcy court's resolve to limit the amount of proceeds available under the policies in order to protect the *policies* themselves. *Adelphia III*, 302 B.R. at 452-53.

The decision in *Adelphia III* raises significant questions concerning the extent to which directors and officers can reliably prevent amounts payable from their D&O policy—including amounts payable to cover defense costs—from being frozen following a bankruptcy filing by their corporation. In particular, by blurring the critical distinction between a D&O policy and the proceeds of a D&O policy, the *Adelphia* decisions have made it potentially more difficult for directors and officers to take appropriate precautions to protect their coverage in the event of a bankruptcy filing by their corporation. S*ee, e.g., In re Louisiana World Exposition Inc.*, 832 F.2d 1391, 1399 (5th Cir. 1987) ("The question is not who owns the policies, but who owns the liability proceeds. Although the answer to the first question quite often supplies the answer to the second, this is not always so[.]"). Query, for example, whether a "priority of payments" endorsement is sufficient to address the concerns raised by the bankruptcy court in *Adelphia III*. *Compare Adelphia I*, 284 B.R. at 597, n.25 *with Adelphia III*, 302 B.R. at 453.

A recent decision from the Delaware bankruptcy court reached an outcome similar to that of several other courts concerning the circumstances under which D&O policy proceeds will be deemed to be assets of a corporation's bankruptcy estate.

- ***In re Allied Digital Technologies Corp.*** (Bankr. D. Del. March 16, 2004)—In *Allied Technologies*, the United States Bankruptcy Court for the District of Delaware considered the issue of whether and when the proceeds of a D&O insurance policy are property of the debtor's estate. *In re Allied Digital Technologies Corp*., 306 B.R. 505, 507 (Bankr. D. Del. March 16, 2004). The court held that the proceeds of a D&O policy providing coverage for claims against the corporate entity are property of the debtor's estate. *Id*. at 512. The court, however, granted relief from the stay because, as a practical matter, a claim could not be brought against the corporate entity. *Id*. at 514. The court also rejected the bankruptcy trustee's attempts to freeze the policy proceeds in order to preserve funding of an eventual judgment by the trustee: "The Trustee's real concern is that payment of defense costs may affect his rights as a plaintiff seeking to *recover from* the D&O Policy rather than as a potential defendant seeking to be *protected by* the D&O Policy. . . . No one has suggested that such a plaintiff would be entitled to an order limiting the covered defendants' rights to reimbursement of their defense costs." *Id*. at 513.

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Policy Rescission for Application Fraud

Recent decisions concerning the Adelphia, Tyco and Cutter & Buck D&O programs shed further light on the grounds on which a D&O insurer may and may not rescind coverage as a consequence of fraudulent statements made in the application process and in documents appended to the application, such as company financial statements. These decisions also shed light on whether a D&O insurer must advance defense costs pending a final adjudication of its purported grounds for rescission.

- ***Federal Ins. Co.* v. *Tyco Int'l Ltd.*** (N.Y. Supr. Ct. March 5, 2004)—Following disclosure in 2002 of the evident misappropriation of corporate assets and various disclosure violations by certain Tyco directors and officers, the directors and officers of Tyco were sued in numerous securities class actions and ERISA fiduciary actions. Federal thereafter unilaterally rescinded the Tyco policies. Federal asserted that it had issued coverage to the Tyco directors and officers "based on material misrepresentations and omissions in the information that

Federal relied upon in issuing and extending the Policy." *Federal Ins. Co.* v. *Tyco Int'l Ltd.*, No. 600507/03, slip op. at 1, 6 (N.Y. Supr. Ct. March 5, 2004). Federal purported to rescind coverage as to all insureds—outside as well as inside directors—regardless of their knowledge of or involvement in these misrepresentations. "D&O Insurance In 2003/2004," AIG White Paper, p. 25 (2004), available at http://home.aigonline.com/global/files/pdf/d&o_insurance_in_2003_2004_briefing_paper.pdf. Federal purported to take this step despite a clear severability provision in the Tyco policy. Specifically, the Policy provided that the "written application(s) for coverage shall be construed as a separate application for coverage by each Insured Person . . . [N]o statement in the application or knowledge possessed by any insured person shall be imputed to any other Insured Person for purpose of determining if coverage is available." *Id*. The outside directors and the company subsequently reached a settlement with Federal to avoid the risk of rescission of the Federal policy. *See* Mark Maremont and Christopher Oster, "Tyco Pays $92 million to Keep Insurance for Officers and Directors," *Wall Street Journal*, A3 (May 14, 2003).

Following the settlement by the Tyco outside directors and the company, former CEO Dennis Kozlowski, and other insiders litigated the propriety of Federal's purported rescission of their coverage. On March 5, 2004, a trial court in the State of New York issued an opinion rejecting Federal's claim that the Tyco policy had been rescinded as to Kozlowski and requiring Federal to fund Kozlowski's defense. The court held that "an unproven claim for rescission" does not alter the insurer's other obligations under a D&O policy. *Federal Ins. Co.*, No. 600507/03 at 7. Accordingly, under the *Tyco* precedent, an insurer may not rescind a D&O policy unless and until there has been a final adjudication showing a material misrepresentation in the policy application. *Id*. The Court also rebuffed Federal's efforts to invoke the policy's exclusions for fraud and self-dealing. Notably, the court, relying on several "duty to defend" cases, held that an insurer is obligated to fund an insured's defense where "any portion of a complaint might result in coverage." *Id*. 9-10.

- ***Associated Elec. & Gas Ins. Svcs. Ltd.* v. *Rigas*** (E.D. Pa. March 17, 2004)—John, Timothy and Michael Rigas, along with another officer of Adelphia, Peter Venetis, brought this action seeking a declaratory judgment that the Adelphia D&O insurers were legally obligated to advance defense costs to the Rigases and Venetis on a current basis, pending resolution of the insurers' claim of rescission against the Rigases and Venetis. *Associated Elec. & Gas Ins. Svcs. Ltd.* v. *Rigas*, 2004 WL 540451, *1 (E.D. Pa.) ("*AEGIS I*"). The United States Bankruptcy Court for the Southern District of New York's decisions in *AEGIS I*, *Adelphia I* and *Adelphia III* barred the district court from adjudicating the merits of the insurer's rescission claims, and the insureds sought advancement pending such an adjudication. *Id.* at *3; *see also AEGIS* v. *Rigas*, 2004 WL 838140, *1 (E.D. Pa.) ("*AEGIS II*"). The United States District Court for the Eastern District of Pennsylvania held that the Adelphia D&O insurers were indeed obligated to advance defense costs—subject to the bankruptcy court's limitation on the amount of proceeds available to each insured—pending the outcome of the insurers' rescission claim. *Id*. The district court held, among other things, that, because the insurers had not returned the insurance premiums to Adelphia and were barred by the automatic stay from doing so, the insurers could not unilaterally rescind coverage in the circumstances. *AEGIS I*, at *4; *AEGIS II*, at *2.

> [U]nder the *Tyco* precedent, an insurer may not rescind a D&O policy unless and until there has been a final adjudication showing a material misrepresentation in the policy application.

The district court further held that the insurer could not deny coverage based on the "fraud" exclusion because that exclusion requires a "final adjudication" before it is triggered. *AEGIS I*, at *12. The court further held that an exclusion of coverage for any claim arising out of facts and circumstances of which any insured had prior knowledge at the time of the application for coverage would not operate to bar coverage notwithstanding the fact that this exclusion did not require a "final adjudication" of the exclusion's applicability. *Id*. at *12. Importantly, the court noted that "[i]f a carrier wants the unilateral right to refuse a payment called for in the policy, the policy should clearly state that right." *Id*. at *14. This ruling calls into question for insurers the effectiveness of the prevalent "in fact" language contained in certain D&O exclusions.[‡]

[‡] Many policies provide that the "fraud" and "self-dealing" exclusions are triggered by conduct that "in fact" falls within the scope of the exclusions. With policies containing this "in fact" language, insurers may be tempted to construe such language to mean that the insurer has the right unilaterally to declare that the exclusion triggered. The court's holding in *Tyco*, it would seem, calls into question whether "in fact" language in an exclusion is sufficient to "clearly state" that the insurer is claiming the right to declare unilaterally that the exclusion has been triggered.

- ***Cutter & Buck, Inc.* v. *Genesis Ins. Co.*** (W.D. Wash. Feb. 11, 2004)—Following the announcement of a restatement of the financial results for Cutter & Buck and the filing of several securities actions against the company and its directors and officers, the Genesis Insurance Company declared that it was rescinding coverage as to all insureds, including outside as well as inside directors. In supporting its claim for rescission, Genesis asserted that it relied on material misrepresentations made in the renewal application submitted to Genesis for coverage of the Cutter & Buck directors and officers. *Cutter & Buck, Inc.* v. *Genesis Ins. Co.*, 2004 WL 405958, *1-5 (W.D. Wash.). The court held that there were material misrepresentations made in Cutter & Buck SEC filings, which were deemed part of the renewal application, and that, therefore, the insurers were permitted to rescind coverage. *Id.* at *12. The court held that Genesis could rescind as to all insureds. *Id.* at *21.

  The fact that Genesis was able to rescind coverage for alleged misstatements made in a renewal application is notable. Leaving aside the applicability of any policy exclusions, had the material facts and circumstances concerning the risk of a substantial claim been disclosed in the renewal application—as the insurers insisted should have been disclosed—presumably such disclosure would have triggered coverage under the policy in effect for the policy period prior to the renewal period. It is also remarkable that Genesis was able to rescind as to all insureds. The court found that the policy's severability provision did not protect the innocent directors and officers. *Id.* at *21. The Cutter & Buck severability provision, if it can be called that, stated that "in the event that the Application, including the materials submitted therewith, contains misrepresentations made with the actual intent to deceive . . . this policy in its entirety shall be void and of no effect whatsoever; and provided, however, that no knowledge possessed by any DIRECTOR or OFFICER shall be imputed to any other DIRECTOR or OFFICER except for material information known to the person or persons who signed the application." *Id.* at *20. Because the "severability" imputed the knowledge of the person signing the application to all other directors and officers, and because the court found that the person signing the Cutter & Buck application—C&B's CFO—was aware of the material misstatements in the Company's SEC filings, the court held that Genesis was entitled to rescind as to all insureds regardless of their knowledge of or involvement in the alleged financial misstatements. *Id.* at 21.

- ***In re HealthSouth Corp. Ins. Litig.*** (N.D. Ala. March 16, 2004)—In a lengthy decision relying in significant respect on Alabama state law, the United States District Court for the Northern District of Alabama held that various D&O insurers to the HealthSouth corporation and its directors and officers did not have the right to rescind the HealthSouth D&O policies in their entirety as to all insureds. *In re HealthSouth Corp. Ins. Litig.*, 308 F. Supp. 2d 1253, 1285 (N.D. Ala. 2004). Like the court in *Cutter & Buck*, the *HealthSouth* court, interpreting Alabama state law, held that the HealthSouth D&O insurers could potentially rescind the D&O policies based on misrepresentations made in the renewal application process. *Id.* at 1273-74. At the same time, however, the court found that many of the HealthSouth D&O policies included a full severability provision, which stated in part ". . . no statement in the [policy] application or knowledge possessed by any Insured Person shall be imputed to any other Insured Person for the purpose of determining if coverage is available." *Id.* at 1261. The court held that this severability provision protected innocent directors from the threat of coverage rescission. The Court rejected, among other arguments, the claim by certain D&O insurers that, because this provision is a part of the policy itself and because, according to the insurers, the law permits D&O insurers to rescind a policy in its entirety (including all provisions contained therein) for material misstatements made in an application for the policy, the severability provision was not effective to prevent rescission of the entire policy as to all insureds. *Id.* at 1279-80.❖

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