AVOIDING THE TWO-FRONT WAR:

Simultaneous Litigation Against Plaintiffs and Insurers

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A recent decision emanating from the infamous R. Allen Stanford "ponzi scheme" litigation underscores the need for precise language in a directors' and officers' liability insurance policy (a "D&O Policy") if it is to respond when directors and officers need it. You will want to work with your skilled D&O insurance broker to ensure that the "conduct" exclusions (*e.g.*, exclusions for fraud, theft, etc.) in your policy require a "final adjudication in the underlying case" before they are triggered. Without this specifically negotiated language, your insurer may have the ability to avoid paying legal fees by:

- Making a unilateral assessment that a violation of the conduct exclusion occurred; or
- Suing you in a separate, parallel coverage action.

In *Laura Pendergest-Holt v. Certain Underwriters at Lloyd's of London,* Allen Stanford and three other Stanford Financial Group executives filed a coverage suit against their directors' and officers' liability insurer (the "Insurer").[1] They sued because the Insurer had denied them coverage under their D&O Policy pursuant to the policy's "Money Laundering" exclusion. The exclusion defined the excluded conduct very broadly. Indeed, the definition in the policy was broader than the federal Money Laundering statutes and encompassed a variety of non-criminal financial transactions. The result was a diminution in the coverage the D&O Policy might have otherwise afforded.

In addition, the D&O Policy stated that the insurer would advance legal costs to defend a Money Laundering allegation "until such time that it is determined that the alleged [Money Laundering] did in fact occur." [emphasis added][2] The trigger language for the Money Laundering exclusion was different from the trigger language for the other conduct exclusions in the Stanford D&O Policy. The other conduct exclusions could only be triggered upon a "final adjudication" that the conduct in question had occurred.

1 *Pendergest-Holt v. Certain Underwriters at Lloyd's of London*, 2010 U.S. Dist. (S.D. Tex., Jan. 26, 2010)

2 *Pendergest-Holt v. Certain Underwriters at Lloyd's of London,* 2010 U.S. Dist. (S.D. Tex., Jan. 26, 2010) at 13.

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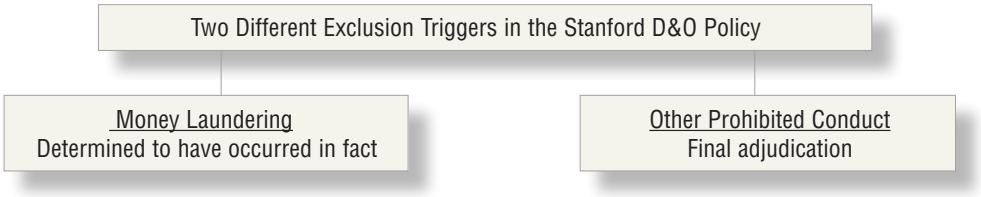

In the coverage litigation, the Insurer argued that the wording of the Money Laundering exclusion allowed it to determine unilaterally that the other directors and officers did "in fact" engage in Money Laundering.[3] The Insurer argued that Money Laundering had "in fact" occurred based in large part on the guilty plea of a former executive, in addition to other evidence in the SEC's case, and denied coverage.

The District Court rejected the Insurer's view of its unilateral ability to apply the exclusion and ordered it to pay the defense costs of the insureds. The Insurer appealed.

On appeal, the United States Court of Appeals for the Fifth Circuit, applying Texas state law, ruled that the Insurer had to continue to advance legal costs until there could be an adjudication on the question of whether Money Laundering had "in fact" occurred.[4] However, the Insurer was not required to wait until the question of whether the conduct in question had occurred until the underlying litigation was resolved. Instead, it could bring a separate coverage action against its insureds to decide the matter. The Court of Appeals came to this middle ground as a consequence of seeking to give meaning to the policy's use of "in fact" language in the policy's Money Laundering exclusion and the "final adjudication" language in the other conduct exclusions.

To understand fully what the Court of Appeals was doing, it is useful to understand the spectrum of language that can be used to trigger an exclusion in a D&O Policy. One end of the spectrum is the "final adjudication" language in the D&O Policy's conduct exclusions. The Court of Appeals interpreted this language to be insurance speak for "this exclusion will not be triggered unless a court of competent jurisdiction determines in an adjudication of the underlying litigation that the excluded conduct took place."

The other end of the spectrum is language that would allow an insurer to trigger the exclusion unilaterally. According to the Court of Appeals, the "determination in fact" language in the policy's Money Laundering exclusion did not allow the Insurer to trigger the exclusion unilaterally. On this point, the Court noted that if insurers want to be the ones who determine that an exclusion had been triggered, they are capable of stating this:

> Because "[i]t would be possible for carriers issuing D & O policies to explicitly reserve to themselves the unfettered discretion whether to advance defense costs," if an insurer "wants the unilateral right to refuse a payment called for in the policy, the policy should clearly state that right."[5]

The Court of Appeals found that the "determination in fact" exclusion trigger language occupies the middle ground between the two ends of the exclusion trigger language spectrum. Specifically, the Court of Appeals held that the "in fact" language requires a judicial determination in a parallel coverage action as opposed to a "final determination" in the underlying action. Thus, the Court of Appeals referred the coverage case back to the District Court to determine whether Money Laundering "in fact" occurred.

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3 *Id.* at 16.

4 *Pendergest-Holt v. Certain Underwriters at Lloyd's of London,* No. 10-20069, 2010 WL 909090, (5th Cir. March 15, 2010.)

5 *The Court of Appeals went on to note that a policy with such "draconian power might be difficult to sell."* (internal quotes omitted) *Pendergest-Holt v. Certain Underwriters at Lloyd's of London,* No. 10-20069, 2010 WL 909090, (5th Cir. March 15, 2010.) at page 13.

The Court of Appeals ruling is a positive one for the insureds in the Stanford case in so far as, at least for now, their Insurer will have to advance their legal fees. Unfortunately, by referring the case to the District Court, the Court of Appeals has placed the insureds in a position of having to defend themselves simultaneously in two actions — one by the plaintiffs, and a second by their insurance carriers.

> California insureds may have a procedural option available to them that can help them avoid the two-front war the Stanford executives find themselves in. California insureds frequently can secure the funding of a defense owed to them by filing a lawsuit against their insurer and then seeking a stay of the coverage action pending the outcome of the underlying liability action. While the stay is in effect, the insurer has an obligation to continue to fund a defense of the underlying liability action. *Montrose Chemical Corp. v. Superior Court* (1993) 6 Cal.4th 287.

Before the Claim Hits: Optimizing Your D&O Policy in Light of the Fifth Circuit's Recent Decision.

Insureds that have "determination in fact" exclusion trigger language should take note of the *Pendergest-Holt* case. While an insurance carrier may not seek to avoid covering its insureds by bringing a parallel coverage action in most cases, the "in fact determination" trigger gives the insurance carrier the ability to do so. If nothing else, the threat of a parallel action may pressure insureds to accept less money from their insurance policy than they may otherwise be entitled to receive. This would be an unfortunate outcome for an insured. The question of a parallel coverage action against an insured is not just a matter of time, money, and attention being diverted from the defense of the underlying litigation; the insurance litigation will inevitably implicate issues in the underlying litigation. A parallel coverage action could perhaps lead to a *Catch-22* situation in which insureds could find themselves having to choose whether to waive their fifth amendment right against self-incrimination to defend their right to policy benefits in the coverage action, or go bankrupt trying to defend themselves without the benefit of insurance proceeds.

What should you learn from the *Pendergest-Holt* decision in terms of avoiding a two-front war, or otherwise being disappointed by the coverage that is actually afforded by your insurance policy? First, minimize the number and effect of exclusions that appear in your policy. If you work with a skilled, experienced insurance broker, you can often have exclusions removed from policies altogether. For example, it would be unusual for a sophisticated, experienced insurance broker placing a policy today to allow a Money Laundering exclusion to appear in a client's D&O Policy. The state of today's insurance market is such that a good broker normally would be able to negotiate this exclusion out of the policy altogether.

But what if, even after vigorous negotiation by your skilled insurance broker, a particular exclusion is unavoidable? The next step is to ensure that the exclusion is drawn as narrowly as possible. The Stanford D&O Policy is instructive in the negative: rather than have the narrowest Money Laundering exclusion possible, it had one that was broader than the behavior that is actually prohibited by criminal law. As a result, it likely excludes more than what the policyholder otherwise would consider to be excluded.

After ensuring that a particular exclusion is drawn as narrowly as possible, consider next what will trigger the exclusion. The Stanford D&O Policy's inconsistent exclusion triggers turned out to be problematic. The clear teaching of the *Pendergest-Holt* decision is that insureds should avoid inconsistent triggers as well as "determination in fact" language. Instead, insureds should attempt to negotiate their policy so that exclusions relating to conduct can only be triggered by a "final adjudication" of the underlying case. For example:

> The Insurer shall not be liable to make any payment for "Loss" in connection with any "Claim" made against an Insured . . . arising out of, based upon or attributable to the committing any [excluded conduct such as fraud or Money Laundering] established by final adjudication.

Of course, the devil is in the details and each insurance policy is different. For this reason, the best way to avoid the "two-front war" is to work with your skilled insurance advisors to ensure that all the exclusions in your D&O Policy are negotiated properly.

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