Wiley Rein LLP

EXECUTIVE SUMMARY

Developments Affecting Professional Liability Insurers | August 2015

ALSO IN THIS ISSUE

2 Dishonesty Exclusion Bars Coverage for Claim Alleging Fraudulent Inducement to Extend Loan

2 Delaware Chancery Court Rejects Proposed Merger Settlement Emphasizing Need for Case-Specific Assessment of Settlement Consideration and Attorneys' Fees

3 Equitable Subrogation Allows Excess Insurer to Recover Settlement Contribution from Later Insurer After Proper Policy Period Is Determined

3 Financial Institution Bond Bars Coverage for Loss Not Resulting Solely from Duties of Outside Investment Advisor

4 Court Applies Subjective Standard to Prior Knowledge Exclusion

4 Bad Faith Action to Go To Jury

5 Summary Judgment Premature Where Insurer Reserved Rights Under Capacity and Equity Interests Exclusions

5 No Coverage for a Lawsuit Filed Two Years after the Expiration of a Claims-Made-and-Reported Policy

6 "Regardless of Any Apparent Intent," Excess Policy Does Not Follow Notice Condition of Primary Policy

6 Policy Provision Requiring Insurer's Consent to Incur Clean-Up Costs Not Void Against Public Policy

continued on page 2

Criminal Adjudication Final Upon Sentencing Under Fraud Exclusion Notwithstanding Appeal

A New York appellate court has affirmed a trial court's application of a fraud exclusion and order requiring the insured to reimburse defense costs where the insured had been convicted and sentenced for fraud, holding that the insured's pending appeal did not change the finality of the criminal judgment. *Dupree v. Scottsdale Ins. Co.*, 2015 NY Slip Op. 05405 (N.Y. App. Div. Jun. 23, 2015).

An insured chief investment officer (CIO) was indicted for conspiracy to commit bank fraud, bank fraud, and making false statements. In a subsequent coverage action, the trial court issued a preliminary injunction directing the insurer to pay for the CIO's criminal defense under the company's D&O policy. When the CIO was convicted and sentenced, the insurer sought to be relieved of any defense obligations on the basis that the policy contained a fraud exclusion that was triggered upon a "final judgment against its insured." The lower court agreed with the insurer and vacated the preliminary injunction notwithstanding an ongoing appeal of the criminal conviction.

continued on page 9

Material Misrepresentations in Application Preclude Coverage for More Than $2 Million Embezzlement

The United States Court of Appeals for the Eleventh Circuit, applying Alabama law, has held that a policy providing crime coverage does not afford coverage to an insured for its employee's embezzlement of more than $2 million because of material misrepresentations in the policy's application. *Scottsdale Indem. Co. v. Martinez, Inc.*, 2015 WL 38223728 (11th Cir. June 22, 2015).

The insured is a building-maintenance company. In 2004, the insured hired an individual, who later became the insured's CFO and CEO, to handle the company's financial accounting, including overseeing the insured's bank accounts. The individual was fired in 2011 after the owner of the insured company discovered that the CFO/CEO had embezzled more than $2 million from the company's bank accounts for personal use by writing checks to herself and using the company's petty cash for personal purchases.

continued on page 9

© 2015 Wiley Rein LLP | www.wileyrein.com

Dishonesty Exclusion Bars Coverage for Claim Alleging Fraudulent Inducement to Extend Loan

Applying New York law, the United States District Court for the Northern District of New York has held that a dishonesty exclusion bars coverage for a claim alleging that a law firm representing the sellers of an inn fraudulently induced the underlying claimants to extend a loan to the inn's purchaser. *Lewis & Stanzione v. St. Paul Fire & Marine Ins. Co.*, 2015 WL 3795780 (N.D.N.Y. Jun. 17, 2015).

The underlying claim included a single count against the law firm's named partner for fraud. Specifically, the underlying claimants alleged that the attorney was aware of representations made to the sellers of an inn regarding the inn purchaser's ability to make loan repayments. The claimants contended that the attorney was simultaneously aware that the purchaser was indigent, but nonetheless aided and abetted the sellers' fraud that induced the claimants' extension of a loan to the purchaser so as to profit from mortgage proceeds, resulting in the claimants' multimillion loss in foreclosing on the purchaser's defaulted loan. The law firm's E&O insurance policy barred coverage for claims "[a]rising out of any dishonest, fraudulent, criminal or malicious act, error, omission or 'personal injury' committed by, at the direction of, or with the knowledge of an insured[.]" After the insureds tendered the underlying claim for

continued on page 10

ALSO IN THIS ISSUE

7 Adversaries in Litigation Prohibited From Assigning Legal Malpractice Claim Arising From Same Litigation

7 Motion to Dismiss Record Insufficient to Make "Related Claims" Determination

8 Dishonesty Exclusion Bars Coverage for Attorney's Charging Exorbitant Fee

13 Speeches & Events

Delaware Chancery Court Rejects Proposed Merger Settlement Emphasizing Need for Case-Specific Assessment of Settlement Consideration and Attorneys' Fees

On July 8, 2015, Vice Chancellor Laster of the Delaware Chancery Court rejected an unopposed motion for a final settlement and attorneys' fees in a case challenging a merger transaction. *Acevedo v. Aeroflex Holding Corp.*, CA No. 7930-VCL (Del Ch. July 8, 2015).

The proposed settlement consisted of supplemental disclosures and two deal modifications, the reduction of a termination fee from $32 million to $18 million and the reduction of the matching rights period by one day. The seller, however, did not receive any final topping bid, and plaintiff's counsel conceded that they found no evidence of any conflict in connection with the transaction. The court acknowledged that this is the type of settlement that courts "have long approved on a relatively routine basis." However, Vice Chancellor Laster questioned the value of the settlement consideration and ultimately concluded that the relief obtained was insufficient to support the "intergalactic" or "broad class-wide release that extinguish[ed] all claims against" defendants that the parties had sought.

In rejecting the proposed settlement and plaintiff's fee award of $825,000, Vice Chancellor Laster provided important guidance on assessing the value of therapeutics-only settlements and the accompanying claims for a plaintiff's fee award. Vice Chancellor Laster emphasized the importance of context in valuing settlement consideration and fee awards. In the hearing, he focused extensively on the deal modifications, observing that this relief did not match the alleged problems with the merger and that plaintiff "fixed something that didn't need fixing . . . and [argued] that it's worthy of a release and fee." He noted that this relief might "be worth something to someone" but it had little to no value here. Thus, with respect to a proposed fee award, plaintiff could not simply rely on formulas or guidelines set forth in prior cases.

While plaintiff argued for a significant fee award for the deal modifications based on *In re Compellent Technologies, Inc. Shareholder Litig.*, 2011 WL 6382523 (Del. Ch. 2011), Vice

continued on page 8

Equitable Subrogation Allows Excess Insurer to Recover Settlement Contribution from Later Insurer After Proper Policy Period Is Determined

A California federal court permitted an excess D&O liability insurer to pursue equitable subrogation against a later excess carrier to recover its contribution to a settlement of securities litigation after a finding that the securities litigation was first made during the later carrier's policy period. *Genesis Ins. Co. v. Magma Design Automation, Inc.*, 2015 WL 4128986 (N.D. Cal. July 8, 2015).

The insured purchased claims-made D&O liability policies from the same primary insurer for the 2003-04 policy period and the 2004-06 policy period. The first excess carrier for each period was different. The insured provided a copy of a patent infringement lawsuit to the 2003-04 carriers as a notice of circumstances. During the 2004-06 policy period, the insureds' shareholders filed a securities class action against the company. The primary insurer determined that the earlier patent infringement lawsuit served as a notice of circumstances to which the securities litigation related, implicating coverage under the 2003-04 primary policy. The 2003-04 excess insurer disagreed with the primary insurer's treatment of the patent infringement lawsuit as a notice of circumstances and denied coverage under the 2003-04 excess policy. The 2004-06 excess insurer agreed that the securities litigation and later filed derivative actions were properly treated as claims first made during the 2003-04 policy period and also denied coverage. While coverage litigation was pending, the securities litigation settled. The primary insurer paid its $10 million limit toward settlement and the 2003-04 excess insurer paid $5 million of its limit toward the settlement, subject to its right to recoup.

Prior rulings in this long-running coverage litigation from the United States Court of Appeals for the Ninth Circuit established that the

continued on page 11

Financial Institution Bond Bars Coverage for Loss Not Resulting Solely from Duties of Outside Investment Advisor

The New York Supreme Court Appellate Division has held that a financial institution bond barred coverage for loss that did not result solely from the dishonest acts of an outside investment advisor. *Jacobson Family Inv., Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA*, 2015 WL 3767850 (N.Y. App. Div. June 18, 2015).

The insured asset manager sought coverage under a financial institution bond for losses sustained as a result of the dishonest acts of Bernard L. Madoff. The insured contended that the losses were covered under Rider 14 of the bond, which provided coverage for "loss resulting directly from the dishonest acts of any Outside Investment Advisor, named in the Schedule below, solely for their duties as an Outside Investment Advisor." Madoff was listed as an outside investment advisor, and the insured asset manager disclosed that Madoff managed over $120 million in assets for it.

The court held that the losses resulting from Madoff's dishonest acts were not covered for two reasons. First, the court held that Madoff's acts did not trigger coverage under Rider 14 because Madoff was not acting solely in his capacity as an outside investment advisor. When committing the dishonest acts, Madoff was acting as a securities broker and an outside investment advisor to the insured as evidenced by the insured's claim for compensation under the Securities Investor Protection Act for Madoff's theft of assets as a securities broker. Because the insured could not separate whether Madoff's activities as an outside investment advisor or his activities as a securities broker resulted in the insured's losses, it could not meet its burden to prove that the losses were covered under Rider 14. Second, the court held that an exclusion barred coverage for the losses. The exclusion precluded coverage for "loss resulting directly or indirectly from any dishonest or fraudulent act or acts committed by any non-Employee who is a securities . . . broker." The court held that Madoff was a non-employee and that he was a registered broker-dealer at all relevant times. ■

© 2015 Wiley Rein LLP | www.wileyrein.com

Court Applies Subjective Standard to Prior Knowledge Exclusion

In an unpublished decision applying Maryland law, a federal court has held that a subjective standard should be applied to determine whether a prior knowledge exclusion applies to preclude coverage for a matter. *McDowell Building, LLC v. Zurich American Ins. Co.*, 2015 WL 1656497 (D. Md. April 13, 2015). The court also held that while Section 19-110 of the Insurance Article of the Maryland Code does not apply to notices of circumstances, Section 19-110 does require insurers to establish prejudice to deny coverage under claims-made-and-reported policies on late notice grounds.

The insurer issued a professional liability insurance policy to the insured, which was hired by a real estate developer to complete applications for tax credits in connection with a building project. The insured later discovered that no application had been filed and the state historical trust advised that it was too late at that point to file the application for the tax credit. As a result, the real estate developer filed suit against the historical trust and its accounting firm. A cross claim was also filed by an individual against the insured in June 2006, but that claim was stayed pending the outcome of the case against the trust.

In May 2009, the accounting firm also filed a cross-claim against the insured and in June 2009, the insured notified the insurer of the matter. In September 2010, the accounting firm's claims were settled, pursuant to which the insured did not pay anything. The real estate developer's case against the trust also proceeded to trial in September 2010, and the court found that the developer failed to prove that it had filed its application for the tax credit. At that time, the

continued on page 10

Bad Faith Action to Go To Jury

A California federal court has denied cross-motions for summary judgment and held that issues of material fact remained as to whether an insurer should have settled a case for less than its policy limit and as to whether it filed an interpleader action in bad faith. *Doublevision Entm't, LLC v. Navigators Spec. Ins. Co.*, 2015 WL 3919587 (N.D. Cal. June 25, 2015).

An insured escrow agency was sued for breaching various duties to its client by allegedly mishandling escrow funds. The escrow agency tendered its defense to its E&O carrier, which accepted the defense. The claimant, a film producer, made an initial settlement offer of $245,000 pursuant to California Code of Civil Procedure Section 998, which imposes penalties on a party that refuses a written settlement offer and fails to ultimately achieve a better result than that offer. The insurer did not accept the offer.

Subsequently, the escrow agency went into receivership after it faced multiple other claims related to the mishandling of its escrow business. The insured's defense counsel believed that the other claims put the insured at an increased risk of an adverse verdict. The insured's defense counsel recommended that the insurer settle for $300,000, but there was no evidence that the insurer considered whether to make that settlement offer. Because the insurer faced multiple claims against the policy, the insurer then filed an interpleader action and deposited the balance of the policy limit, $466,358.48, with the court. The court overseeing the interpleader action reserved $49,000 for the film producer. The film producer then won a judgment against the escrow agency for $1.5 million. The escrow agency assigned its rights under the policy to the film producer, which brought an action for bad faith against the insurer.

In the ensuing bad faith action, the court denied in pertinent part cross-motions for summary judgment by the carrier and the film producer, holding that issues of material fact remained. The film producer argued that the filing of the interpleader action was in bad faith. The court held that "when an insurer institutes or prosecutes an interpleader in bad faith and as a way to relieve itself of the burden of conducting a defense, then the insurer may be liable for the tort of bad faith refusal to defend the insured."

continued on page 11

Summary Judgment Premature Where Insurer Reserved Rights Under Capacity and Equity Interests Exclusions

Applying New York law, a New York appeals court has affirmed denial of a policyholder's motion for summary judgment as premature, where questions of fact remain regarding the applicability of capacity and equity interests exclusions to claims against a policyholder attorney. *Law Offices of Zachary R. Greenhill P.C., v. Liberty Ins. Underwriters, Inc.*, 128 A.D.3d 556 (N.Y. App. Div. May 21, 2015). In so doing, the court determined that the insurer did not breach its duty to defend by defending subject to a reservation of rights.

The insurer issued a lawyers professional liability insurance policy to the insured law firm. The policy included an exclusion precluding coverage for "any claim arising out of [the policyholder's] services and/or capacity as . . . an officer, director, partner, trustee, manager operator, or employee of an organization other than that of the name insured . . . ." (Capacity Exclusion). The policy also provided that: (1) "[i]f a person insured under this policy owns, along with his or her spouse" a ten percent or greater equity interest in an organization and "simultaneously provides professional legal services with respect to such an organization," the policy "will provide no coverage to that person for any claims that result therefrom"; and (2) "[i]f the collective equity interest of" the insureds in an organization, including spouses of insured persons, is at least thirty-five percent, "and any person simultaneously provides professional legal services with respect to such an organization, this policy will provide no coverage to any person insured or to the named insured for any claims that result therefrom" (Equity Interests Exclusion).

continued on page 12

No Coverage for a Lawsuit Filed Two Years after the Expiration of a Claims-Made-and-Reported Policy

Applying California law, a federal district court has held that there is no coverage under a claims-made-and-reported policy for a legal malpractice suit that was filed two years after the expiration of the policy period and reported to the insurer two years later. *Petersen v. Arch Ins. Co.*, 2015 WL 3968590 (C.D. Cal. June 30, 2015).

In May 2009, a client retained the insured attorney to bring a civil rights lawsuit. The attorney missed several filing deadlines, which led to the dismissal of the suit. The dismissal was upheld on appeal in January 2012.

In May 2012, the client filed a malpractice suit against the attorney, and the court entered a default judgment in favor of the client in January 2014. During post-judgment proceedings, the client learned that the attorney had purchased a claims-made-and-reported professional liability policy for the period of May 20, 2009 to May 20, 2010. In November 2014, the client assigned the default judgment to a third party, who then sought coverage under the policy.

In granting the insurer's motion to dismiss, the court held that no malpractice claims were asserted against the attorney or reported to the insurer during the policy period, as required by the language of the policy. The court rejected all of the assignee's arguments to the contrary. First, the court held that this case did not present the sort of unique factual circumstances that warrant application of the "equitable excuse" rule. The court observed that, unlike a case where a claim is made against an insured mere days before the expiration of the policy, the malpractice suit here was filed two years after the policy expired and was not reported to the insurer until two years later—a delay of years, not hours. Second, the court held that the "idle act rule"—which excuses a party from performing a condition precedent to a contract when such performance would be futile or would cause further harm—did not apply. According to the court, although the client's appeal was not resolved until 2012, the attorney's malpractice "was complete and final" upon the missing of the deadlines, such that the client could have sent a demand letter in 2009, which would have constituted a "claim" under the policy. Finally, the court rejected the assignee's

continued on page 13

“Regardless of Any Apparent Intent,” Excess Policy Does Not Follow Notice Condition of Primary Policy

A Texas appellate court has held that an endorsement to a “follow form” excess liability policy caused the policy to follow only the definitions, exclusions, and limitations of the primary policy, but not its claim reporting requirement. *Illinois Union Ins. Co. v. Sabre Holdings Corp.*, 2015 WL 3917981 (Tex. Ct. App. June 25, 2015). The court therefore rejected the excess insurer’s late notice defense.

In March 2005, the insured provided notice of several lawsuits to the primary carrier, which accepted coverage. The insured did not notify the excess carrier until December 2010. After the primary carrier exhausted its limit in September 2012, the excess carrier denied coverage.

The primary policy required claims to be reported in writing to the insurer during the policy period. The excess policy contained a “Non-Follow Form” endorsement, which replaced the excess policy’s insuring clause and provided that the excess insurer agreed

> “to provide insurance coverage to the insureds in accordance with the terms, definitions, conditions, exclusions and limitations of the Followed Policy, [defined as primary insurer Policy No. 6409472,] except as otherwise provided herein. However, the Insurer shall not provide Insurance coverage to the Insureds in accordance with the terms and conditions, including those pertaining to Guaranteed Renewal as set forth in the endorsement of the [primary insurer], Policy Number 006409472, as that coverage is provided under the [primary insurer]’s Policy.”

The court concluded that the endorsement “could be reasonably interpreted to mean that the excess policy follows form to the definitions, exclusions, and limitations of the primary policy but not the terms and conditions of the primary policy.” The court therefore reasoned that “[b]ecause the reporting requirements in the primary policy are more properly characterized as conditions rather than definitions, exclusions, or limitations, the amended insuring clause can be read as not incorporating the notice conditions of the primary policy.” The court acknowledged that this interpretation appears to conflict with other sections of the policy, but concluded that “it is

continued on page 13

Policy Provision Requiring Insurer’s Consent to Incur Clean-Up Costs Not Void Against Public Policy

Applying New York law, the United States District Court for the Southern District of New York has held that a policy provision that requires an insured to seek approval from the insurer prior to incurring environmental clean-up costs is not void as against public policy. *SI Venture Holdings, LLC v. Catlin Spec. Ins.*, 2015 WL 4191453 (S.D.N.Y. July 10, 2015).

A real estate development company incurred $250,000 in costs to address a petroleum contamination problem at one of its properties. After incurring these costs, the company sought coverage under its insurance policy, which contained a consent provision stating that the insurer would reimburse only those clean-up costs incurred with the insurer’s prior written consent after the pollution condition is tendered to the insurer. The insurer denied coverage for the pre-tender clean-up costs. The company argued that the consent provision is void as against public policy because it impedes compliance with environmental regulations by slowing down a policyholder’s ability to address contamination problems.

The court sided with the insurer, holding that the consent provision is not void as against public policy. The court noted that numerous New York courts have enforced similar consent provisions, and thus a contrary ruling by this court would “revolutionize” New York insurance law. In addition, the court stated that accepting the real estate company’s position would unfairly eliminate an insurer’s ability to make even reasonable objections to any clean-up costs incurred by an insured. ■

Adversaries in Litigation Prohibited From Assigning Legal Malpractice Claim Arising From Same Litigation

The South Carolina Supreme Court, applying South Carolina law, has held that a legal malpractice claim may not be assigned between two adversaries in litigation where the alleged malpractice arises out of the same litigation. *Skipper v. ACE Prop. & Cas. Ins. Co.*, 2015 WL 4269817 (S.C. July 15, 2015).

An individual was in a car accident with the driver of a truck owned by an insured logging company. The insurer retained counsel for the insured company and its driver in an underlying personal injury action against the driver and the company. Without informing the insurer, the underlying plaintiff and the insured company and its driver entered into a settlement and consent judgment whereby the insureds admitted liability, agreed to pursue a legal malpractice claim against the attorneys retained for the insureds by the insurer, and assigned a large interest in the legal malpractice claim to the underlying plaintiff.

In answering a certified question addressing this matter, the South Carolina Supreme Court adopted the "majority rule in other jurisdictions . . . to prohibit the assignment of legal malpractice claims between adversaries in the litigation in which the alleged malpractice arose." In so doing, the court stressed the "potential for collusion and inflated consent judgments" if the assignment of such malpractice actions was permitted. The court also stated that "permitting the assignment of legal malpractice claims between adversaries threatens the integrity of the attorney-client relationship" by creating a conflict of interest between the defense attorney and his client. The court further explained that permitting such an assignment of a legal malpractice claim "would lead to disreputable role reversals in which the plaintiff-assignee would be required to take a position 'diametrically opposed' to its position in the underlying litigation" by forcing the plaintiff-assignee to argue that the underlying defendant would have won his case but for the actions of the defense attorneys in order to be successful in the legal malpractice action.

For these reasons, the court held that, "in South Carolina, the assignment of a legal malpractice claim between adversaries in litigation in which the alleged malpractice arose is prohibited." ■

Motion to Dismiss Record Insufficient to Make "Related Claims" Determination

A federal district court in California has denied an insurer's motion to dismiss based on a "related claims" argument because the coverage litigation pleadings did not contain sufficient information to resolve the dispute as a matter of law. *Rancho Tehama Ass'n v. Federal Ins. Co.*, 2015 WL 3454610 (E.D. Cal. May 29, 2015). The insurer denied coverage for a lawsuit on the basis that it was deemed related to a claim made before the start of the insured's claims-made policy and moved to dismiss the insured's coverage action seeking coverage for the lawsuit on that basis. The court concluded, however, that the issue of whether the underlying lawsuit and the prior matter are "related claims" "necessarily entails a factual inquiry, which is premature for the Court to conduct on a motion to dismiss."

The court found that it could not "determine the scope of each claim" because the insured's complaint alleged only that the claimant "requested a meeting" prior to the policy period and that the insured "met with [the claimant]." The court refused the insurer's request to consider letters between the claimant and the insured because they were not properly before the court as documents referenced in or "central" to the insured's complaint. The court also determined that a dispute in the motion to dismiss briefing about the content of the underlying lawsuit was "entirely extra-record, and perfectly encapsulates why the relatedness of claims is not properly addressed on a motion to dismiss." ■

© 2015 Wiley Rein LLP | www.wileyrein.com

Dishonesty Exclusion Bars Coverage for Attorney's Charging Exorbitant Fee

The U.S. Bankruptcy Court for the Middle District of Florida, applying Florida law, has held that a dishonesty exclusion precludes coverage for a claim under a professional liability policy issued to a trusts and estates attorney who made fraudulent representations and abused his fiduciary position to obtain an exorbitant fee from an estate. *Fla. Lawyers Mut. Ins. Co. v. John W. West, III, P.A. (In re West)*, 530 B.R. 809 (M.D. Fla. May 20, 2015).

The insured attorney represented the personal representative and co-trustee of her father's estate. The personal representative signed the attorney's "standard" fee agreement, but the agreement did not state the amount the attorney would charge for his work. The attorney's paralegal told the personal representative that Florida law required the attorney to charge a percentage of the value of the estate. Upon learning that the attorney was charging over $300,000, the personal representative filed suit against the attorney on behalf of the estate. The attorney and his wife subsequently filed for bankruptcy, and the personal representative filed an adversary proceeding on behalf of the estate. The bankruptcy court determined that the estate's claim was nondischargeable because the attorney had falsely represented to the personal representative that Florida law required him to charge certain fees and that her father had approved the arrangement. The court concluded that only a portion of the amount the attorney had collected from the estate was actually earned and entered a nondischargeable judgment against the attorney for the remaining balance. The attorney then sought coverage under his professional liability policy, and the insurer sought a declaration that it was not liable for the unsatisfied judgment.

The court held that the judgment was excluded from coverage under the policy's fraudulent and dishonest conduct exclusion, which applied to any claim "arising out of a criminal, dishonest, intentional, malicious or fraudulent act, error or omission committed by" the attorney. The court looked to its earlier ruling that the attorney's misrepresentations and breach of fiduciary duty were intentional, dishonest, and fraudulent, and held that the exclusion applied. The court rejected the estate's argument that the exclusion applied only to a narrow category of criminal behavior because the plain and unambiguous language of the exclusion included fraudulent and dishonest conduct. The court further held that the fact that the attorney's conduct constituted a breach of fiduciary duty did not overcome the fact that the attorney had also committed intentional fraud.

Because the court found that the dishonesty exclusion barred coverage for the judgment, it declined to determine whether the judgment fell outside the policy's insuring agreement, which only covered acts, errors, or omissions in connection with "professional services." The policy specifically provided that "professional services" did not include "any matters pertaining to or relating to an Insured lawyer's charges for services or expenses." However, the court observed in dicta that the judgment appeared to fall within the coverage provision, even though the damages sought were the amount of the excessive fees paid by the estate, because the claim was for the attorney's fraudulent representations and abuse of fiduciary duty. ■

Delaware Chancery Court Rejects Proposed Merger Settlement Emphasizing Need for Case-Specific Assessment of Settlement Consideration and Attorneys' Fees *continued from page 2*

Chancellor Laster commented that "you have to look at these things in context." He thus valued the deal modifications in this context as worth $40,000 to $50,000. He also valued the supplemental disclosures as worth "a low-end disclosure fee" around approximately $200,000. In so doing, he acknowledged he had previously advocated "the $500,000 baseline" fee award for disclosures but advised that this number "wasn't supposed to be something that would displace case-specific analysis." ■

Criminal Adjudication Final Upon Sentencing Under Fraud Exclusion Notwithstanding Appeal

continued from page 1

The appellate court first explained that it is well settled in the context of criminal prosecution that the imposition of the sentences constitutes final judgment against the accused. According to the court, that "an appeal may, at some point, relieve [the insured] of that judgment" does not change that finality. Finding the exclusion's language clear, the court concluded that once the final judgment for fraud was entered against the CIO, the insurer's obligation to defend him ceased. The court also agreed with the trial court's decision that its findings—that the CIO was excluded from receiving further coverage under the policy and also obligated to reimburse the insurer for the monies it had expended—entitled the insurer to an offset of the CIO's claim on past legal fees. ■

Material Misrepresentations in Application Preclude Coverage for More Than $2 Million Embezzlement

continued from page 1

The insured company sought coverage for the more than $2 million that was embezzled under a business and management indemnity policy that provided, among other things, crime coverage. The policy provided that "[i]n the event the Application . . . contains any misrepresentation or omission made with the intent to deceive, or contains any misrepresentation or omission which materially affects either the acceptance of the risk or the hazard assumed by Insurer under this Policy, this Policy, including each and all Coverage Sections, shall not afford coverage . . . for any Claim alleging, based upon, arising out of, attributable to, directly or indirectly resulting from, in consequence of, or in any way involving, any untruthful or inaccurate statements, representations or information." The policy further provided that this provision applies if "any past or present chief executive officer, [or] chief financial officer . . . of the [insured company] knew the facts misrepresented or the omissions, whether or not such individual knew of the Application, such materials, or this Policy."

In applying for renewal of the policy, the insured submitted an application stating that: (i) there was an annual audit or review by a CPA of the insured's books and accounts, including a complete verification of all securities and bank accounts; and (ii) the bank accounts were reconciled by someone not authorized to deposit or withdraw from the accounts. Because the individual who embezzled the money was the former CFO and CEO of the insured and filled out the renewal application, the insurer denied coverage for the claim based on alleged material misrepresentations in the renewal application relating to the insured's financial accounting practices. The trial court granted summary judgment to the insurer, and an appeal followed.

On appeal, the Eleventh Circuit ruled that, while a CPA may have cursorily reviewed the insured's books each year, as asserted by the insured, "no reasonable jury could conclude that an 'annual audit or review performance by an independent CPA on the books and accounts, including a complete verification of all securities and bank balances' occurred. Consequently, . . . [the CFO/CEO's] response to [this question] was a misrepresentation." Likewise, the court held that there was a misrepresentation with respect to the reconciling of accounts given that the embezzling CFO/CEO performed reconciliation functions and also had access to the insured's bank accounts.

The court next held that the misrepresentations "were material to the issuance of the policy." In this regard, the court noted that, based on the testimony of the underwriter of the policy, the insurer's "underwriting policies assigned a higher rating factor and higher total premium where an insured answers 'no'" to the questions at issue and that the insurer "would normally have charged an increased premium for the policy in question had [the CFO/CEO] provided correct answers about [the insured's] accounting practices."

Because the misrepresentations were material, the misrepresentations undisputedly were related to the claimed loss at issue, and the CFO/CEO irrefutably knew of the facts misrepresented, the court held that the policy did not afford coverage for the embezzled funds. ■

© 2015 Wiley Rein LLP | www.wileyrein.com

Dishonesty Exclusion Bars Coverage for Claim Alleging Fraudulent Inducement to Extend Loan

continued from page 2

coverage, their insurer disclaimed coverage and cited its dishonesty exclusion.

In the coverage litigation that followed, the court held that because the underlying claim "allege[d] exclusively dishonest and fraudulent conduct on the part of [the insureds] and . . . assert[ed] only a single claim of fraud against [the insureds]," the dishonesty exclusion barred coverage for the underlying claim. The court rejected the insureds' argument that the underlying claim arose out of covered events—namely, the allegation that the firm was providing legal services—because "[i]f the court were to read the [p]olicy to impose coverage obligations . . . solely because the [u]nderlying [c]omplaint allege[d] that [the insureds] rendered services, it would vitiate the . . . exclusion." The court also rejected the insureds' argument that a ruling for the insurer would conflict with an intermediate appellate court case that held that an insurer had a duty to defend an underlying wrongful death action where the insured was sued for negligence but extrinsic evidence indicated that the insured had acted intentionally. According to the court, the appellate court case was distinguishable because the allegations of the underlying fraud claim were "wholly within" the fraud exclusion. Finally, the court rejected the insured's suggestion that an internal email by the insurer's claims counsel expressing doubts about the merits of denying coverage rendered the dishonesty exclusion ambiguous. In the court's view, "[w]hat claims counsel may or may not have initially questioned [wa]s irrelevant" given that all of the underlying allegations were within the ambit of the dishonesty exclusion. ■

Court Applies Subjective Standard to Prior Knowledge Exclusion

continued from page 4

insured again notified the insurer of the matter and sought coverage under its professional liability policy for the June 2006 cross claim. The insurer denied coverage pursuant to the policy's prior knowledge exclusion and coverage litigation ensued.

In denying the insurer's motion for summary judgment, the court first applied a subjective knowledge standard to determine whether the policy's prior knowledge provision applied to preclude coverage. According to the court, although there was no question that the insured was aware of the facts that ultimately gave rise to its liability to the real estate developer prior to the effective date of the policy at issue, the insured's contention that the developer assured him that he would not be sued was sufficient to avoid summary judgment. Additionally, the court determined that summary judgment in favor of the insured was not appropriate because of evidence of internal correspondence from the developer implying that the insured could be the subject of a lawsuit.

The court rejected the argument that a prior policy provided coverage, finding that Section 19-110 of the Insurance Article of the Maryland code, which requires a showing of prejudice in order to deny coverage on late notice grounds, did not apply to a notice of circumstance. Thus, the court determined that the prior policy did not respond to the matter because a claim had not been made during that policy period. The court did find, however, that Section 19-110 applied to claims-made-and-reported policies, but denied the parties' motions because factual issues regarding whether the insurer was prejudiced as a result of the late notice of the matter remained unresolved. ■

Equitable Subrogation Allows Excess Insurer to Recover Settlement Contribution from Later Insurer After Proper Policy Period Is Determined *continued from page 3*

submission of the patent infringement lawsuit to the 2003-04 excess insurer did not constitute adequate notice of circumstances. The Ninth Circuit also found that the primary insurer had invoked its 2003-04 policy and thus the 2004-06 primary policy had not been exhausted, so the 2004-06 excess policy could not be triggered until a judicial determination that the primary insurer's decision to invoke its 2003-04 policy was incorrect enabled the primary insurer to adjust its records.

On remand, the trial court determined that the Ninth Circuit's finding regarding the adequacy of the notice of circumstances as to the 2003-04 excess insurer was conclusive as to the adequacy of the notice of circumstances as to the 2003-04 primary insurer, as it involved the same notice under the same policy language. The court therefore concluded that the 2004-06 primary policy had been exhausted because the primary insurer had maintained the position that its payment could be considered covered by either its 2003-04 policy or its 2004-06 policy.

The court rejected the 2004-06 excess insurer's contrary arguments. It held that the primary insurer did not waive the right to disavow the 2003-04 notice of circumstances because it expressly reserved all rights and expressed a position that it would honor either one of its policies. The court further rejected the "conclusory statement of opinion" provided by the 2004-06 insurer's industry expert that shifting coverage form one insurer to the other does not comport with standard practices in the insurance industry. Moreover, the court determined that the 2004-06 excess insurer could not assert equitable estoppel because the insurer did not demonstrate that it detrimentally relied on the primary insurer providing coverage under its 2003-04 policy. In addition, the court rejected the 2004-06 excess insurer's argument that the "known loss' rule would apply, because California law makes clear that "previous knowledge of a potential future dispute does not preclude it from insurance coverage" where "the insured's *liability* in a potential future action [i]s not a certainty."

Because the 2004-06 policies had been triggered, the court found that the 2004-06 primary policy had been exhausted, and the 2004-06 excess insurer was liable under its policy. The court concluded that that the 2003-04 excess insurer could recover from the 2004-06 excess insurer its $5 million settlement contribution through equitable subrogation. Because the 2003-04 excess insurer had initially denied coverage, its payment was not "voluntary"—a requirement for subrogation. The court also awarded prejudgment interest from the date the 2003-04 excess insurer made its payment at the California statutory rate of 10% applicable to breach of contract. ■

Bad Faith Action to Go To Jury *continued from page 4*

However, the court found that the "the summary judgment record [was] too fact-bound to say conclusively whether" this was or was not the case.

The court also found that there were issues of material fact as to whether the insurer should have perceived a substantial likelihood of damages in excess of the policy limits at the time of the Section 998 offer. In addition, the court found that issues of material fact remained as to whether the insurer should have made an affirmative offer to settle at a later stage of the litigation. As such, the court declined to resolve the bad faith claim on summary judgment. ■

© 2015 Wiley Rein LLP | www.wileyrein.com

Summary Judgment Premature Where Insurer Reserved Rights Under Capacity and Equity Interests Exclusions *continued from page 5*

An insured attorney was a founding member of a company, which was organized to partner with a high school in China to operate a joint Chinese-American high school program. Per the company's operating agreement, the attorney and his wife collectively held a 49% equity interest in the company; however, the company's operating agreement was never executed. The insured attorney and his wife brought a contract action against the company and a company co-founder, seeking to enforce a partially executed consulting agreement and to recover consulting fees for various services. The defendants counterclaimed, alleging repudiation of the consulting agreement, legal malpractice, self-dealing and fraud. The parties settled the underlying contract action, and the insured sought coverage for the costs incurred in defending against the counterclaims.

After initially denying coverage based on the Capacity and Equity Interests Exclusions, the insurer agreed to defend the policyholder subject to a full reservation of rights. In its coverage letter, the insurer expressed its intent to investigate further the policyholder's status as a company executive and to determine whether "he was wearing two hats – one as a solo practitioner and the other as negotiator and executive" for the company. The insured brought the present coverage action and moved for summary judgment.

The trial court denied the insured's motion for summary judgment. In affirming the denial, the appellate court first rejected the insured's assertions that the insurer's reservation of rights constituted an "outright refusal to defend" and a breach of the policy. The court explained that a reservation of rights allows an insurer the flexibility of fulfilling its duty to provide a defense "while continuing to investigate the claim further."

The court also held that the policyholder's motion for summary judgment was "premature" because "no discovery had been conducted as to whether the allegations in the counterclaims fall within either or both exclusions to coverage." The court characterized the malpractice counterclaim against the policyholder as a "hybrid"claim, in that the insured, a practicing attorney who was compensated by the company for his legal services, sought payment of consulting fees of a "nonlegal nature." The court reasoned that the situation was precisely what the Capacity and Equity Interests Exclusions "seem to encompass" where the policyholder is "serving two masters: his client and himself." Because the counterclaims contained "intertwined allegations" about the policyholder's legal services to the company in which he apparently had a financial interest, the court found that, at a minimum, discovery is necessary on the issue of the policyholder's ownership interests and whether they fall within the Equity Interests Exclusion. ■

"Regardless of Any Apparent Intent," Excess Policy Does Not Follow Notice Condition of Primary Policyt *continued from page 6*

the only reasonable way to resolve the apparent conflict in the two sentences of the [endorsement] clause." The court held that "the excess policy, regardless of any apparent intent between the parties, does not follow form to the reporting requirements in the primary policy."

The court concluded that the excess policy's notice provision, which only specifically addressed changes in the underlying insurance, did not otherwise incorporate the primary policy's claim reporting requirement. It therefore affirmed the trial court's judgment rejecting the excess insurer's late notice defense. ■

No Coverage for a Lawsuit Filed Two Years after the Expiration of a Claims-Made-and-Reported Policy *continued from page 5*

argument that the policy was unconscionable as applied to him because the insurer never provided him with a copy of the policy or otherwise disclosed its limitations. The court noted that claims-made-and-reported policies are "perfectly legal" and that, because the assignee was a "complete stranger" to the contract between the attorney and the insurer, the insurer owed no duties to him. ■

SPEECHES/UPCOMING EVENTS

ACI's 19th Forum on D&O Liability
KIMBERLY M. MELVIN, Speaker
• D&O and Financial Institutions
SEPT. 18, 2015 | NEW YORK, NY

Professional Liability Attorneys

Name	Phone	Email
Kimberly A. Ashmore	202.719.7326	kashmore@wileyrein.com
Matthew W. Beato	202.719.7518	mbeato@wileyrein.com
Mary E. Borja	202.719.4252	mborja@wileyrein.com
Edward R. Brown	202.719.7580	erbrown@wileyrein.com
Jason P. Cronic	202.719.7175	jcronic@wileyrein.com
Cara Tseng Duffield	202.719.7407	cduffield@wileyrein.com
Benjamin C. Eggert	202.719.7336	beggert@wileyrein.com
Ashley E. Eiler	202.719.7565	aeiler@wileyrein.com
Michael J. Gridley	202.719.7189	mgridley@wileyrein.com
Dale E. Hausman	202.719.7005	dhausman@wileyrein.com
John E. Howell	202.719.7047	jhowell@wileyrein.com
Leland H. Jones, IV	202.719.7178	lhjones@wileyrein.com
Parker J. Lavin	202.719.7367	plavin@wileyrein.com
Charles C. Lemley	202.719.7354	clemley@wileyrein.com
Jessica C. Lim*	202.719.3749	jlim@wileyrein.com
Mary Catherine Martin	202.719.7161	mmartin@wileyrein.com
Kimberly M. Melvin	202.719.7403	kmelvin@wileyrein.com
Jason O'Brien	202.719.7464	jobrien@wileyrein.com
Leslie A. Platt	202.719.3174	lplatt@wileyrein.com
Nicole Audet Richardson	202.719.3746	nrichardson@wileyrein.com
Marc E. Rindner	202.719.7486	mrindner@wileyrein.com
Kenneth E. Ryan	202.719.7028	kryan@wileyrein.com
Frederick H. Schutt	202.719.7502	fschutt@wileyrein.com
Gary P. Seligman	202.719.3587	gseligman@wileyrein.com
Richard A. Simpson	202.719.7314	rsimpson@wileyrein.com
William E. Smith	202.719.7350	wsmith@wileyrein.com
Daniel J. Standish	202.719.7130	dstandish@wileyrein.com
Karen L. Toto	202.719.7152	ktoto@wileyrein.com
David H. Topol	202.719.7214	dtopol@wileyrein.com
Jennifer A. Williams	202.719.7566	jawilliams@wileyrein.com
Bonnie Thompson Wise*	202.719.3763	bwise@wileyrein.com

* Not admitted to the DC bar. Supervised by the principals of the firm.

To update your contact information or to cancel your subscription to this newsletter, visit: www.wileyrein.com/?NLS=1

This is a publication of Wiley Rein LLP, intended to provide general news about recent legal developments and should not be construed as providing legal advice or legal opinions. You should consult an attorney for any specific legal questions.

Some of the content in this publication may be considered attorney advertising under applicable state laws. Prior results do not guarantee a similar outcome.