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NEWSLETTER

Estate Representative Breaches D&O Policy Cooperation Clause

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A federal district court in Kansas has held that the representative of a bankrupt entity breached the cooperation clause of a D&O policy by colluding with plaintiffs in a securities fraud action and filing an answer that admitted liability for all of plaintiffs' claims. *Youell, et al. v. Cynthia Grimes, et al.*, No. 02-2207-JWL (D. Kan. Aug. 19, 2002).

In August 1997, a state court action was filed against Stoico Restaurant Group (SRG) and its directors and officers alleging securities fraud in connection with an initial public offering. SRG tendered the defense of the action to its directors and officers liability insurer, and the insurer accepted the claim under a reservation of rights. The insurer consented to defense counsel, who ultimately negotiated a $410,000 settlement of the securities suit. Before the settlement was finalized, however, SRG filed for reorganization under chapter 11 and counsel sought approval of the settlement by the bankruptcy court.

While the motion to approve the settlement was still pending, the bankruptcy court appointed a designated representative of SRG's estate (the "Representative"). Thereafter, the Representative withdrew the pending motion, and her counsel called plaintiffs in the securities suit informing them that SRG's files contained "every smoking gun memo imaginable." The Representative's counsel then sent plaintiffs a letter reporting that "$410,000 is not an adequate amount to settle all claims" and that it "appears that an award could exceed $2 million." The Representative also informed plaintiffs that SRG's documents supported their securities fraud claims. Moreover, the Representative filed an answer in the securities suit admitting liability for the claims. After filing the answer, she agreed to settle the securities suit for $1.7 million, and sought the insurer's consent for the settlement. The insurer denied coverage for the settlement based on the Representative's breach of the cooperation clause, finding the settlement to be the result of collusion between the Representative and plaintiffs. After denying coverage, the insurer brought an action seeking a declaration that it was not liable for the settlement.

In granting the insurer's motion for summary judgment, the court determined that the cooperation clause in the D&O policy unambiguously provided that SRG could not take any action to increase the insurer's exposure under the policy. The court found that the following conduct of the Representative violated the cooperation clause: (1) withdrawing the motion to approve the settlement; (2) informing plaintiffs that their claims were viable and supported by SRG's documents; (3) filing an answer in the securities suit admitting liability; and (4)

agreeing to settle the securities suit for $1.7 million. These acts, according to the court, "dramatically increased" the insurer's exposure and demonstrated the exact type of collusion that the cooperation clause is intended to eliminate. The court also found that the Representative's breach of the cooperation clause substantially prejudiced the insurer because the $1.7 settlement was more than three times the original agreement with the plaintiff and the admission of liability foreclosed the insurer from "effectively defending" the claims in the securities suit.

The court also determined that the fact that the Representative had a right to pursue claims against SRG's directors and officers for potential wrongdoing did not relieve the Representative of her obligation to cooperate under the policy. Rather, the Representative should have considered "whether the action would breach the insurance contract covering such wrongdoing" and weighed that consideration against the potential benefit of pursuing the claims.

For more information, please contact one of WRF's Professional Liability Attorneys at 202.719.7130