

D&O Policy Covers Attorneys' Fees for Defense of Criminal Action But Insured Is Estopped From Arguing That Guilty Plea Does Not Bar Coverage

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The United States District Court of the Southern District of Texas, applying Texas law, has held that attorneys' fees associated with the defense of criminal proceedings against directors and officers are covered as they are incurred under professional liability policies, at least until there is a "final adjudication" that the losses result from dishonest, fraudulent or criminal conduct. *In re Enron Corp. Securities, Derivative & "ERISA" Litigation*, 2005 WL 2230250 (S.D. Tex. Aug. 1, 2005). While the court held that a guilty plea in a criminal action does not become a final adjudication until a sentence is imposed, the court held that the insureds would be judicially estopped from asserting that the pleas did not trigger the policy's exclusion for coverage of dishonest, fraudulent or criminal conduct.

The ruling arises out of a statutory interpleader action filed by numerous excess D&O liability insurers against directors and officers of a corporation accused of participating in a scheme to defraud investors and the public. Many of these directors and officers are currently involved in parallel civil, criminal and administrative actions. The corporation purchased one primary and 10 excess D&O policies providing coverage for directors and officers up to \$350 million. The primary layer and first three excess policies have been exhausted, leaving \$200 million in coverage available. The remaining excess carriers filed the interpleader action after they received competing demands seeking more than \$200 million in total payments.

The remaining policies followed form to the primary policy which defined a covered "Claim" as "any demand, suit or proceeding . . . which seeks actual monetary damages or other relief and which may result in [the insureds] becoming legally obligated to pay Ultimate Net Loss by reason of any Wrongful Act . . ." The policy defined "Ultimate Net Loss" as "total Indemnity and Defense Cost with respect to which this Policy applies." In addition, the primary policy barred coverage for "Ultimate Net Loss arising from any Claims(s) . . . for any fines or penalties imposed in a criminal suit, action or proceeding" and the policy explicitly excluded coverage for claims "brought about or contributed to by the dishonest, fraudulent, criminal or malicious act or omission of such Director or Officer if a final adjudication establishes that acts of active and deliberate dishonesty were committed or attempted . . ." The excess insurers, along with other insureds not involved in

criminal proceedings, asserted that the excess policies did not cover costs incurred in defending certain insureds in criminal actions because the definition of "Claim" limited coverage to actions seeking "actual monetary damages or other relief," remedies most often associated with civil proceedings.

After concluding that the choice of law provisions in the primary and first layer excess policies resulted in a "patent ambiguity" under which Texas law would apply, the court rejected the argument that the policies barred coverage for costs associated with criminal actions. In concluding that there was "sufficient ambiguity" in the primary policy to find coverage, the court first noted that neither the definition of "Claim" nor "Ultimate Net Loss" provided for a distinction in coverage between civil and criminal actions. The court then looked at the dictionary definitions of "compensatory damages" and "relief," noting that they related to compensation for injury sustained and "deliverance from oppression, wrong, or injustice," which did not mandate a restriction to civil proceedings. In addition, the court observed that the definition of "Wrongful Act" did not address the state of mind of the insured and that the conduct specified (*e.g.*, breach of duty, neglect, error, misstatement, etc. . . .) could encompass both civil and criminal acts.

Moreover, the court noted that the failure of the definition of "Ultimate Net Loss" to address attorneys' fees, along with the carve-out of coverage for "fines or penalties" in a criminal suit or claims brought about or contributed to by dishonest, fraudulent, criminal or malicious acts, led to the conclusion that the policies covered the attorneys' fees incurred in defending against criminal actions—at least until the point when the insured was found guilty of a fraudulent, dishonest or criminal act that would negate coverage pursuant to a policy exclusion.

Having reached this conclusion, the court then addressed whether the insureds' defense costs were to be reimbursed as incurred, or only after the "final adjudication" of the criminal case. The district court held that these costs should be reimbursed by the insurer as incurred, with repayment by the insured after final adjudication, if necessary. To hold otherwise, the court reasoned, would allow an insurer to withhold payment until final adjudication was reached in any case where allegations of intentional dishonesty were made, or "virtually every case," bringing "financial ruin" upon most every director or officer.

Finally, the court rejected the excess insurers' and other insureds' argument that a guilty plea in which the defendant waived all right to appeal or mount a collateral attack constituted a "final adjudication" sufficient to preclude coverage. Citing to Federal Rule of Criminal Procedure 32, the court observed that it is "clear that a criminal adjudication is not final until a sentence is imposed on the defendant." Nevertheless, the court agreed that the insureds were judicially estopped from arguing in the coverage litigation that their guilt had not been established. The court concluded that any such attempt by the insureds would satisfy the elements of judicial estoppel because it would amount to the taking of a position clearly inconsistent with their plea in the criminal action that was accepted by the judge and not "inadvertent." The court noted that a "final adjudication" was not needed for judicial estoppel to apply, so long as the first court had adopted the prior position "either as a preliminary matter or as part of a final disposition." The court also rejected the contention of one of the insureds that payment of some defense costs was warranted because many of the allegations against him were based on reckless or negligent, as opposed to criminal, behavior. The court

observed that coverage for all losses "contributed to" by the dishonest conduct was precluded by the policy and that the same conduct to which the insured pled guilty provided the basis for the allegations of negligence and recklessness.

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