## COMMENTS

# A Common Law Approach to D&O Insurance "In Fact" Exclusion Disputes

*Joshua Phares Ackerman*†

## INTRODUCTION

Directors' and Officers' (D&O) liability insurance policies are a staple of the modern corporate world. Held by virtually all major organizations,[1] these policies protect their beneficiaries from losses suffered in connection with directors' and officers'[2] performance of their duties. The policies fund the defense of lawsuits and reimburse policyholders for settlements and adverse judgments.

Like other types of liability insurance, D&O policies do not provide universal coverage. One common exclusion—the personal profit exclusion—prevents coverage of losses caused by the insured's wrongful conduct from which he inappropriately profited. For example, this provision would preclude coverage of a judgment against an executive for accepting kickbacks from a corporation's suppliers. These exclusions shield insurance carriers from the significant moral hazard that would result if executives could be reimbursed for damages that arise from their illegal profiteering. They also protect organizations, as they ensure that D&O policies do not create perverse incentives for executives to engage in wrongdoing. For the executives, of course, the exclusions matter because they may strip the executives of the benefits of coverage.

Personal profit exclusions generally state that they apply when executives have "in fact" profited from their conduct.[3] This "in fact"

---

† BA 2007, The University of Chicago; JD Candidate 2013, The University of Chicago Law School.

1 Tom Baker and Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 Georgetown L J 1795, 1796–97 & n 5 (2007).

2 This Comment will use the term "executives" to refer to both directors and officers.

3 Other exclusions, typically those that prevent coverage based on the insured's conduct, also use this language and are subject to the same interpretive difficulties. For example, exclusions barring recovery for losses stemming from fraud and money laundering sometimes use this formulation. For an example of the money laundering exclusion, see *Pendergest–Holt v Certain Underwriters at Lloyd's of London*, 600 F3d 562, 570 n 17 (5th Cir 2010).

formulation has caused confusion both about when the insurer can invoke the exclusion and about the quantum of proof necessary to establish that the exclusion applies. To understand the problem, imagine a situation in which an organization's directors misappropriated company information and used it to start their own firm. The shareholders of the original organization bring suit, alleging in their complaint that the board members breached their duty of loyalty by usurping a corporate opportunity. Imagine further that these board members make a claim under their D&O policy. The insurance carrier, naturally, seeks to prevent coverage—to avoid paying for the board members' defense and for any ultimate judgment—by invoking the policy's personal profit exclusion.

What should the carrier need to establish to show that the board members profited from their conduct? Are allegations of personal profit in the complaint against the insured sufficient? Or should there be a judicial determination that the executives reaped an improper personal profit? Should the carrier be able to produce its own evidence that the executives profited? If so, when should the carrier be allowed to make this showing? Can it deny the executives coverage before the underlying case is litigated? Or must it wait until that case has concluded?

In several recent diversity cases, the courts of appeals have followed different approaches to answering these questions despite similar bodies of applicable state law. The Seventh Circuit held the exclusion applied because the shareholders' complaint alleged that the executives profited.[4] The Fifth Circuit required a judicial determination—either in the shareholders' suit or in a separate coverage suit—that the board members profited.[5] Lastly, the Eighth Circuit required some factual evidence of personal profit—something more than just the shareholders' complaint but short of a full judicial adjudication.[6]

Disputes over whether an insurer must defend its insured are common in insurance litigation. In deciding these issues, states follow a generally consistent body of common law that defines the scope of a carrier's duty to defend. The duty to defend is a standard policy provision that obligates the carrier "to defend the insured from all actions brought against the insured based on alleged facts or circumstances falling within the purview of coverage under the policy,

4 See *Brown & LaCounte, LLP v Westport Ins Corp*, 307 F3d 660, 663–64 (7th Cir 2002).
5 See *Pendergest–Holt*, 600 F3d at 576.
6 See *Wintermute v Kansas Bankers Surety Co*, 630 F3d 1063, 1074 (8th Cir 2011).

regardless of the suit's validity or invalidity."[7] Most states require insurance carriers to defend their insured against a broader set of lawsuits than those in which the carrier must indemnify their insured for losses. The reasoning behind this approach is that it prevents carriers from avoiding their defense obligations in cases where it might not be clear if the policy applies at the outset, but the claims are later found to be within the scope of coverage. This Comment argues that proper application of these common law rules would offer clarity regarding both the question of when a carrier may invoke an "in fact" exclusion and what level of proof they must bring forward to do so.

Part I provides an overview of D&O insurance and introduces the personal profit exclusion. Part II discusses the various approaches followed by the courts of appeals as to the application of "in fact" exclusions. Part III explains the importance of standardizing these divergent approaches to provide greater clarity for litigants, particularly in light of the variance in pleading standards from jurisdiction to jurisdiction. Part IV provides background on the common law duty to defend doctrine and explains the circumstances in which it does and does not attach. Part V argues the duty to defend doctrine offers a framework for resolving D&O insurance "in fact" exclusion disputes. This Comment's proposed approach would require courts to first determine whether a duty to defend exists. If one does, and if there is any possibility that the claim could fall within the policy's coverage, carriers should be required to finance the defense until there has been a judicial determination that the "in fact" exclusion applies. If a duty to defend does not exist, the executive must finance his own defense but can attempt to recover reimbursement.

## I. OVERVIEW OF D&O LIABILITY INSURANCE

D&O insurance shields corporate leaders from the significant liability risks associated with their roles. The scope of possible claims against directors and officers is broad; they may have to defend themselves against claims that they breached their fiduciary duties, violated securities laws, or committed crimes.[8] Further, lawsuits against executives are at an all-time high in the wake of the 2008 financial crisis.[9] In response to these heightened litigation risks,

7 Steven Plitt, Daniel Maldonado, and Joshua D. Rodgers, *Insurer's Duty to Defend: Nature, Commencement and Termination*, in Lee R. Russ and Thomas F. Segalla, eds, 14 *Couch on Insurance* § 200:1 (Thomson Reuters 3d ed 2011).

8 See Baker and Griffith, 95 Georgetown L J at 1803–04 (cited in note 1).

9 See Jessica Silver-Greenberg, *Why Merger Lawsuits Don't Pay*, Wall St J B9 (Aug 27, 2011) ("Last year, a record 353 lawsuits challenging proposed corporate marriages were filed in

organizations have increased their D&O insurance coverage limits.[10] There is also evidence that executives recognize the importance of D&O coverage. According to the consultancy Towers Watson, 69 percent of plan administrators reported fielding inquiries from directors or officers regarding the amount and scope of their coverage in 2011, up from 57 percent in 2010.[11]

## A. Components of D&O Insurance and the Market for Coverage

D&O policies have three distinct prongs of coverage, commonly called Side A, Side B, and Side C coverage. Side A coverage protects executives from personal liability. Given that many organizations will directly indemnify their executives,[12] Side A coverage is most important when the organization is insolvent or does not indemnify (or is prohibited from indemnifying) its executives.[13] Side B coverage reimburses the organization for any losses resulting from indemnification of its directors and officers.[14] Side C coverage reimburses the organization for judgments against the organization itself.[15] A majority of organizations purchase all three types of coverage, but a

. . . courts across the U.S., a 58% increase from 2009."); David Benyon, *D&O Pressured by Corporate Scrutiny*, Reactions 37 (Apr 2011) (noting that "2010 was a record year for US securities litigation" and predicting increased fiduciary duty claims as a result of the subprime crisis); Jonathan D. Glater, *Financial Crisis Provides Fertile Ground for Boom in Lawsuits*, NY Times B1 (Oct 18, 2008) (summarizing aspects of the financial crisis that are likely to result in litigation); *In re MF Global Holdings Ltd*, 469 BR 177, 193–94 (Bankr SDNY 2012) (holding that MF Global's executives are entitled to the proceeds of their D&O policies to pay for their defense, notwithstanding the automatic stay imposed by MF Global's bankruptcy). See also Barry R. Ostrager and Thomas R. Newman, 2 *Handbook on Insurance Coverage Disputes* § 20.02[h][2] at 1524 (Wolters Kluwer 15th ed 2010) ("Whether a personal/illegal profit . . . exclusion will bar coverage in litigation arising from the subprime mortgage crisis is an issue that courts will likely face.").

10 Towers Watson, *Directors and Officers Liability Survey: 2010 Summary of Results* 13–15 (2010), online at http://www.towerswatson.com/assets/pdf/3790/DandO_Survey_2011.pdf (visited Nov 25, 2012) (citing data indicating that companies have increased their D&O coverage in response to a "severe litigation environment" in which liability exposure is "arguably at an all-time high"). See also Towers Watson, *Directors and Officers Liability Survey: 2011 Summary of Results* 7–11 (2011), online at http://www.towerswatson.com/assets/pdf/6532/Towers-Watson-Directors-and-Officers-Liability-2011-Survey.pdf (visited Nov 25, 2012) (observing that a quarter of public companies had higher levels of D&O coverage in 2011).

11 Towers Watson, *2011 Summary of Results* at 7–11 (cited in note 10).

12 See, for example, 8 Del Code Ann § 145(b) (allowing corporations to indemnify directors and officers).

13 See 8 Del Code Ann § 145(g); Baker and Griffith, 95 Georgetown L J at 1802–03 & n 25 (cited in note 1).

14 See *Level 3 Communications, Inc v Federal Ins Co*, 272 F3d 908, 909 (7th Cir 2001) ("Despite its name, such a policy insures not only officers and directors themselves but also their corporation if . . . the corporation indemnifies them for their liability.").

15 See Tom Baker and Sean J. Griffith, *Ensuring Corporate Misconduct: How Liability Insurance Undermines Shareholder Litigation* 46–48 (Chicago 2010).

substantial minority opts for only Sides A and B coverage, and some purchase only Side A coverage.[16]

Premiums for D&O insurance are paid by the organization.[17] While there is no reason, in principle, why executives could not pay for their own coverage, "the managerial labor market appears to have allocated the expense of individual D&O coverage, like any other executive perquisite, to the corporation itself."[18] Some commentators have questioned whether this is in the best interests of shareholders,[19] but it remains a reality in the D&O market.

D&O policies are available from a wide range of insurance carriers,[20] and policyholders do not often switch carriers.[21] Consistent with this suggestion, Towers Watson reports that 53 percent of companies had not reviewed whether to change their D&O carrier or policy limits in two years.[22]

## B. The Mechanics of D&O Coverage

D&O policies are "claims made" policies, meaning they cover all claims made against the insured during the period the policy is effective, regardless of whether the acts that led to liability occurred during the policy period.[23] As one might expect given D&O policies' broad scope, the coverage provisions are typically written in very

16 Towers Watson, *2011 Summary of Results* at 12 (cited in note 10) (reporting that 60 percent of responding insureds carried all three types of coverage, 20 percent carried only Sides A and B, and 6 percent carried only Side A).

17 See 8 Del Code Ann § 145(g).

18 Baker and Griffith, 95 Georgetown L J at 1821 & n 128 (cited in note 1) ("D&O insurance coverage represents a form of compensation for directors and officers.").

19 See id at 1799 (arguing that because D&O insurance shields executives from personal liability and because insurers do not impose governance controls as a condition of coverage, D&O insurance may increase shareholder losses).

20 See Towers Watson, *2011 Summary of Results* at 21–35 (cited in note 10).

21 See Dan A. Bailey, *D&O Policy Commentary*, 702 PLI/Lit 205, 209 (2004).

22 Towers Watson, *2011 Summary of Results* at 7 (cited in note 10) ("In spite of a heightened interest in coverage, the majority of companies participating in the survey (53%) have not conducted an independent review of their policies in the past two years.").

23 See *National Union Fire Ins Co of Pittsburgh v Baker & McKenzie*, 997 F2d 305, 306 (7th Cir 1993) (noting that in claims-made policies, "[t]he coverage is less, but so, therefore, is the cost"); Bailey, 702 PLI/Lit at 210 (cited in note 21); Neil A. Doherty, *The Design of Insurance Contracts When Liability Rules Are Unstable*, 58 J Risk & Ins 227, 240, 243–44 (1991) (concluding that claims-made policies benefit insurers by increasing the predictability of claims obligations and suggesting they have helped the insured by reviving insurance markets); Paul E.B. Glad, William T. Barker, and Michael Barnes, *Introduction to Liability Insurance*, in Jeffrey E. Thomas and Francis J. Mootz III, eds, 3 *New Appleman on Insurance Law Library Edition* § 16.07[5] at 16-180.5 to -182 (LexisNexis 2011) (explaining that claims-made policies allow insurers to more effectively manage the "tail" of liability coverage—that is, the length of time during which they must anticipate claims made on old policies).

general terms. For example, the policy at issue in *Wintermute v Kansas Bankers Surety Co*[24] contained the following grant clause: "The Underwriter [KBS] . . . agrees: (A) to indemnify each . . . Director . . . for personal Loss which the Director . . . is legally obligated to pay by reason of any Wrongful Act solely in their capacities of Director."[25] The definition of "loss" is similarly broad: "'Loss' . . . shall mean any amount which the Directors . . . are legally obligated to pay . . . for a claim . . . made against the Directors . . . for Wrongful Acts and shall include but not be limited to damages, judgments, . . . and defense of legal claims."[26]

D&O policies contain exclusions that bar coverage in certain circumstances. The most common exclusions prevent coverage for claims of fraud, claims that pit one insured party against another,[27] claims for losses incurred from litigation commenced prior to the start of coverage, and claims for losses stemming from incidents in which the insured personally profited from his wrongful conduct.[28] The personal profit exclusions are perhaps the most important example of "in fact" exclusions and have been interpreted differently by the courts of appeals.

### C. The Personal Profit Exclusion

Exclusions barring coverage for wrongful acts from which the insured personally profited are a universal feature of D&O policies. While the wording of these exclusions varies slightly between policies, the personal profit exclusion from the policy at issue in *Wintermute* is typical: "[The Insurer] shall not be liable for payment or defense of any claim for Loss made against a Director 'based upon or attributable to the Director [] . . . gaining in fact any personal profit or advantage to which [she was] not legally entitled.' "[29]

This policy's use of the words "in fact" is consistent with most other D&O personal profit exclusions,[30] and is also sometimes used

24 630 F3d 1063 (8th Cir 2011).

25 Id at 1068 (quotation marks omitted).

26 Id at 1068–69.

27 See, for example, Bailey, 703 PLI/Lit at 215–16 (cited in note 21) (explaining that this exclusion was added to policies after several lawsuits suggested that corporations were attempting to convert their policies into cash by bringing suits against their own insured executives).

28 See Baker and Griffith, *Ensuring Corporate Misconduct* at 180–95 (cited in note 15) (summarizing typical exclusions); Bailey, 703 PLI/Lit at 213–18 (cited in note 21) (same).

29 *Wintermute*, 630 F3d at 1070–71.

30 For other examples of "in fact" exclusions, see *TIG Specialty Ins Co v PinkMonkey.com Inc*, 375 F3d 365, 368–71 (5th Cir 2004) (describing a personal profit exclusion, which "exclud[ed] from coverage 'any Claim [against any Insured] based upon, arising from, or in consequence of an Insured having gained in fact any personal profit, remuneration, or

in other types of exclusions.[31] It bears noting, however, that not all policies use this language. Some personal profit exclusions set out more detailed requirements as to what kind of factual showing must be made to invoke the exclusion.[32]

The purpose of the personal profit exclusion is to avoid a mismatch of incentives between the insured executive, the insurance carrier, and the organization. Imagine, for example, what would happen if an executive accepted kickbacks in exchange for entering into loss-making contracts with a supplier. If this individual were covered by a D&O policy without a personal profit exclusion, the insurance carrier would be required to finance his defense in a resulting shareholder lawsuit and to pay any civil judgment on his behalf.[33] These costs would either be absorbed by the insurance carrier or passed to the executive's organization (or D&O policyholders generally) in the form of higher premiums. If the cost of the judgment were passed on as higher premiums, shareholders would ultimately bear these costs—every additional dollar spent on D&O premiums is one less dollar of shareholder profit. This would be rather perverse because, as the hypothetical shows, shareholders are often the victims when executives reap wrongfully obtained profits. In other words, without the exclusion, shareholders would essentially be financing their own damages award. In this hypothetical, shareholders would bear the costs associated with the loss-making contracts and

advantage to which such Insured was not legally entitled'"); *Brown & LaCounte, LLP v Westport Ins Corp*, 307 F3d 660, 661 n 2 (7th Cir 2002) (describing the personal profit exclusion at issue, which provided that "[t]his POLICY shall not apply to any CLAIM based upon, arising out of, attributable to, or directly or indirectly resulting from . . . any INSURED having gained in fact any personal profit or advantage to which he or she was not legally entitled"); *Alstrin v St. Paul Mercury Ins Co*, 179 F Supp 2d 376, 384 (D Del 2002) (providing the personal profit exclusion at issue, which excluded claims "arising out of, based upon or attributable to the gaining in fact of any profit or advantage to which an insured was not legally entitled"); *The American Chemical Society v Leadscope, Inc*, 2005 WL 1220746, *11 (Ohio App) (providing the personal profit exclusion, which excludes from coverage claims "arising out of, based upon or attributable to the gaining in fact of any profit or advantage to which an insured was not legally entitled"). See also Kenneth S. Abraham, *Insurance Law and Regulation* 594 (Foundation 5th ed 2010) (reproducing a sample D&O policy issued by the Chubb Insurance Company containing a personal profit exclusion).

31 See, for example, *Virginia Mason Medical Center v Executive Risk Indemnity, Inc*, 2007 WL 3473683, *4 (WD Wash) (describing the policy's fraud exclusion, which excludes "[c]laims brought about or contributed to in fact [ ] by any dishonest or fraudulent act or omission").

32 See, for example, *In re Donald Sheldon & Co,* 186 BR 364, 368 (Bankr SDNY 1995); *Axis Reinsurance Co v Bennett*, 2008 WL 2600034, *2 (SDNY) (quoting policies that require a "final adjudication adverse to the insured" as a condition precedent to application of a personal profit exclusion).

33 Unless, of course, a court voids the insurance contract as contrary to public policy, as one might if the reimbursement were for criminal penalties.

would also partially finance any judgment award through higher D&O premiums while the executive would walk away with his undeserved gains.[34]

## II. THE COURTS OF APPEALS' APPROACHES TO "IN FACT" EXCLUSIONS

In several recent diversity cases, the courts of appeals have followed different approaches for applying "in fact" exclusions in D&O liability policies.[35] The courts have articulated different evidentiary requirements for establishing the exclusion's factual trigger, as well as different rules as to when the carrier may invoke the exclusion as a defense to coverage. The Seventh Circuit allowed the carrier to deny coverage at the pleadings stage based on the language of the complaint.[36] The Fifth Circuit required a judicial determination of fact, either in the underlying action or in a separate coverage action.[37] A recent Eighth Circuit decision found a middle ground between these two approaches—requiring "some" proof that the exclusion should apply and allowing the carrier to make this showing in a separate action.[38] The remainder of this Part examines the reasoning behind the courts of appeals' respective decisions.

34 See *Nicholls v Zurich American Ins Group*, 244 F Supp 2d 1144, 1160 (D Colo 2003) (noting that personal profit exclusions prevent "the looting of corporate assets by directors and officers and then, after being forced to remit the funds, turning to an insurer seeking indemnification for their wrongful acts"). For a general argument that D&O insurance should not cover illegal profits, see *Level 3 Communications*, 272 F3d at 910 ("The interpretive principle . . . that a 'loss' within the meaning of an insurance contract does not include the restoration of ill-gotten gain—is clearly right [as a matter of public policy]."); Baker and Griffith, *Ensuring Corporate Misconduct* at 188 (cited in note 15) (describing the personal profit exclusion as "an extension of the common public policy rationale against unjust enrichment"). Corporate law tries to prevent this same mismatch of incentives by limiting corporations' power to indemnify their executives. See, for example, 8 Del Code Ann § 102(b)(7) (allowing corporations, through their certificates of incorporation, to limit the personal liability of directors, provided that, inter alia, such limitation does not apply to "any transaction from which the director derived an improper personal benefit").

35 In most insurance disputes, federal courts exercise diversity jurisdiction. Interpretation of the terms of an insurance contract (including the exclusions) is a matter of state substantive law. See Benedict M. Lenhart, et al, *Dispute Resolution*, in Jeffrey E. Thomas and Francis J. Mootz III, eds, 1 *New Appleman on Insurance* § 7.07 at 7-80 to -100 (LexisNexis 2011) (noting that state law governs insurance coverage disputes, except in cases involving bankruptcy, marine insurance, and the Foreign Sovereign Immunities Act).

36 *Brown & LaCounte, LLP v Westport Ins Corp*, 307 F3d 660, 663–64 (7th Cir 2002).

37 *Pendergest–Holt v Certain Underwriters at Lloyd's of London*, 600 F3d 562, 576 (5th Cir 2010).

38 *Wintermute*, 630 F3d at 1072–73.

A. Applying the Exclusion Based on Allegations in the Complaint

The Seventh Circuit was the first court of appeals to interpret the words "in fact" in a D&O personal profit exclusion. The case, *Brown & LaCounte, LLP v Westport Ins Corp*,[39] stemmed from the Saginaw Chippewa Indian Tribe of Michigan's (the Tribe) allegations against the law firm Brown & LaCounte (Brown). The Tribe alleged that Brown illegally retained payments for legal services under a void contract.[40] The case before the Seventh Circuit was a declaratory action filed by Brown against its insurance company, Westport Insurance (Westport). Brown sought to establish that Westport was responsible for defense costs associated with the Tribe's suit.[41] Specifically, Brown alleged that Westport had a duty to defend under the D&O policy and was therefore required to reimburse Brown for defense costs.[42] Westport argued that it was under no obligation to defend Brown, as the personal profit exclusion barred coverage.[43]

Interpreting Wisconsin law, the Seventh Circuit held that the proper way to determine if the exclusion applies is to look at the complaint against the insured.[44] If the complaint alleges that the insured received a wrongful profit from his acts, the exclusion bars coverage. In other words, if any part of the Tribe's complaint alleged that the insured at Brown unjustly profited, Westport would be absolved of any responsibility to provide defense and coverage for all the claims.

This holding reflects the Seventh Circuit's concern that an alternative rule would unduly prejudice the carrier. Specifically, the *Brown & LaCounte* panel reasoned that if the determination of whether Brown profited required some proof beyond the complaint, "an insurer could never invoke the exclusion to deny coverage without first litigating the underlying allegations."[45] To hold otherwise, according to the court, would render the exclusion "meaningless in contravention of both the plain language of the policy and the

39 307 F3d 660 (7th Cir 2002).

40 Id at 661.

41 Id.

42 See id at 661–62 ("Brown argues the district court erred in interpreting the policy's personal profit exclusion . . . and urges this court to find that Westport has a duty to defend."); Brief for Appellant-Plaintiff, *Brown & LaCounte, LLP v Westport Ins Corp*, No 02-1245, *18–19 (7th Cir filed Feb 14, 2002) (available on Westlaw at 2002 WL 32115068) ("Brown Brief") (arguing that the policy imposes a duty to defend on Westport).

43 *Brown & LaCounte*, 307 F3d at 661; Brief of Defendant-Appellee, *Brown & LaCounte, LLP v Westport Ins Corp*, No 02-1245, *7–12 (7th Cir filed May 13, 2002) (available on Westlaw at 2002 WL 32114179) ("Westport Brief").

44 *Brown & LaCounte*, 307 F3d at 662.

45 Id at 663.

parties' apparent contractual intent to exclude some kinds of claims from coverage."[46] The court further justified its holding by reasoning that because interpretation of an insurance contract is a matter of law, no factual findings are needed to apply an exclusion.[47]

While several other courts have similarly held that the applicability of an "in fact" exclusion can be determined solely by reference to the complaint,[48] the court in *Alstrin v St. Paul Mercury Ins Co*[49] adopted a slight variant of the *Brown & LaCounte* approach. The *Alstrin* opinion differed in two respects. First, the court distinguished "a profit or gain that is illegal" from "an illegal act that produces a profit or gain to the insured as a by-product," holding that the exclusion applies only in cases involving the former.[50] Under this formulation, theft and insider trading trigger the exclusion, but misrepresentations or breaches of fiduciary duty that result only in incidental profits to the insured do not.[51] Given that misrepresentations and other securities-related disclosures represent a significant fraction of shareholder litigation, this reading significantly limits the scope of the personal profit exclusion.

The *Alstrin* court's second departure from *Brown & LaCounte* relates to the analysis of the complaint. Attempting to determine whether a securities fraud complaint alleged that the insured personally profited, the court noted that "[a]lmost all securities fraud complaints will allege that the defendants did what they did in order to benefit themselves in some way. If such an allegation were sufficient to invoke [the policy's exclusion] . . . the broad coverage for 'Securities Claims' provided by the . . . policy would be rendered valueless."[52] As a solution to this problem, the court held that the analysis "must focus not only on the factual allegations, but on the elements of the causes of action that are alleged."[53] Under this approach, the exclusion applies if the success of the plaintiff's claim hinges on

46 Id.

47 See id at 663–64.

48 See, for example, *Aetna Casualty & Surety Co v Clasby*, 788 F Supp 61, 65 (D Mass 1991) (holding that a carrier can avoid its duty to defend or indemnify when it is clear the claims lie outside the scope of coverage); *International Ins Co v Johns*, 874 F2d 1447, 1470 (11th Cir 1989) (Cox specially concurring) (arguing that whether a personal profit exclusion applies depends solely on the allegations in the underlying claim).

49 179 F Supp 2d 376 (D Del 2002).

50 Id at 400.

51 See id.

52 Id.

53 *Alstrin*, 179 F Supp 2d at 400.

showing that the insured wrongfully profited.[54] Despite its attempt to mitigate the possibility—raised by *Brown & LaCounte*'s reliance on the complaint alone—that plaintiffs may strategically draft their complaints to manipulate the likelihood of coverage, the *Alstrin* approach has not adopted many adherents.

The virtue of both the *Brown & LaCounte* and *Alstrin* approaches is their simplicity. By allowing the coverage determination to be made on the pleadings (or, in the case of *Alstrin*, readily ascertainable legal distinctions), they provide bright line rules that are easy for courts to follow. On the other hand, these approaches leave the fate of the insured to the vagaries of the pleading process—a problem discussed in more detail below.[55] Perhaps unsurprisingly, given the limitations of this approach, more recent decisions by the Fifth and Eighth Circuits have taken a different path.

### B. Requiring a Judicial Determination before Applying the Exclusion

In *Pendergest–Holt v Certain Underwriters at Lloyd's of London*,[56] the Fifth Circuit had occasion to consider when Texas law requires application of an "in fact" exclusion.[57] The insured in *Pendergest–Holt* faced civil and criminal allegations that they ran a multibillion-dollar Ponzi scheme in which they defrauded investors by selling sham certificates of deposit.[58] The case before the Fifth Circuit was an appeal from a separate action brought by the insured against their D&O carrier to compel payment of their defense costs, in which the district court granted an injunction in favor of the insured.[59]

54 See id at 400 ("If an element of the cause of action that must be proved requires that the insured gained a profit or advantage to which he was not legally entitled, then, if proved, this exclusion would be applicable.").

55 See Part III.

56 600 F3d 562 (5th Cir 2010).

57 Id at 569–70.

58 See *Pendergest–Holt v Certain Underwriters at Lloyd's of London*, 681 F Supp 2d 816, 818–20 (SD Tex 2010), affd in part 600 F3d 562, 565–66 (5th Cir 2010) (summarizing the government's civil and criminal charges against the insured); Kara Scannell, Miguel Bustillo, and Evan Perez, *SEC Accuses Texas Financier Of 'Massive' $8 Billion Fraud*, Wall St J A1 (Feb 18, 2009) (reporting allegations that Stanford—the CEO and Chairman of the Board—defrauded investors by claiming high returns on funds invested in "easy-to-trade assets" but in fact made losing investments in real estate and private equity funds that suffered during the real estate downturn); Steve Stecklow, *Hard Sell Drove Stanford's Rise and Fall*, Wall St J A1 (Apr 3, 2009) (outlining the mechanics of Stanford's Ponzi scheme and reporting that authorities expect to recover less than half of $8 billion in missing assets).

59 *Pendergest–Holt*, 600 F3d at 565 ("The district court entered a preliminary injunction ordering reimbursement of defense costs pending its further order.").

The D&O policy in *Pendergest–Holt* included a duty to advance defense costs—an arrangement that allows the insured to control a carrier-funded defense.[60] When the insurance company learned that one of the executives pleaded guilty and named the others as co-conspirators, however, it retroactively denied coverage dating to the time of the guilty plea.[61] The carrier based the denial on its determination that the guilty plea established that the executive's conduct fell under the policy's money laundering exclusion. That exclusion barred coverage for losses resulting from any claim "arising directly or indirectly as a result of or in connection with any act or acts (or alleged act or acts) of Money Laundering."[62] The policy further specified that notwithstanding the money laundering exclusion, the carrier "shall pay Costs, Charges and Expenses in the event of an alleged act or alleged acts *until such time that it is determined that the alleged act or alleged acts did in fact occur*."[63] The crux of the dispute was whether the carrier was entitled to make the determination—based on the complaint—that the alleged acts occurred or whether there needed to be a judicial determination of fact.

The Fifth Circuit held that "a 'determ[ination] . . . in fact'—absent language unambiguously pointing to the underwriters as the decisionmakers—[requires] a judicial act."[64] The court accordingly affirmed the injunction "insofar as it provides for coverage until judicial determination in a separate coverage action" and remanded the case to the district court.[65]

The Fifth Circuit explained that, under Texas law, interpretation of an insurance agreement is identical to the interpretation of any other contract, meaning that the goal is to identify the intent of the parties.[66] Under Texas contract law, if the policy's language is ambiguous,

60 Some policies include this arrangement rather than the more typical duty to defend. As explained in Part IV, the duty to advance defense costs arrangement allows the insured to conduct their own defense but also allows the carrier to retain some influence. In this case, the carrier retained the discretion as to whether to advance defense costs, but the policy stated that such payments would not be unreasonably withheld. See *Pendergest–Holt*, 681 F Supp 2d at 822–23, affd in part 600 F3d at 566. See also Julie J. Bisceglia, Comment, *Practical Aspects of Directors' and Officers' Liability Insurance—Allocating and Advancing Legal Fees and the Duty to Defend*, 32 UCLA L Rev 690, 711–12 (1985) (explaining that it is common practice for D&O policyholders to seek advance payments, even in the absence of a duty to defend, and that such requests are typically granted).

61 *Pendergest–Holt*, 600 F3d at 565–66.

62 Id at 567–68 (quotation marks omitted).

63 Id at 567 (quotation marks omitted).

64 Id at 573–74 (quoting the policy).

65 *Pendergest–Holt*, 600 F3d at 576.

66 See id at 569.

the ambiguities are to be interpreted against the carrier.[67] Applying these principles to the policy, the court noted that the policy did not specify *who* was eligible to make determinations as to whether money laundering had occurred.[68] The court observed that had the underwriters wanted to reserve this right for themselves, they could have written the policy in a way that explicitly did so, and the court further speculated that Lloyd's failed to reserve the right because a policy including such a reservation would be difficult to sell.[69]

An important element of the *Pendergest–Holt* decision is that the required judicial determination may be made either in the underlying action against the insured or in a separate coverage action. The court reached this conclusion by comparing the money laundering exclusion to the policy's separate fraud exclusion. The fraud provision excluded losses "brought about or contributed to in fact by . . . any dishonest, fraudulent, or criminal act or omission by the Directors or Officers . . . as determined by a final adjudication."[70] Lloyd's argued that the inclusion of an explicit judicial determination requirement in the fraud exclusion implies that the "in fact" language in the money laundering exclusion requires a lower threshold of proof.[71] In response to this argument, the court decided the "final adjudication" language in the fraud exclusion requires a judicial determination *in the underlying action*, while its absence in the money laundering exclusion indicates that the determination could be made in a separate coverage action.[72]

The court speculated that the carrier bargained for the more ambiguous language in the money laundering exclusion—requiring coverage "until such time that *it is determined* that the alleged act or alleged acts did in fact occur"[73]—to preserve its option to litigate a separate coverage dispute.[74] In sum, the court's holding indicates that both the "final adjudication" and the "in fact" language require a

67 Id ("[I]f a policy is susceptible to more than one reasonable interpretation . . . Texas law requires [it] to be construed against the insurer and in favor of the insured—in other words, in favor of coverage.") (quotation marks omitted). See also *Rules of Construction*, Lee R. Russ and Thomas F. Segalla, eds, 2 *Couch on Insurance* §§ 22:14, 22:15 (Thomson Reuters 2011) ("The words, 'the contract is to be construed against the insurer' comprise the most familiar expression in the reports of insurance cases.").

68 See *Pendergest–Holt*, 600 F3d at 570.

69 See id at 571.

70 Id at 566–67 (quotation marks omitted) (quoting the policy's fraud exclusion for contrast with the money laundering exclusion).

71 Id at 571.

72 *Pendergest–Holt*, 600 F3d at 573.

73 Id at 569 (emphasis added).

74 See id at 573.

judicial decision maker, but that only the "in fact" language allows a separate coverage proceeding.[75]

While the Fifth Circuit is the first court of appeals to follow this approach, several lower courts have similarly required judicial findings of fact to invoke the exclusion.[76] Further, at least one court has adopted something of a hybrid between the *Brown & LaCounte* and *Pendergest–Holt* approaches. Bound by precedent, the Central District of Illinois first applied the *Brown & LaCounte* pleadings analysis in *St. Paul Mercury Ins Co v Foster*.[77] The court distinguished *Brown & LaCounte*, however, reasoning that it was possible to apply the exclusion in that case only because the complaint clearly alleged an *illegal* profit.[78] Noting that nothing in the complaint against the insured in *Foster* alleged that they gained an illegal personal profit,[79] the court concluded that a judicial determination would be required for the exclusion to have effect.[80] In other words, the *Foster* court appeared willing to follow the *Brown & LaCounte* rule if the complaint clearly alleged the specific elements required by the exclusion but, failing such allegations, was willing to await a later judicial determination. It bears noting that the court's conclusion was not identical to that in *Pendergest–Holt*, however, as it specified that this judicial determination had to be in the underlying action.[81] The *Foster* court's approach is therefore less permissive than the Fifth Circuit's, which allows a separate coverage action.

### C. Requiring "Some Proof" that the Exclusion Should Apply before Barring Coverage

The underlying dispute in *Wintermute* concerned the indictment of Susan Wintermute—a board member of Sinclair National Bank (SNB)—for fraud, including filing false statements in connection

75 See id at 572.

76 See, for example, *Virginia Mason Medical Center v Executive Risk Indemnity Inc*, 2007 WL 3473683, *5 (WD Wash) (holding that the phrase "in fact" requires a factual finding in either the underlying action or in a separate coverage action); *The American Chemical Society v Leadscope, Inc*, 2005 WL 1220746, *12 (Ohio App) (holding that there must be a final adjudication to determine whether an "in fact" exclusion applies, but not specifying whether this determination could be made in a separate proceeding).

77 268 F Supp 2d 1035 (CD Ill 2003).

78 Id at 1046.

79 See id at 1045.

80 See id (holding that, because whether the insured are "legally entitled" to retain their personal profits must be determined at trial, "any determination as to whether an insured in this case gained personal profit in fact must await resolution of the underlying litigation").

81 See *Foster*, 268 F Supp 2d at 1045.

with her purchase of SNB.[82] By the time the Eighth Circuit decided the case—which was a separate coverage dispute under Arkansas law—Wintermute had been convicted on several charges but was cleared of all wrongdoing during her tenure as a director of SNB.[83] Wintermute claimed that her carrier, Kansas Banker Surety Company (KBS), wrongly refused to defend her in the criminal action in derogation of its duty to defend.[84] KBS argued that it was not obligated to pay for Wintermute's defense because her conduct fell under the ambit of the policy's personal profit exclusion.[85]

The court ruled in favor of Wintermute, holding that "[t]o give effect to [the meaning of the words 'in fact'], the insurer cannot deny a defense based solely on the allegations in the complaint unless the facts are uncontested."[86] Unlike the Fifth Circuit in *Pendergest–Holt*, the Eighth Circuit in *Wintermute* did not take the additional step of requiring a judicial determination of those facts.[87] Rather, the court held only that a finding "in fact" requires "some evidentiary proof that the insured reaped an illegal profit."[88]

This holding rejected the district court's approach, consistent with *Brown & LaCounte*, that the court should determine whether the exclusion applies based solely on the pleadings in the underlying action.[89] Noting that scrutiny of the pleadings is the proper analysis for determining whether the complaint triggered the duty to defend, the court distinguished that question from the question of whether an exclusion applies.[90] In the *Wintermute* court's view, determining whether the duty to defend applies (whether there is coverage) is analytically distinct from the question of whether an exclusion strips coverage.[91] The court indicated that the significance of this distinction is that an exclusion cannot bar coverage "[a]bsent absolute clarity on

82 See *Wintermute*, 630 F3d at 1065–66 (explaining that some charges against Wintermute predated her tenure as a director).

83 Id (convicting Wintermute of two counts related to the false filings made associated with their purchase of SNB but acquitting her of four criminal charges related to activities *after* the bank was purchased and while she was a director).

84 See id at 1065.

85 See Brief for Appellee/Cross-Appellant, *McAninch v Kansas Bankers Surety Co*, No 05-2798, *23–24 (8th Cir filed Dec 13, 2005) (available on Westlaw at 2005 WL 5265858) ("KBS Brief").

86 *Wintermute*, 630 F3d at 1072.

87 See id.

88 Id, quoting *PMI Mortgage Ins Co v American International Specialty Lines Ins Co*, 2006 WL 825266, *7 (ND Cal) (quotation marks omitted).

89 See *Wintermute*, 630 F3d at 1071–72.

90 Id at 1071 ("While *coverage* is determined based on the allegations in the complaint, we are dealing here with an *exclusion* issue, not with a coverage issue.").

91 Id, citing *Madden v Continental Casualty Co*, 922 SW2d 731, 734 (Ark App 1996).

the face of the complaint" that it applies.[92] It further noted that to apply the exclusion solely based on the complaint's allegations of personal profit would effectively read the words "in fact" out of the exclusion.[93]

Much like the Fifth Circuit in *Pendergest–Holt*, the Eighth Circuit in *Wintermute* interpreted the "in fact" language by conducting a comparative reading of the policy's various exclusions.[94] The other exclusions barred coverage for actions "involving" various prohibited activities, unlike the personal profit exclusion, which required that the insured have profited from his activities "in fact."[95] The court found this distinction significant and determined that the word "involving" covered any conduct alleged in the pleadings, while "in fact" required additional proof.[96] The court did not clarify what would constitute sufficient "additional proof." The court did, however, establish that the insured's acquittal on underlying criminal charges is not sufficient to preclude application of the exclusion.[97] By the time Wintermute's case reached the Eighth Circuit, Wintermute had been acquitted of her criminal charges, but the court declined to rely on the acquittal as evidence that Wintermute had not engaged in wrongdoing sufficient to trigger the exclusion and instead remanded for further proceedings.[98]

The *Wintermute* approach to the interpretation of "in fact" is relatively unique,[99] perhaps because the decision is so recent or perhaps because it sets out a vague standard. This ambiguity is especially problematic in the interpretation of insurance policies, as it makes it difficult for the parties to adjust the terms of their policy to achieve predictable outcomes. In sum, while the *Wintermute* decision avoids the all-or-nothing nature of the *Brown & LaCounte* and *Pendergest–Holt* approaches—where the coverage determination is made either

92 *Wintermute*, 630 F3d at 1071 (quotation marks omitted), quoting *Lorenzo v Capitol Indemnity Corp*, 928 NE2d 1274, 1278 (Ill App 2010).

93 *Wintermute*, 630 F3d at 1071 (noting that "gaining in fact" should be given some meaning by the court and consequently rejecting the proposal to rely solely on the allegations in the complaint of personal gain).

94 See id at 1071–72.

95 See id; KBS Brief at *22 (listing several other exclusions in the policy, none of which use the words "in fact").

96 *Wintermute*, 630 F3d at 1071–72 ("Whether an insured in fact gained a personal profit is a fact issue that must be decided by a trier of fact if the relevant evidence is disputed.").

97 Id at 1074.

98 See id (distinguishing the issue of whether the government could establish the elements of the charged crimes from the issue of whether the exclusions apply because of the heightened burden of proof required in criminal trials).

99 One case, cited in *Wintermute*, followed a similar approach. See *PMI Mortgage*, 2006 WL 825266 at *5.

at the outset of the litigation based on the pleadings or at its conclusion—the decision is unsatisfactory in that it would create a perpetual state of uncertainty for the parties.

## III. THE CURRENT APPROACHES TO APPLYING "IN FACT" EXCLUSIONS FAIL TO PROVIDE SUFFICIENT CLARITY FOR LITIGANTS

Where do *Brown & LaCounte*, *Pendergest–Holt*, and *Wintermute* leave carriers and D&O policyholders? The answer, unfortunately, is not clear. This Part discusses the shortcomings of the current approaches in interpreting D&O "in fact" exclusions and then explains why it would be difficult for carriers to resolve these problems by changing policy language.

### A. Each of the Approaches Adopted by the Courts of Appeals Has Significant Drawbacks

*Brown & LaCounte*'s method of assessing whether the exclusion applies based on the pleadings is undesirable because it might make the plaintiff's choice of forum outcome determinative in many coverage disputes. As alluded to earlier,[100] the variation in pleading requirements from state to state,[101] as well as the fact that federal pleading standards are undergoing a period of change,[102] leaves the insured in a tenuous position. Imagine, for example, what would happen if shareholders sued an executive for breaching the duty of loyalty to the organization by disclosing confidential information to a competitor. If the shareholders brought suit in a notice-pleading jurisdiction or in federal court, they might only need to allege that the executive disclosed the information to the competitor, doing so was a breach of his duty, and the shareholders are entitled to relief.[103] To successfully plead a claim for breach of the duty of loyalty in a code-pleading regime like Illinois,[104] however, the plaintiff might need to allege specific

100 See note 55 and accompanying text.

101 Compare Del Ch Ct R 8(a) (requiring only that pleadings contain a "short and plain statement of the claim" and a demand for relief), with Ill Rev Stat ch 735 § 5/2-603 (requiring complaints to include, in addition to a short and plain statement, factual allegations that satisfy each element of the cause of action alleged).

102 See Morgan Smith, *On Notice: The Supreme Court's Recent Decisions Regarding Heightened Pleading Requirements Leave Much to Be Desired*, 10 Appalachian J L 47, 57–62 (2010) (arguing that the heightened pleading requirements developed in recent Supreme Court cases have resulted in unclear standards). See also *Ashcroft v Iqbal*, 556 US 662 (2009); *Bell Atlantic Corp v Twombly*, 550 US 544 (2007).

103 See FRCP 8.

104 See Ill Rev Stat ch 735 § 5/2-603.

facts indicating that the executive advanced his own interests at the expense of the organization.[105] In this hypothetical, the *Brown & LaCounte* approach would require the carrier to reimburse defense costs in the federal case because the pleadings would not contain sufficient detail to bar coverage under the exclusion. On the other hand, a complaint that satisfied Illinois's pleading requirements would likely contain enough detail to invoke the exclusion, thereby absolving the carrier of coverage responsibilities. This seems anomalous—surely the parties did not intend the availability of coverage to be so sensitive to the plaintiff's choice of forum.[106] Indeed, federal courts are supposed to prevent this kind of situation when hearing diversity cases. As the Supreme Court has explained:

> [T]he intent of [*Erie*] was to insure that, in all cases where a federal court is exercising jurisdiction solely because of the diversity of citizenship of the parties, the outcome of the litigation in the federal court should be substantially the same . . . as it would be if tried in a State court.[107]

The *Pendergest–Holt* and *Wintermute* approaches, insofar as each requires some level of proof beyond the pleadings, avoid these problems. However, both of these approaches have issues of their own. First, both approaches leave many questions about their mechanics unanswered. For example, neither opinion makes it clear when the insured may bring a separate coverage action—must the insured await receipt of a complaint in the underlying action, or can the insured seek coverage as soon as the plaintiff threatens suit? Wait until the suit begins and the carrier declines to advance defense costs? In the case of *Wintermute*, as noted above, there is even greater uncertainty.[108] It is not even clear what quantum of proof is needed to invoke the exclusion. Such uncertainty frustrates the ability of the parties to draft policies that lead to predictable outcomes.

Second, neither approach accounts for whether the policy includes a duty to defend. As discussed in Part V, whether a policy includes a duty to defend or a duty to advance defense costs should be

105 See *Maercker Point Villas Condominium Association v Szymski*, 655 NE2d 1192, 1194 (Ill App 1995) ("Once [a fiduciary] relationship exists in a corporate setting, a fiduciary has the duty to act with utmost good faith and loyalty in managing the corporation and is prohibited from enhancing his or her own personal interests at the expense of corporate interests.") (quotation marks omitted).

106 See *Fitzpatrick v American Honda Motor Co*, 575 NE2d 90, 94 (NY 1991) ("[A]n insured's right to a defense should not depend solely on the allegations a third party chooses to put in the complaint.").

107 *Guaranty Trust Co v York*, 326 US 99, 109 (1945).

108 See text accompanying notes 96–100.

an important factor in resolving "in fact" exclusion disputes. In duty to defend policies, part of what the insured pays for is the right to have the carrier conduct the insured's defense at trial, which would allow carriers to avoid this obligation by seeking a judicial determination at the outset of the trial and would therefore frustrate the insured's expectations.

In sum, relying on the pleadings to determine whether an "in fact" exclusion applies has the odd effect of making the plaintiff's choice of forum a significant determinant of whether the carrier must provide coverage for the defense. Requiring a judicial determination is also fraught with difficulties. No court has made clear how such a system would work in practice, and allowing carriers to avoid their defense obligations by filing separate suits is inconsistent with their obligations under the duty to defend.

## B. Changing Policy Language to Solve the "In Fact" Problem Would Be Difficult

It seems reasonably certain that if carriers were to rewrite their policies to include language that requires, for example, "a final adjudication by a federal or state court in the underlying action or separate coverage proceeding," courts would follow the Fifth Circuit's approach. However, were carriers to take this step, their expected payouts under the policy would rise, as they would incur defense costs in cases that otherwise would have fallen under an exclusion. Carriers might not be able to pass the cost of this increased risk on to the insured due to the current state of the D&O insurance market.[109] Insurance markets are characterized by an underwriting cycle that oscillates between a "hard market" (where underwriting standards tighten, resulting in higher premiums) and a "soft market" (where underwriting standards relax in response to competitive pressure).[110] As the D&O insurance market has been soft for the past several years—and does not appear to have hit the bottom of the cycle[111]—it

109 See *Soft Market Reaching Bottom, RIMS Says*, Natl Underwriter Prop & Casualty 10 (Aug 22/29, 2011) (reporting that, in a survey of four commercial insurance lines, three had price declines of less than 1 percent, but that D&O policies fell by 4.5 percent); Susanne Sclafane, *Commercial Prices Still above Prior Soft Market, Advisen Index Reveals*, Natl Underwriter Prop & Casualty 12 (July 18, 2011) (noting that despite price declines in commercial insurance since 2005, inflation-adjusted market prices were still 15 percent higher than at year-end 2000).

110 See Baker and Griffith, *Ensuring Corporate Misconduct* at 55 (cited in note 15) (describing underwriting cycles generally).

111 See *S&P "Sceptical" about D&O Insurance Market*, Future & Options Intelligence 84 (May 19, 2011) (quoting an S&P report "expect[ing] [D&O] prices to continue to fall," and

would likely be difficult for carriers to raise premiums. While carriers might be able to pass on rate raises if they act in concert with one another—avoiding the possibility of a unilateral first mover losing market share—such concerted action might be difficult.[112]

A change in language attempting to require the *Brown & LaCounte* approach—language excluding, for example, coverage for claims in which the complaint alleges that the insured personally profited—seems like an even less workable option for carriers. As the insured would likely object to such a change as an attempt to weaken coverage, carriers face the same first-mover problem outlined above: a unilateral change by one carrier may induce the insured to switch carriers. Indeed, there is reason to think that weakening the terms of coverage might be one policy change that is especially likely to prompt the insured to shop for different coverage. D&O beneficiaries are often the ultimate decision makers within their organizations and have an obvious incentive not to reduce the scope of D&O liability coverage, as reductions might put their personal assets at risk.[113] The executives that benefit personally from D&O insurance might not be the only individuals in an organization that would resist reducing the scope of D&O coverage; corporate risk managers, who are often responsible for the initial selection of D&O policies, have an incentive to secure broad coverage. As "their superiors will tend to view loss from an ex post point of view," the worst-case scenario for a risk manager is an adverse judgment that is not covered by the policy.[114] Accordingly, there is reason to think that corporate decision makers systematically prefer broader D&O coverage.

Even if carriers were able to solve this problem with a change in policy language, there would still be a lengthy transition period during which litigation would arise from policies containing the current language. Further, changing the language of insurance policies is a difficult process that carriers are reluctant to undertake, as policy changes impact a number of aspects of a carrier's operations, and

noting that "because of uncertainty . . . the D&O business' current and future profitability could be questioned").

112 Although, such concerted action is perhaps not illegal. Depending on a given state's insurance regulation scheme, collective rate setting might not run afoul of federal antitrust law. See *In re Workers' Compensation Ins Antitrust Litigation*, 574 F Supp 525, 531 (D Minn 1983) (explaining that concerted insurance rate setting, even if it would normally violate federal antitrust law, may fall under the McCarran-Ferguson Act's antitrust exemption).

113 See Baker and Griffith, 95 Georgetown L J at 1834 (cited in note 1) (explaining that top executives are likely to resist attempts to cut costs by reducing D&O coverage).

114 Baker and Griffith, *Ensuring Corporate Misconduct* at 74–75 (cited in note 15) (arguing that "[r]isk manager agency costs" lead to overinvestment in D&O insurance coverage).

might even require prior approval from state insurance regulators.[115] Therefore, there does not seem to be a short-term way to remove the uncertainty surrounding "in fact" exclusions by redrafting policy language. Reconciling the current state of the law regarding "in fact" exclusions would thus be helpful to carriers and insureds alike—and careful application of the common law duty to defend doctrine might achieve this result.

## IV. THE DUTY TO DEFEND AND THE COMPLAINT ALLEGATION RULE

In many ways, determination of whether a D&O insurance "in fact" exclusion applies is no different from coverage litigation in any other insurance context. In other insurance coverage disputes, the first question courts often ask is whether the policy includes a duty to defend.[116] Although many D&O policies contain this duty, courts have failed to consistently apply the common law duty to defend doctrine to resolve "in fact" exclusion disputes. This Part sets out the duty to defend doctrine and then explains how it relates to D&O insurance. Part V argues that courts should borrow from the common law duty to defend doctrine in deciding D&O "in fact" exclusion cases.

### A. Triggering the Duty to Defend

The duty to defend is a staple provision of most liability insurance policies.[117] This duty stems from language in the agreement between the carrier and the insured. It is generally not imposed by

115 See Jeffrey W. Stempel, *Interpretation of Insurance Contracts: Law and Strategy for Insurers and Policyholders* § 10.7 at 304–09 (Aspen 1994) ("[C]hanging the standard form insurance policy is a somewhat arduous process that requires contributions from legal, claims, actuarial, and other industry personnel as well as customers and state insurance regulators."). Indeed, there is evidence that insurance carriers have been reluctant or unable to redraft their policies to respond to coverage disputes. See Abraham, *Insurance Law* at 650 (cited in note 30) (noting that although "the issue has been the subject of litigation for over twenty years," carriers have failed to amend their policies to ensure that they recoup the cost of defending claims that fall outside the scope of coverage).

116 See notes 90–91 and accompanying text.

117 See Abraham, *Insurance Law* at 624 (cited in note 30) (explaining that most liability insurance policies include a duty to defend); Charles Silver, *Does Insurance Defense Counsel Represent the Company or the Insured?*, 72 Tex L Rev 1583, 1594 (1994) (explaining that primary liability insurance policies contain the duty to defend); Robert E. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 Harv L Rev 1136, 1137–38 (1954) (stating that liability insurance policies typically include a duty to defend); Plitt, Maldonado, and Rodgers, *Insurer's Duty to Defend* §§ 200:1, 200:8 (cited in note 7).

law, but it is nonetheless understood to be a core component of liability insurance policies.[118] When the duty to defend attaches, carriers have an obligation to conduct the defense of the insured at trial. The carrier's responsibility includes hiring the defense counsel and conducting the litigation. This approach makes the defense less costly for both the carrier and the insured.[119] The carrier is a repeat player and thus better able to negotiate favorable rates with defense counsel. Further, this arrangement avoids the principal-agent problems that would arise if the insured could simply pass defense bills on to the carrier.[120]

There is extensive case law defining the circumstances in which the duty to defend attaches. Although the duty is contractual, carriers have left the determination of when it attaches to the courts.[121] The normal rule—called the "complaint allegation rule"—provides that the duty to defend "arises whenever allegations against the insured state a claim which is *potentially* within the scope of the policy's coverage, even if such allegations are groundless, false or fraudulent."[122] Any ambiguity is to be resolved in favor of the insured.[123]

Exclusions do not allow the carrier to avoid its duty to defend if the applicability of the exclusion depends on facts to be proven at

118 See, for example, *FACE, Festivals and Concert Events, Inc v Scottsdale Ins Co*, 632 F3d 417, 420 (8th Cir 2010) (noting the duty to defend is contractual); *Fitzpatrick v American Honda Motor Co*, 575 NE2d 90, 93 (NY 1991) (same); Plitt, Maldonado, and Rogers, *Insurer's Duty to Defend* § 200:5 (cited in note 7) (same); Glad, Barker, and Barnes, *Liability Insurance* § 16.06 at 16-147 to -171 (cited in note 23) (explaining that liability carriers have both the duty to defend and the duty to indemnify and distinguishing indemnity policies, which contain only the duty to indemnify).

119 See Silver, 72 Tex L Rev at 1594–97 (cited in note 117) (arguing that both the insured and the carrier benefit from requiring the carrier to control the defense as the carrier is better able to control costs, and the insured benefits from the carrier's expertise, risk tolerance, ability to select counsel, and bargaining power).

120 See Baker and Griffith, *Ensuring Corporate Misconduct* at 129–30 (cited in note 15).

121 See Abraham, *Insurance Law* at 624 (cited in note 30):

> [I]nsurance policies state the duty [to defend] in general terms; insurers have not taken the opportunity to specify the scope and limits of the duty. The courts have therefore stepped into this vacuum and created a body of common law rules governing the duty. Apparently carriers can live with these rules and have not revised their policies to alter these common law rules.

122 *Beckwith Machinery Co v Travelers Indemnity Co*, 638 F Supp 1179, 1186 (WD Pa 1986) (quotation marks omitted). See also *Exterovich v City of Kellogg*, 80 P3d 1040, 1042 (Idaho 2003) ("The duty to defend arises upon the filing of a complaint containing allegations that, in whole or in part and read broadly, reveal a potential for liability that would be covered by the insured's policy."); *General Agents Ins Co of America v Midwest Sporting Goods Co*, 828 NE2d 1092, 1098 (Ill 2005); Plitt, Maldonado, and Rogers, *Insurer's Duty to Defend* §§ 200:11, 200:19 (cited in note 7) (explaining when a complaint triggers the duty to defend and collecting state cases).

123 See Plitt, Maldonado, and Rogers, *Insurer's Duty to Defend* § 200:23 (cited in note 7).

trial.[124] To successfully invoke an exclusion to avoid coverage, the carrier must establish *as a matter of law* that all of the facts alleged in the complaint fall within the scope of an exclusion thereby demonstrating that there is no possibility that the claim would be covered.[125] Note that here, as before, ambiguity in the meaning of exclusions is interpreted against the carrier.[126] As explained by one New York court, "To negate coverage by virtue of an exclusion, a carrier must establish that the exclusion is stated in clear and unmistakable language, is subject to no other reasonable interpretation, and applies in the particular case."[127] For example, one Maryland court held that a policy's duty to defend did not attach because the complaint alleged only fraud claims, and an exclusion clearly stated that the policy excluded all claims except those for negligence.[128] The carrier prevailed because factual proof of whether the insured committed fraud was irrelevant; no interpretation of the facts would transform a fraud claim into a negligence claim.[129]

Two other rules highlight how difficult it is for a carrier to avoid its duty to defend. In most jurisdictions, if any one of the claims might be covered, the carrier must defend against all the claims in the complaint.[130] Some jurisdictions go further, requiring the carrier

124 See *Equine Assisted Growth and Learning Association v Carolina Casualty Ins Co*, 266 P3d 733, 736 (Utah 2011) ("Where factual questions render coverage uncertain . . . the insurer must defend until those uncertainties can be resolved against coverage.") (quotation marks omitted); Seth D. Lamden, *Duty to Defend*, in Thomas and Mootz, eds, 3 *New Appleman on Insurance* § 17.01[2][a] at 17-9 to -14 (cited in note 23).

125 See Lamden, *Duty to Defend* § 17.01[2][a] at 17-9 to -14 (cited in note 124).

126 See *Rules of Construction* § 22:31 (cited in note 67).

127 *Pepsico, Inc v Winterthur International America Ins Co*, 13 AD3d 599, 600 (NY Sup Ct 2004) (quotation marks omitted), quoting *Belt Painting Corp v TIG Ins Co*, 795 NE2d 15, 17 (NY 2003). See John T. Harding and Caryn L. Anlage, *Triggering the Duty to Defend*, *Insurer's Duty to Defend* 1, Part IV.C (DRI 2005) (explaining that to avoid coverage when there is a duty to defend, a carrier must prove that the complaint falls "so clearly within the scope of an exclusion that there is no potential for coverage"); Plitt, Maldonado, and Rogers, *Insurer's Duty to Defend* § 200:15 (cited in note 7) ("An insurer can establish the absence of potential coverage by showing that a policy exclusion applies, and that there is no other reasonable interpretation of the policy language that would allow for coverage."); Lamden, *Duty to Defend* § 17.01[2][a] at 17-9 to -14 (cited in note 124) ("An insurer is not obligated to defend a suit when it can establish, as a matter of law, that . . . all of the facts alleged in the complaint fall solely and entirely within the scope of policy exclusions, thereby eliminating any potential for covered liability.").

128 *Moscarillo v Professional Risk Management Services, Inc*, 921 A2d 245, 250–53 (Md App 2007).

129 Id at 253.

130 See Plitt, Maldonado, and Rogers, *Insurer's Duty to Defend* § 200:25 (cited in note 7) (reporting that a majority of jurisdictions require a carrier to defend against all claims—including those that have no possibility of being covered—as long as there is one potentially covered claim); Lamden, *Duty to Defend* § 17.01[3][a] at 17-23 to -24 (cited in note 124)

to defend the insured even when the complaint does not allege a covered claim. In these jurisdictions, if the carrier possesses or is made aware of extrinsic evidence indicating that the claim might be covered, it must defend.[131] Taken together, these rules characterize a rather robust duty in which the carrier has an obligation to defend any time a claim could conceivably fall within the scope of coverage.

These rules also reflect the general principle that the duty to defend is broader than the duty to indemnify. In other words, the carrier is obligated to defend the insured against a broader set of claims than that for which it must reimburse the insured for the cost of an adverse judgment or settlement.[132] Judge Learned Hand explained that this corresponds to the likely intent of the parties—namely that the carrier would pay for the defense of all the claims that ultimately fall within the policy's coverage.[133] This expectation would be frustrated if the carrier did not defend against claims that were not clearly within the scope of coverage at trial, but later turned out to be covered.[134] By requiring the carrier to defend in a broader set of cases than those in which it must indemnify, the rule ensures that the insured will have the benefit of defense of all covered claims. In duty to defend policies, therefore, there should not be cases in which the duty to defend does not attach but where the carrier is responsible for indemnifying losses.[135]

("Virtually all courts agree that if an action involves both potentially covered and noncovered claims . . . the insurer must defend the entire action.").

131 See *Revelation Industries, Inc v St. Paul Fire & Marine Ins Co*, 206 P3d 919, 926 (Mont 2009) ("[I]nsurers are not entitled to simply ignore factual information supplied to them by their insureds but not alleged in the complaint or petition, where those facts would trigger a duty to defend."); *Hartford Casualty Ins Co v Litchfield Mutual Fire Ins Co*, 876 A2d 1139, 1146 (Conn 2005). See also Plitt, Maldonado, and Rogers, *Insurer's Duty to Defend* §§ 200:21, 200:22 (cited in note 7) (noting that in some jurisdictions extrinsic facts might create but not terminate the duty to defend).

132 See *Beckwith Machinery Co*, 638 F Supp at 1186; *Fitzpatrick*, 575 NE2d at 92.

133 *Lee v Aetna Casualty & Surety Co*, 178 F2d 750, 752 (2d Cir 1949).

134 See Lamden, *Duty to Defend* § 17.01[1][a] at 17-6 (cited in note 124) ("Many insureds purchase liability insurance for the peace of mind that comes with knowing that their insurer will defend them if they are sued in an action that comes within the scope of protection provided by their policy.").

135 See *Crum and Forster Managers Corp v Resolution Trust Corp*, 620 NE2d 1073, 1081 (Ill 1993) (holding that there can be no duty to indemnify where there is no duty to defend). This situation—where the carrier does not defend against covered claims—sometimes arises when carriers breach the contract. In these cases, the insured can recover contract damages, which include defense and judgment costs. This situation also has other adverse consequences for the insurer. It must pay defense costs and the costs of any judgment, but will not have had the opportunity to ensure the policyholder mounted an effective defense. Further, some jurisdictions prevent insurers from asserting coverage defenses when the duty to defend has been breached, while others impose punitive damages. See Lamden, *Duty to Defend* § 17.07[1] at 17-45 to -47 (cited in note 124).

B. Extinguishing the Duty to Defend

Once the duty to defend has been triggered, the carrier is responsible for conducting the defense until the conclusion of the lawsuit or until every claim that could fall within the policy's coverage is eliminated.[136] If a carrier is able to establish that the duty no longer applies before the end of the trial, the carrier may stop financing the defense but generally may not recover costs expended up until that point.[137] This rule is consistent with the notion that the duty to defend is distinct from the duty to indemnify—it is an independent obligation that applies whenever there is the possibility of coverage. Conversely, if it is determined that the carrier expended defense costs but there was *never* a proper basis for triggering the duty to defend, it may attempt to recover those costs.[138]

Notwithstanding this general rule, there is a split of authority as to whether carriers should be allowed to recoup costs expended under the duty to defend when the carrier has agreed to defend subject to a reservation of rights. This situation is common when the carrier believes that the duty to defend does not exist but does not want to risk breaching the terms of the policy by refusing to defend.[139] Most recent decisions have not allowed the carrier to recover, emphasizing that the duty to defend is a distinct obligation that must be met *whenever* there is uncertainty as to whether a claim is within the scope of coverage.[140] In jurisdictions that allow carriers to recover defense costs expended under a reservation of rights, application of the complaint allegation rule does not reduce the uncertainty facing litigants, but this uncertainty is unavoidable unless those jurisdictions change their rule.

In the event that the insured suffers an adverse judgment, determination of whether the carrier must indemnify the insured is a

136 See Plitt, Maldonado, and Rogers, *Insurer's Duty to Defend* § 200:47 (cited in note 7) ("[A]n insurer's duty to defend . . . lasts until the conclusion of the underlying lawsuit, or until it has been shown that there is no potential for coverage."); Lamden, *Duty to Defend* § 17.05[1] and [3] at 17-37 to -39 and 17-41 to -42 (cited in note 124) (explaining that if a plaintiff files an amended complaint omitting claims that triggered the duty to defend or if facts are established that preclude the possibility of coverage, the carrier may be relieved of its obligation to defend).

137 See Plitt, Maldonado, and Rogers, *Insurer's Duty to Defend* § 200:47 (cited in note 7) ("When an insurer's duty to defend the insured is extinguished before the conclusion of the action . . . it is extinguished only prospectively and not retroactively.").

138 See *Scottsdale Ins Co v MV Transportation*, 115 P3d 460, 462–63 (Cal 2005).

139 See, for example, *American and Foreign Ins Co v Jerry's Sport Center, Inc*, 2 A3d 526, 532 (Pa 2010) (acknowledging the split); Glad, Barker, and Barnes, *Liability Insurance* § 16.11[2] at 16-215 to -218 (cited in note 23) (collecting cases).

140 See *American and Foreign Ins*, 2 A3d at 605–09, 618.

separate inquiry from that concerning the duty to defend.[141] The determination is separate because the duty to indemnify is only triggered when the insured is found to actually be liable for covered damages.[142] In other words, the key difference is that the duty to indemnify requires a final judicial determination of liability.[143] In many cases, however, the duty to defend decision substantially overlaps with the question of whether the carrier must indemnify for the cost of a judgment. After all, if at any point during the litigation the carrier could demonstrate that the claims were outside the scope of coverage, it would do so to avoid its defense obligations.[144] Litigated disputes over the duty to indemnify are therefore rare,[145] which suggests that the underlying trials sufficiently clarify factual issues necessary to resolve disputes or to facilitate settlement.[146]

### C. The Duty to Defend and D&O Insurance

D&O insurance is unique relative to other forms of liability insurance in that D&O policies do not always include a duty to defend.[147] Smaller organizations often have D&O policies that include the duty to defend, but larger firms tend to have policies that instead include a duty to advance defense costs.[148] In this arrangement, the insured control their own defense of claims against them and the carrier periodically advances sums to the insured for the cost of this defense.[149] The carrier retains the right to "associate" with the defense: it is entitled to obtain certain information, to consent to settlement, and to specify a list of defense counsel from which the insured must choose.[150] Moreover, the carrier retains the prerogative to control the cost of the defense in some ways including by negotiating with

141 Glad, Barker, and Barnes, *Liability Insurance* § 16.06[3][a] at 16-162 to -164 (cited in note 23).

142 See id.

143 See id; *Buss v Superior Court*, 939 P2d 766, 773 (Cal 1997) ("The insurer's duty to indemnify runs to claims that are actually covered, in light of the facts proved. By definition, it entails the payment of money in order to resolve liability.") (citations omitted).

144 See Glad, Barker, and Barnes, *Liability Insurance* § 16.06[3][a] at 16-162 to -164 (cited in note 23) ("[W]here there is a unitary coverage issue—one that affects the duties to defend and indemnify alike—the duty to defend will subsume the duty to indemnify, and vice versa.").

145 See id at § 16.06[1] at 16-147 to -149.

146 See id.

147 See, for example, Abraham, *Insurance Law* at 596 (cited in note 30) (reproducing a D&O policy stating that the duty to defend rests with the insured, but that the carrier will reimburse for defense costs).

148 See Bailey, 702 PLI/Lit at 219 (cited in note 21).

149 See Baker and Griffith, *Ensuring Corporate Misconduct* at 130 (cited in note 15).

150 See id.

defense counsel and by "monitoring counsel to reduce unnecessary discovery or motion practice."[151]

According to commentators, D&O insurance differs from other lines of liability insurance in this regard because the D&O insured have a strong preference for controlling their own defenses.[152] Professors Tom Baker and Sean Griffith point to two reasons that have been advanced to explain why D&O policies do not include a duty to defend. First, the conventional explanation is that some defense lawyers and corporate risk managers do not trust D&O insurance companies "to act in the insured corporation's best interests once a claim has arisen."[153] Second, Professors Baker and Griffith advance their own explanation, arguing that while mistrust plays a role, D&O policies allow the insured to control their defenses because "that is the structure D&O insurance buyers prefer."[154] This preference for controlling their own defense likely reflects D&O insured's higher level of sophistication—as compared to personal liability policyholders—and comfort with retaining and managing their own counsel. Whatever the reason, duty to advance defense costs policies are much more common in the D&O context than in other lines of insurance.

In cases concerning D&O policies that contain a duty to defend, courts have applied the complaint allegation rule in the same manner as in non-D&O cases: once the court determines that the pleadings show there is a possibility that the claim will be covered, the carrier is bound to finance the defense. For example, in *HomeBank of Arkansas v Kansas Bankers Surety Co*,[155] the court applied the complaint allegation rule and required the carrier to defend, notwithstanding the carrier's claim that various exclusions applied, including an "in fact" exclusion.[156] The next Part argues that extending and developing this approach presents a superior framework for resolving the applicability of "in fact" exclusions than those espoused by the courts of appeals.

151 Id at 132.

152 See id at 131–32. But see Bisceglia, 32 UCLA L Rev at 707–08 (cited in note 60) (arguing that the absence of the duty to defend in D&O cases is due to underwriters' attempts to avoid this coverage).

153 Baker and Griffith, *Ensuring Corporate Misconduct* at 130–31 (cited in note 15).

154 Id at 121–36 (concluding that the mistrust of insurers does not explain why some D&O policies lack a duty to defend, as the incentives between the insured and the carriers are *more* closely aligned in the D&O context than in other insurance lines contexts and arguing that carriers may prefer to control the defense).

155 2008 WL 2704670 (ED Ark).

156 See id at *7 (dismissing the carrier's claims that various exclusions—including an "in fact" personal profit exclusion—should bar coverage).

## V. A DUTY TO DEFEND APPROACH TO D&O "IN FACT" EXCLUSIONS

Most courts that have considered whether a D&O insurance "in fact" exclusion applies have not relied heavily on the duty to defend doctrine in reaching their decisions.[157] This Part argues that these courts have neglected to appreciate the role this doctrine can play in harmonizing the application of "in fact" exclusions with other areas of insurance law. Specifically, it argues that a plain reading of "in fact" exclusions suggests that they can *never* be invoked to avoid the duty to defend.

Such a reading of the exclusion dovetails with the core principle of the complaint allegation rule, which requires the carrier to fund the defense if there is any possibility of coverage. Because "in fact" exclusions require that a condition be established before the exclusion applies, they necessarily imply that the carrier is responsible for defending against the claim until the factual trigger is proven. A contrary reading would deprive the words "in fact" of any meaning. Since the facts needed to trigger the exclusion cannot be established (absent stipulation) by the pleadings, "in fact" exclusions can never categorically bar coverage at the pleading stage. There is *always* a possibility—and a possibility is all that the complaint allegation rule requires[158]—that the plaintiff will be unable to establish the exclusion's factual trigger. Thus, in D&O policies that include a duty to defend, courts should *never* allow a carrier to assert an "in fact" exclusion to avoid its defense obligations.

This approach distinguishes between D&O policies that contain a duty to defend and those that contain a duty to advance defense costs. Unlike the duty to advance defense costs, the duty to defend is broader than the duty to indemnify. Accordingly, when an insured has a duty to defend policy, part of what he has purchased is the right to be defended until the "in fact" ambiguity is resolved. In other words, the carrier's coverage of the cost of defense is part of the policy. Therefore, under this Comment's approach, regardless of the ultimate outcome of the exclusion dispute, the insured is entitled to

157 The Fifth Circuit briefly considered the issue in *Pendergest–Holt* but did not pursue it because the policy explicitly stated that the carrier did not have the duty to defend. *Pendergest–Holt*, 600 F3d at 566. In *Brown & LaCounte*, the court stated that its task was to decide whether Westport had a duty to defend, but its analysis did not comport with the normal common law analysis, as discussed below. *Brown & LaCounte*, 307 F3d at 662–64. See notes 185–89 and accompanying text. Similarly, the court in *Wintermute* rejected the duty to defend doctrine as irrelevant for making the determination of whether an exclusion applies to a given case. *Wintermute*, 630 F3d at 1071.

158 See notes 124–28 and accompanying text.

this coverage, and the carrier cannot deny it or claw it back. By contrast, duty to advance defense costs policies contain no obligation to defend in cases where the carrier would not be responsible for indemnification of the insured's losses. Therefore, in cases involving duty to advance defense costs policies, this Comment's approach does not require carriers to pay defense costs until after the resolution of the underlying action, at which time the parties can rely on the trial record to determine if the exclusion applies.

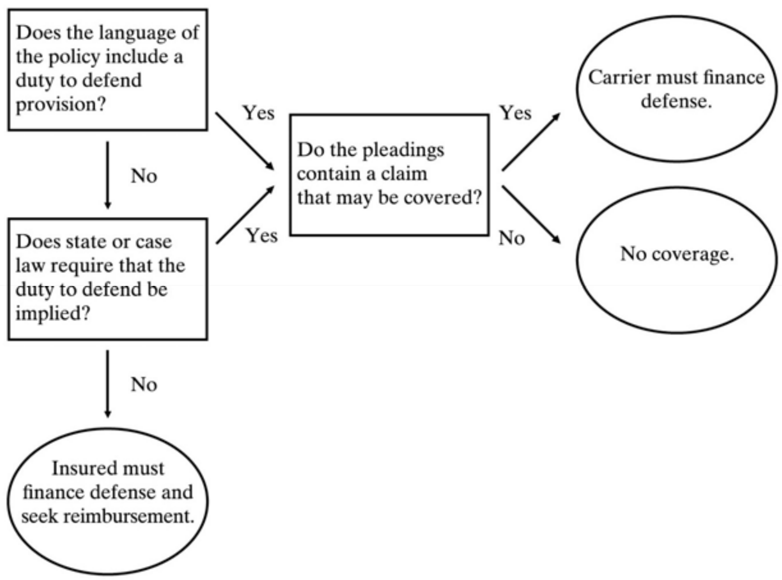
This Part first explains when and how courts should apply the duty to defend analysis to these cases. It then discusses the advantages of this approach. Last, it concludes with an analysis of how this approach would have worked in the cases discussed in Part II.

### A. Mechanics of Applying the Duty to Defend Approach to "In Fact" Exclusions

Figure 1 sets out a graphical overview of this Comment's proposed approach. When confronted with the task of determining whether an "in fact" exclusion applies, courts should first determine whether the policy contains a duty to defend. Ordinarily, of course, this will be a matter of consulting the language of the policy, which might explicitly specify whether there is such a duty. Courts should also inquire whether state law or precedent requires them to read an implied duty to defend into policies that do not contain one.[159] If other law does require such an implied duty, courts should treat the policy in the same way as one that explicitly includes the duty to defend.

[159] See, for example, Cal Civil Code § 2778 (imposing a duty to defend unless the policy indicates otherwise); *Combs v International Ins Co*, 354 F3d 568, 598–99 (6th Cir 2004) (holding, in a D&O case, that even if there is no duty to defend the insurer should advance defense costs); Harding and Anlage, *Triggering the Duty to Defend* at Part I.C.1 (cited in note 127) (noting that some courts have implied a duty to defend where one is not included in the policy).

FIGURE 1




In assessing whether a policy contains a duty to defend, courts should not equate the duty to advance defense costs found in many D&O policies with the duty to defend.[160] As this Part argues more fully below, equating these duties fails to give effect to meaningful differences in D&O policy language. The one exception to this rule is that courts should treat the duty to defend and the duty to advance defense costs identically if clearly established state law requires that they do so.[161]

Consider first what a court should do after it determines a policy contains the duty to defend. In these cases, the court should apply the complaint allegation rule: if any of the alleged claims potentially fall within the scope of coverage, the court should require the carrier to advance defense costs. Moreover, as noted above, even if the

160 See, for example, *Pendergest–Holt v Certain Underwriters at Lloyd's of London*, 681 F Supp 2d 816, 828 (SD Tex 2010) (applying the duty to defend doctrine notwithstanding that the policy disclaimed the duty), affd in part 600 F3d 562, 574 (5th Cir 2010) (declining to equate the duty to advance defense costs with the duty to defend). See also Plitt, Maldonado, and Rogers, *Insurer's Duty to Defend* § 200:4 (cited in note 7) (noting that the duty to defend is distinct from the duty to reimburse defense costs).

161 See, for example, *Wedtech Corp v Federal Ins Co*, 740 F Supp 214, 221 (SDNY 1990) (explaining that New York law equates the duty to defend and the duty to advance defense costs). See also Ostrager and Newman, *Handbook on Insurance Coverage Disputes* § 20.02[h][3][i] at 1525–27 (cited in note 9) (collecting cases following both approaches).

complaint does not allege facts within the possible scope of coverage, the carrier may still need to defend if it becomes aware of extrinsic facts indicating that coverage is possible.[162] In almost all D&O cases, this would result in a determination in favor of the insured.

As discussed above, in "in fact" exclusion disputes, even if the complaint alleges facts that, if proved, would satisfy the exclusion's trigger, the duty *still* attaches.[163] The carrier would need to defend, at least until the factual condition is proved or the complaint is narrowed in a way that removes its allegations from the scope of coverage.[164] Consistent with the principle that the duty to defend is broader than the duty to indemnify, this approach avoids situations where the insured is held liable for a covered claim but did not have the benefit of the carrier's defense.[165] At the conclusion of the underlying action, if there remains any dispute as to whether the factual conditions necessary to support the exclusion have been established, a carrier may seek a declaratory judgment.[166] A successful declaratory judgment would allow the carrier to avoid indemnifying the insured for the cost of an adverse judgment but would not allow the carrier to recoup the defense costs.[167] This situation is most likely to arise in cases that settle, as the parties may have had less of an opportunity to develop the factual record.

If the court determines that the policy includes a duty to advance defense costs and the carrier disputes coverage, the court should not require it to finance the defense. If the factual record in the underlying action ultimately indicates that the claim should have been covered, however, the court should allow the insured to bring a separate coverage action.

## B. Benefits of the Duty to Defend Approach

This approach to "in fact" exclusions has a number of advantages relative to the approaches followed in cases described in Part II.

First, it preserves the common law's presumption in favor of coverage when there is a duty to defend. This presumption is preserved only where it is warranted—namely where the parties have included

162 See note 131 and accompanying text.

163 See note 122 and accompanying text.

164 See notes 122–31 and accompanying text.

165 See notes 132–35 and accompanying text.

166 See Plitt, Maldonado, and Rogers, *Insurer's Duty to Defend* § 200:48 (cited in note 7). This resembles *Pendergest–Holt*, except that the carrier would need to show that there was no possibility of coverage before filing the declaratory action.

167 Plitt, Maldonado, and Rogers, *Insurer's Duty to Defend* § 200:48 (cited in note 7).

the duty to defend in the policy. Applying the complaint allegation rule when the policy includes only a duty to advance defense costs imposes a greater burden on the carrier than the parties intended.

Consider, for example, the policy in *Pendergest–Holt*, which explicitly disclaimed the duty to defend: "It shall be the duty of the Directors and Officers . . . and not the duty of the Underwriters to defend Claims."[168] To use the complaint allegation rule in a case like this, as the district court in *Pendergest–Holt*[169] and other courts have done,[170] fails to honor the intent of the parties to assign defense costs to the insured.[171] One can think of the parties' choice to opt for a duty to advance defense costs policy, rather than a duty to defend policy, as a decision to reserve coverage disputes until after the conclusion of the underlying action. This makes sense in light of the differences in the parties' expectations in duty to advance defense costs versus duty to defend cases. In duty to defend cases, the carrier is not entitled to recover defense costs expended, even if it is ultimately determined that the claims fall outside the scope of coverage.[172] By contrast, duty to advance defense costs agreements allow the carrier to claw back defense costs in the event that the parties agree or a judge decides that an exclusion applies.[173] Thus, the terms of duty to advance defense costs policies contemplate resolution of coverage issues after the conclusion of the underlying action.

The exception to this rule noted above[174]—that courts should equate the duty to defend and the duty to advance defense costs when required to do so by state law[175]—also conforms to the parties' expectations. In such cases, the parties know (or should know) that the state's law treats the duty to defend and the duty to advance defense costs in the same way. Accordingly, in these states the application of the

168 *Pendergest–Holt*, 681 F Supp 2d at 823.

169 *Pendergest–Holt v Certain Underwriters at Lloyd's of London*, 681 F Supp 2d 816 (SD Tex 2010).

170 See id at 828; *The American Chemical Society v Leadscope, Inc*, 2005 WL 1220746, *8 (Ohio App).

171 Note that the terms of the *Pendergest–Holt* policy did contemplate ongoing reimbursement of defense costs, but the carrier conditioned these payments on its prior written consent. See *Pendergest–Holt*, 681 F Supp 2d at 823.

172 See note 137 and accompanying text.

173 See, for example, *Pendergest–Holt*, 681 F Supp 2d at 823–24 (quoting a policy provision requiring the insured to reimburse the carrier if an exclusion is found to apply).

174 See note 161 and accompanying text.

175 Note that this was not the case in *Pendergest–Holt*, 600 F3d at 574 (noting that no Texas state court had applied a duty to defend doctrine to a duty to advance defense costs case).

complaint allegation rule is an expected consequence of including a duty to advance defense costs in the policy.

Second, this approach sensibly balances the equities involved in personal profit cases. It honors the expectations of both parties to D&O policies that include a duty to defend: the insured expect to be covered from the outset of litigation unless they did something wrongful to enrich themselves, and carriers expect to have some meaningful opportunity to cease coverage when it is clear that the insured broke the policy's rules. Given the uncertainty inherent in "in fact" exclusion disputes—insofar as they turn on whether the carrier can demonstrate the exclusion's prerequisite facts—no rule can fully vindicate both the carrier's and the insured's interests at the outset of a dispute. As discussed above, however, there is a good chance that the insured's interests may be totally frustrated in cases where the carrier refuses to defend a suit that should have been covered.[176] By contrast, requiring carriers to defend in accord with the common law duty to defend rules does not pose the same threat of irreversible harm. Carriers are accustomed to the operation of the rules from other lines of insurance and should therefore have no difficulty pricing their effects into the policy; they can therefore shift the incremental costs to the market as needed. Given the choice, therefore, between protecting the insured's interests or the carrier's, it makes sense to err on the side of protecting the insured. Nor does this unduly burden the ability of the carrier to avoid incurring defense and indemnification costs once it is clear that the insured reaped a wrongful personal profit; it merely requires that the carrier wait until there is factual proof of wrongdoing, as the wording of the exclusion suggests.

Third, interpreting the complaint allegation rule as requiring the carrier to defend "in fact" exclusion cases avoids a separate coverage action whenever possible. By reading the duty to defend as requiring a carrier-provided defense in all "in fact" exclusion cases, the determination of whether the exclusion applies is delayed until after the factual record in the underlying trial is complete. As facts relevant to the exclusion are likely to be highly relevant to the insured's liability in the underlying action, they are likely to come out in that trial.[177]

176 See notes 134–35 and accompanying text.

177 Consider, for example, personal profit exclusions. In many of these cases, the underlying complaint against the insured will be that he took an action adverse to the organization's financial interests for his own gain. In such a case, proving the harm to the organization—which is what would be necessary for the stakeholder to recover—would almost certainly entail the discovery of financial records showing where the money went. If the insured "in fact" profited, these records would likely make that abundantly clear.

The resulting factual record should obviate the need for most coverage disputes; it will often be apparent to both parties whether the exclusion's factual trigger is satisfied, thereby eliminating the need to litigate.

Of course, there might be some cases where a carrier would try to establish the exclusion's trigger in a declaratory action to avoid indemnifying the insured. In these cases, coverage litigation under a duty to defend policy would look very similar to coverage litigation under a duty to advance defense costs policy. Both would take place at the end of the underlying action, once the court determined that the insured was liable for damages. There are, however, two differences between how a declaratory action would proceed in a duty to defend case and in a duty to advance defense costs case. First, in a duty to defend case, the carrier would have the burden of proving that the exclusion applies to relieve it of its duty to indemnify.[178] This is so because, as discussed above, once the duty to defend attaches, the carrier has the burden of establishing that the claims are not covered. If it is unable to do so, the duty to indemnify attaches once the insured is liable for a judgment.[179] Conversely, in a duty to advance defense costs case, the insured has the burden of establishing that he is entitled to coverage. A second difference between duty to defend and duty to advance defense costs coverage litigation is that the insured can recover defense costs in duty to advance defense cost cases, but the carrier cannot recover previously spent defense costs in duty to defend cases. This is so because the duty to defend, by its nature, contemplates a carrier's expenditure of defense costs in cases where it is not ultimately responsible for indemnification costs (for example, in the case of a groundless suit).[180] Notwithstanding these two differences, coverage litigation would proceed in essentially the same way in duty to defend and duty to advance defense costs cases. Accordingly, this Comment's approach would reduce the frequency of separate coverage actions and, when they do occur, would standardize the timing and availability of evidence from the underlying litigation against the insured across all D&O "in fact" exclusion disputes.

Fourth, because "in fact" exclusion disputes will be litigated only after the underlying action in the context of separate coverage actions, this Comment's approach settles the question of what level of evidentiary proof is needed to invoke the exclusion. In all "in fact"

178 As discussed above, this will likely be difficult. See note 144 and accompanying text.

179 See notes 141–46 and accompanying text.

180 See note 122 and accompanying text.

exclusion disputes, a court will decide whether the factual trigger has been met based on the evidence from the underlying trial, as well as other fact-finding if needed.[181] In either case, the factual determination will be judicial.

It bears noting here that although the complaint allegation rule relies on the pleadings to determine whether an "in fact" exclusion applies, it does not suffer from the same shortcomings as the *Brown & LaCounte* approach.[182] When coverage denials that cannot be relitigated are made based on the pleadings—as in *Brown & LaCounte*—the insured is denied a chance to demonstrate that exclusion does not apply. Under this Comment's approach, the question is deferred until the conclusion of the underlying action, thus avoiding the problems related to varying pleading standards described above.[183] This result is consistent with the general principle that ambiguities in insurance policies are to be construed against the carrier.[184]

### C. Application of the Duty to Defend Approach to *Brown & LaCounte*, *Pendergest–Holt*, and *Wintermute*

To shed light on how this Comment's approach would work in practice, consider the ways in which the outcome of all three cases discussed in Part II would be different under this Comment's approach.

The *Brown & LaCounte* court applied the exclusion based on the complaint against the insured, but this Comment's approach would have required the carrier to defend Brown. The language in Brown's policy appeared to include a duty to defend, as it included language typical of that duty.[185] Accordingly, under Wisconsin's duty to defend common law, the court should have required the carrier to finance Brown's defense against the Tribe's complaint until the conclusion of the case.[186] In the actual case, the court determined—despite the ambiguity of the "in fact" exclusion and the policy's grant

181 Such fact-finding might be needed, for example, in a coverage dispute where the underlying litigation settled before discovery or in a criminal trial where the insured was acquitted but where the carrier thinks it may be able to establish wrongdoing under the less-exacting civil preponderance of the evidence standard.

182 See notes 100–07 and accompanying text.

183 See notes 101–04 and accompanying text.

184 See *Rules of Construction* §§ 22:14, 22:15 (cited in note 67).

185 See Brown Brief at *4–5 (providing that Westport shall "have the right and duty to select counsel . . . and to defend any CLAIM for LOSS against any INSURED covered by [the policy], even if such CLAIM is groundless, false or fraudulent").

186 See *Estate of Sustache v American Family Mutual Ins Co*, 751 NW2d 845, 851 & n 8 (Wis 2008) (explaining that Wisconsin courts apply exclusions after the duty to defend determination in a separate coverage suit or at the conclusion of underlying suit).

of coverage for "any" claim[187]—that Westport did not have a duty to defend.[188] This decision thus stands at odds with both the rule that a carrier cannot avoid the duty to defend unless coverage is impossible and the common law's preference to resolve ambiguities in favor of the insured.[189]

*Pendergest–Holt*'s outcome would also be different under this Comment's approach.[190] The policy did not contain a duty to defend, so the carrier would not be obligated to finance the defense.[191] The insured could bring a separate action at the conclusion of the underlying case to seek reimbursement for coverage (if warranted) after that case concluded.[192] In other words, while the Fifth Circuit demanded that the carrier provide coverage until it could prove that the exclusion applied,[193] this Comment's approach would require the defendant-insured to finance his own defense until he could prove that the exclusion did not apply. This corresponds with the clear intent of the parties in specifying that the policy did not contain a duty to defend.[194] *Pendergest–Holt* also illustrates the extent to which this Comment's approach could help avoid separate coverage litigation. In the actual case, litigation of the coverage issue required four separate opinions,[195] suggesting that the goal of judicial economy would have been well served by application of this Comment's approach, which would require only one coverage action at the conclusion of the underlying action against the insured.

Under the facts of *Wintermute*, this Comment's approach would have required the insurer to cover the plaintiff-insured's criminal defense costs.[196] In the actual case, the Eighth Circuit remanded for

187 See Westport Brief at *4.

188 Compare *Brown & LaCounte*, 307 F3d at 664 (holding that the "in fact" exclusion obviates Westport's duty to defend but failing to consider the exclusion's ambiguity), with *Smith v Katz*, 595 NW2d 345, 353–54 (Wis 1999) (explaining that under Wisconsin law courts "liberally construe" the complaint and "assume all reasonable inferences" in favor of coverage) (quotation marks omitted).

189 See *Rules of Construction* §§ 22:14, 22:15 (cited in note 67).

190 See Part II.B.

191 See *Pendergest–Holt*, 600 F3d at 566.

192 See id at 576.

193 See id.

194 See note 158 and accompanying text.

195 See generally *Pendergest–Holt*, 681 F Supp 2d 816 (SD Tex 2010); *Pendergest–Holt*, 600 F3d 562 (5th Cir 2010); *Pendergest–Holt v Certain Underwriters at Lloyd's of London*, 2010 WL 1903595 (SD Tex) (clarifying burdens applicable on remand); *Pendergest–Holt v Certain Underwriters at Lloyd's of London*, 751 F Supp 2d 876 (SD Tex 2010) (considering the merits on remand to the Southern District of Texas).

196 See Brief for Appellant, *Wintermute v Kansas Bankers Surety Co*, No 09-2806, *23 (8th Cir filed Oct 13, 2009) (available on Westlaw at 2009 WL 3459541) (arguing that Wintermute is entitled to reimbursement for the costs of her criminal defense).

determination of whether Wintermute actually profited and indicated that if she did, she would not be entitled to recover her defense costs.[197] Under this Comment's approach, however, Wintermute would be entitled to recover these *defense* costs regardless of whether she in fact profited.[198] Her policy contained a duty to defend, and since the question of whether she personally profited remained unresolved at the time of her criminal trial, she was entitled to a defense. A contrary rule—one allowing the carrier to avoid coverage because the criminal trial against Wintermute was inconclusive as to whether she wrongfully profited[199]—would create a perverse incentive for carriers. A carrier could behave as KBS did in *Wintermute*—refusing to fulfill its duty to defend responsibilities in breach of the policy[200]—and then benefit from this misconduct by availing itself of the resulting trial record. Allowing this sort of strategic behavior would eviscerate the duty to defend, as carriers would have every incentive to take a wait-and-see approach, leaving the insured to finance their own defenses.

* * *

As suggested by these examples, applying the complaint allegation rule in "in fact" exclusion cases is straightforward. This ease of application, coupled with the existing body of precedent, should substantially increase parties' ability to predict the outcome of personal profit exclusion disputes.

## CONCLUSION

The problems posed by interpreting "in fact" exclusions are familiar issues in insurance law. In litigation involving other lines of insurance, courts have, over time, determined that the best way to give effect to the intent of both parties in policies containing a duty to defend is through the complaint allegation rule. There is little reason to treat D&O insurance any differently. Indeed, it is puzzling why courts have not recognized that the interpretive difficulties regarding "in fact" exclusions are just a slight variant on an old theme. Recognizing that the common law rule invoking the duty to defend whenever there is a possibility of coverage—as there always is with "in

197 See *Wintermute*, 630 F3d at 1074.

198 If Wintermute was seeking reimbursement for criminal fines or a civil judgment, she would *not* be entitled to recover these costs if KBS could prove the exclusion applied—this would be an issue of the duty to indemnify, not one of the duty to defend. See id at 1071.

199 See id at 1074.

200 See id at 1065.

fact" exclusions—provides a way to resolve "in fact" exclusion disputes in a manner that is sensitive to the interests of all parties involved.

It might be that over time, D&O carriers and policyholders will settle this question themselves by revising the language of D&O policies. Until then, however, there seems to be little reason to discard these common law tools when they offer a ready solution to a problem that has vexed the courts.