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SOUTHERN DISTRICT CIVIL PRACTICE ROUNDUP

Expert Analysis

Saved by Ambiguity: Preliminary Injunction Granted for D&O Coverage

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With increased prosecutorial and regulatory focus directed at holding individuals to account and the steady drumbeat of private shareholder litigation aimed at individual defendants, adequate insurance coverage for officers and directors is indispensable for corporate executives and directors. But generous policy limits may provide false comfort. Southern District Judge Paul Engelmayer's decision in *XL Specialty Insurance v. Level Global Investors,*[1] serves as a warning that the conduct of a single covered individual can jeopardize coverage for the entire group of insureds in a way few might have anticipated.

In *Level Global*, the primary D&O insurer for Level Global and several of its officers (collectively, the Level Global parties) asserted that it was relieved of any duty to cover defense costs for the Level Global parties because of one "renegade" employee's prior knowledge of undisclosed facts giving rise to a claim. The Level Global parties sought and obtained a preliminary injunction requiring the insurer to continue to advance defense costs. They prevailed only because the court found that the policy was ambiguous on the question of whether a single insured's undisclosed knowledge was sufficient to void coverage for "innocent insureds" in connection with a related claim. Thus, despite the positive result for the insureds in *Level Global*, the case raises serious questions as to whether the very risk companies and their employees are trying to insure against in a D&O policy can result in forfeiture of that coverage.

Legal Fees

The policy in *Level Global* was issued by XL in April 2010 and covered claims for approximately 60 of its directors, officers and employees made during the ensuing year. In November 2010, the FBI executed a search warrant at Level Global's offices, and Level Global soon found itself defending parallel civil and criminal investigations by the SEC and U.S. Attorney's Office. Level Global sought and initially obtained coverage from XL for defense of itself and several of its officers and directors. Ultimately, Level Global's cofounder, Anthony Chiasson, was indicted for insider trading and the SEC brought civil securities fraud charges against both Chiasson and Level Global.[2]

The same day that the SEC filed its complaint, the U.S. Attorney's Office also unsealed an information against a former Level Global research analyst, Spyridon Adondakis, to which Adondakis had pled guilty some nine months earlier. In his plea allocution, Adondakis had admitted receiving non-public, material information which he shared with others at Level Global, knowing that the information would be used to execute trades.[3]

Six weeks after the Adondakis information and plea were unsealed, XL notified Level Global that it would no longer advance defense costs related to the government actions. XL also brought suit in the U.S. District Court for the Southern District of New York against the Level Global parties seeking a declaratory judgment that Adondakis's admitted crimes relieved XL of its duty to cover Level Global's defense costs. In addition, XL sought to recover approximately $7.3 million it had already advanced to the Level Global defendants under the primary policy. The Level Global parties countered with a motion for a preliminary injunction compelling XL to continue advancing defense costs.

The Policy Provisions

XL supported its decision to cease coverage on two companion provisions of the insurance application submitted by Level Global. First, the application asked whether "any person(s) or entity(ies) proposed for this insurance [is] aware of any fact, circumstance or situation which might afford valid grounds for any claim such as would fall within the scope of the proposed insurance[.]"[4] Level Global answered "no."

That question was followed by a "prior knowledge exclusion" providing that: "[A]ny Claim arising from any claims, facts, circumstances or situations required to be disclosed in response to [the above question] is excluded from the proposed insurance."[5] XL's position was that because Adondakis—who fell within the class of persons proposed for coverage by the insurance—was aware of facts giving rise to the claim for which coverage was sought, the claim fell within the "prior knowledge exclusion" because those facts were not disclosed in the application.

The Level Global parties relied on two other provisions of the application in opposing XL's position and in support of their motion for preliminary injunction. The first was an attestation, printed in boldface and capital letters, containing a reasonable inquiry provision:

> For the purpose of this application, the undersigned authorized agent of the person(s) and entity(ies) proposed for this insurance declares that to the best of their knowledge and belief after reasonable inquiry, the statements herein are true and complete. The insurer is authorized to make any inquiry in connection with this application.[6]

The 'Level Global' decision serves as a warning that the conduct of a single covered individual can jeopardize coverage for the entire group of insureds in a way few might have anticipated.

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Only Level Global's general counsel/chief operating officer had signed the application.[7] The second was a clause in the application providing that "[n]o knowledge or information possessed by any Insured will be imputed to any other Insured." The Level Global parties argued that when the "prior knowledge exclusion" was read in tandem with these other provisions of the application, the exclusion was at best ambiguous as to whether XL could terminate benefits for all insured parties based on the undisclosed knowledge of one.

Engelmayer's Analysis

Engelmayer analyzed Level Global's motion under the standard test for a preliminary injunction, which requires that a movant "establish that he is likely to succeed on the merits, that he is likely to suffer irreparable harm in the absence of preliminary relief, that the balance of equities tips in his favor, and that an injunction is in the public interest."[8] He noted that a higher showing is required for the entry of a mandatory injunction than for a prohibitory injunction, and that the parties disagreed as to whether the injunction sought by the Level Global parties was mandatory or prohibitive.

He concluded that the Level Global parties had the better argument, observing that "[b]ut for XL's unilateral decision to terminate advancement and file suit, it would have been XL, not the Insureds, that would have been seeking an injunction (and to alter the status quo)." Because the status quo to be preserved "'is the last actual, peaceable uncontested status which preceded the pending controversy,'" the preliminary injunction sought by the Level Global parties was prohibitory.[9] In those circumstances, he noted, the "likelihood of success" prong of the preliminary injunction standard can be satisfied by a showing of sufficiently serious questions going to the merits to make them a fair ground for litigation and a balance of hardships tipping decidedly toward the party requesting injunctive relief.

Although XL conceded at oral argument the issue of irreparable harm, Engelmayer found that "spare concession…quite inadequate to capture the full extent of the harm and risk to these Insureds presented by XL's decision to abruptly stop paying their defense costs." He went on to list several factors aggravating the Level Global parties' irreparable harm including the severity of the charges at issue, the typical price tag of defending against such charges, the cost of changing lawyers and getting them up to speed, the difficulty most individuals would have in affording counsel of similar quality, and the inability to access excess liability insurance until the primary policy was exhausted.

Engelmeyer concluded that the Level Global parties' "need to access additional legal defense costs from XL…[was] immediate and concrete, and that in the absence of the requested injunction, [they] would suffer irreparable harm and sustain 'extreme or very serious damage.'"[10]

Weighed against this severe harm, Engelmayer found that XL faced "at most the loss of an additional $2.7 million," the balance on Level Global's policy at the time of the motion. He further noted that XL could recoup that money should a court eventually find that XL had no duty to advance Level Global's defense costs. In these circumstances, he concluded that "the balance of hardships tips, not only decisively but lopsidedly, in favor of" the Level Global parties.

The court's assessment of the Level Global parties' likelihood of success on the merits turned on the interaction between the "prior knowledge exclusion" and reasonable inquiry provision in the policy application. XL argued that the plain terms of the "prior knowledge exclusion" combined with Adondakis's knowledge of his own fraudulent conduct allowed it to disclaim coverage of defense costs related to that undisclosed conduct. Even though only one employee had knowledge of facts that could form the basis of the claim, XL maintained that coverage of the claim could be excluded as to all insureds.

The Level Global parties argued that the reasonable inquiry provision narrowed the "prior knowledge exclusion" such that the exclusion applied only to claims the application's signatory could have discovered after reasonable inquiry. They bolstered their argument with reference to the provision in the application that disallowed imputation of knowledge from one employee to another.

Finding that the interplay between the particular clauses at issue in the XL policy presented a question of first impression, Engelmayer concluded that both sides' interpretations of the contract were plausible. He found that the Level Global parties had made a strong argument that the reasonable inquiry attestation informs the "prior knowledge exclusion" such that the signatory's negative response to the question as to whether any of the proposed insureds were aware of facts or circumstances that could give rise to a claim under the policy was not an "omniscient statement that no proposed insured knew of a disqualifying 'fact, circumstance, or situation." He concluded that the Level Global parties' position that the signatory's answer to that question was bounded by his own knowledge after reasonable inquiry "jibes with common sense."[11]

Engelmayer also found some logic in XL's argument that language in the reasonable inquiry provision, stating that the statements in the application are true "to the best of their knowledge and belief," meant that the provision referred to all of the proposed insureds, and that the signatory was thus "attesting, omnisciently, that each proposed insured" knew of no disqualifying fact or circumstance.

Engelmayer next considered whether either proposed construction led to an absurd result. He agreed with the Level Global parties' contention that XL's construction of the contract would permit the undisclosed actions of a single renegade employee to jeopardize the insurance coverage for which they had bargained, and that a rational reading of the exclusion would be to exclude the malefactor from coverage rather than the whole universe of insureds. Citing cases finding that prior knowledge exclusions, even if draconian as applied to innocent insureds, are a bargained for method of limiting an insurer's liability, Engelmayer concluded, however, that XL's construction could not be condemned as against public policy or leading to an absurd result. Faced with each side having advanced a plausible interpretation of the policy, Engelmayer relied upon the New York canon of interpretation of insurance contracts requiring that ambiguities be resolved in favor of the insured and concluded that the Level Global parties had raised a "sufficiently serious claim" to make the interpretation of the contract a fair ground for litigation, and issued the injunction.

> Despite the positive result for the insureds in 'Level Global,' the case raises serious questions as to whether the very risk companies and their employees are trying to insure against in a D&O policy can result in forfeiture of that coverage.

Conclusion

Level Global was able to obtain an injunction because the language of its insurance application created enough ambiguity to raise a plausible interpretation supporting coverage. While insurance carriers will undoubtedly seek to remove such ambiguity from D&O policies in the future, lawyers advising companies seeking D&O coverage will need to be sensitive to the risk posed by a single renegade employee.

1. 874 F. Supp. 2d 263 (S.D.N.Y. 2012).
2. Id. at 266–67. Chiasson was formerly represented by the authors' law firm.
3. Id. at 267–68.
4. Id. at 268.
5. Id.
6. Id. at 269.
7. Id. at 286 n.17.
8. Id. at 270 (quoting *Litwin v. OceanFreight*, 865 F. Supp. 2d 385, 391–92 (S.D.N.Y. 2011) (Engelmayer, J.)).
9. Id. at 271-72 (quoting *LaRouche v. Kezer*, 20 F.3d 68, 74 n. 7 (2d Cir.1994) (internal citations omitted)).
10. Id. at 276 (quoting *Cacchillo v. Insmed*, 638 F.3d 401, 406 (2d Cir. 2011)).
11. Id. at 285.

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