RECENT DEVELOPMENTS AFFECTING THE LIABILITY OF PROFESSIONALS, OFFICERS, AND DIRECTORS

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I. LEGAL MALPRACTICE

A. *Assignment of Legal Malpractice Claims*

A majority of states prohibit the assignment of legal malpractice claims. Courts rationalize this prohibition largely on public policy grounds, including the need to preserve the integrity of the judicial process and the attorney-client relationship.[1] A minority of states refuse to adopt a general

1. *See generally* Kevin Pennell, Note, *On the Assignment of Legal Malpractice Claims: A Con-*

prohibition of the assignment of these claims. These courts essentially reason that the assignment of legal malpractice claims does not necessarily offend the public interest.[2]

Solidifying the majority view, an appellate court in Indiana recently clarified that the Indiana rule prohibiting assignments of legal malpractice claims was a "bright-line rule" and was *not* restricted to assignments to the assignor's former adversary. In *Rosby Corp. v. Townsend, Yosha, Kline & Price*,[3] the court noted that the Indiana Supreme Court previously had held that legal malpractice claims could not be assigned, and commented upon the rationale for the ruling:

> It is apparent that the court was concerned with the impact of assigning *any* legal malpractice claim, not merely assignments to an adversary. If legal malpractice claims were freely assignable, then undoubtedly a market to buy and sell such claims would emerge, ultimately leading to the treatment of such claims as a commodity. This outcome would denigrate the unique fiduciary relationship that exists between a client and an attorney.[4]

The court also noted that recognition of assignment of these claims would make insolvent, underinsured, judgment-proof defendants (who might be perceived as more likely to assign claims against counsel) extremely unattractive clients, which would make it harder for them to obtain legal representation. The court also expressed concern about the risk of collusion between the assignor and the assignee.[5] The court concluded that all assignments of legal malpractice claims were contrary to public policy.

In *Essex Insurance Co. v. Tyler*,[6] the U.S. District Court for the District of Colorado considered whether Colorado courts would permit an excess insurer to bring a malpractice action against the defense attorney who represented the insured, acting pursuant to its right of subrogation. The court predicted that the Colorado Supreme Court would not permit a subrogating insurer to pursue such a malpractice claim. The importance that the Colorado Supreme Court places on the existence of an attorney-client relationship as a predicate for malpractice claims was noted. The court also cited the emphasis placed by Colorado courts on the "highly confidential and fiduciary relationship" between the attorney and the client, and the "compromised duty of loyalty to the attorney's client based on the anticipation of possible legal malpractice claims by third parties."[7] The district

tractual Solution to a Contractual Problem, 82 Tex. L. Rev. 481, 482 (2003) (collecting and discussing cases).

2. *Id.* at 490–91.

3. 800 N.E.2d 661 (Ind. Ct. App. 2003)

4. *Id.* at 665–66 (citing and discussing Picadilly Inc. v. Raikos, 582 N.E.2d 338, 342 (Ind. 1991)).

5. *Id.* at 666.

6. 309 F. Supp. 2d 1270 (D. Colo. 2004).

7. *Id.* at 1274 (citing Capitol Indem. Corp. v. Fleming, 58 P.3d 965, 969 (Ariz. 2002)).

court acknowledged that courts in some of the states that prohibited assignment of legal malpractice claims nonetheless recognized the right of insurers to pursue malpractice claims on the basis of equitable subrogation, but concluded that Colorado would not follow them.[8]

In *Silver v. Klehr, Harrison, Harvey, Branzburg & Ellers, LLP*,[9] the U.S. District Court for the Eastern District of Pennsylvania assumed that champerty could be a defense to an assigned legal malpractice claim even though Pennsylvania recognizes assignments of these claims. In *Silver*, the defendant law firm represented an investment partnership in connection with claims arising from its holdings in a petroleum corporation. After a settlement was reached in a securities class action brought on behalf of a class that included the investment partnership, the defendant firm neglected to file a timely proof of claim. The investment partnership assigned its legal malpractice claims to Silver, who brought suit in his own name. The law firm moved for an order substituting the investment partnership for Silver as the real party in interest or, alternatively, to dismiss. The firm argued that, even though Pennsylvania recognized the assignability of legal malpractice claims, the assignment was still unenforceable because it was champertous. The court noted that although "[t]he precise relationship between the doctrine of champerty and the assignment of legal malpractice claims under Pennsylvania law . . . is unclear,"[10] the Pennsylvania Supreme Court had not said that champerty was no longer a defense to such an assignment. The court therefore assumed that champerty *could* be a basis on which to challenge the assignment of a legal malpractice claim, and evaluated the champerty argument on its merits.[11]

B. *Claims by Criminal Defendants*

Courts differ over the standards of pleading and proof that must be met by criminal defendants who wish to bring malpractice claims against their attorneys. Most courts hold that criminal defendants who have been convicted cannot sue defense counsel for malpractice, reasoning that the cause of the criminal's conviction and sentence is the crime committed by the criminal rather than the conduct of defense counsel. Thus, most courts require that, before the criminal defendant can sue his or her attorney for legal malpractice, he or she must obtain relief from the judgment of conviction. A number of the courts adhering to this so-called "exoneration rule" require in addition that the claimant prove by a preponderance of

8. *Id.* at 1274–75 (citing decisions).
9. No. Civ.A. 03–4393, 2004 WL 1699269 (E.D. Pa. July 28, 2004).
10. *Id.* at *3.
11. *Id.* at *3–4.

the evidence that he or she was actually innocent of the charged offense.[12] A minority of courts reject the exoneration rule.[13] Several new decisions adopt or discuss the majority view.

In *Canaan v. Bartee*,[14] the claimant was convicted of murder in the underlying criminal prosecution. He then sued his court-appointed attorneys for legal malpractice. The trial court granted summary judgment for the attorneys on the ground that exoneration by post-conviction relief was a prerequisite to a malpractice claim arising out of a criminal proceeding. The Kansas Supreme Court affirmed, and in doing so adopted the exoneration rule for legal malpractice actions in Kansas. The court rejected the claimant's various arguments, essentially reasoning that the claimant already had a remedy in the right to request post-conviction relief, and that "until a plaintiff has been exonerated, his or her criminal conduct (not his or her attorney's negligence) is the proximate cause of his or her incarceration. Under this theory, the plaintiff has no cause of action . . . until exoneration occurs."[15] The *Canaan* court did not say whether future malpractice claimants in Canaan's position would be required to show actual innocence. The issue was not reached because Canaan's request for post-conviction relief had been denied.

A Washington state appellate court answered the question left open by the *Canaan* court in a case in which the malpractice claimants were acquitted of the underlying criminal charges. In *Ang v. Martin*,[16] the claimants were a husband and wife who accepted the advice of counsel and pled guilty to income tax fraud. After submitting their pleas, the claimants consulted new counsel, who opined that they should have gone to trial rather than plead. The claimants withdrew their guilty pleas, went to trial, and were acquitted. The claimants then sued the original attorneys who advised them to plead guilty, seeking the return of fees paid. The malpractice case went to trial, where the jury found that the claimants had not established that they were actually innocent of the charged offenses. Based on that finding, the trial court dismissed the malpractice claim.

On appeal, the claimants argued that the trial court was wrong to submit to the jury the question of their innocence. According to the claimants, their acquittal at the underlying criminal trial conclusively established their innocence such that there was nothing further for the jury to consider on

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12. *See, e.g.*, Wiley v. County of San Diego, 96 P.2d 983, 985–86 (Cal. 1998) (collecting cases); Kramer v. Dirksen, 695 N.E.2d 1288 (Ill. App. Ct. 1998); Faulkner v. Foshaug, 29 P.3d 771 (Wash. Ct. App. 2001).

13. *See, e.g.*, Mylar v. Wilkinson, 435 So. 2d 1237 (Ala. 1983); Silvers v. Brodeur, 682 N.E. 2d 811 (Ind. Ct. App. 1997); Gebhardt v. O'Rourke, 510 N.W.2d 900 (Mich. 1994); Duncan v. Campbell, 936 P.2d 863 (N.M. 1997); Krahn v. Kinney, 538 N.E.2d 1058 (Ohio 1989).

14. 72 P.3d 911 (Kan. 2003).

15. *Id.* at 921.

16. 76 P.3d 787 (Wash Ct. App. 2004).

that point. The appellate court disagreed, holding that the claimants' acquittal did not prove their innocence *in fact*, but merely proved the existence of a reasonable doubt as to their guilt.[17] The court rejected the claimants' argument that the attorneys were estopped from asserting the defense of actual innocence. The court also rejected the claimants' argument that actual innocence was an affirmative defense and that the defendant attorneys had the burden of proving the claimants' guilt.[18] The court affirmed the judgment in favor of the attorneys. At this writing, the decision of the appellate court is pending further review by the Washington Supreme Court.[19]

In the Arizona case of *Glaze v. Larsen*,[20] the claimant was convicted of sexual abuse while represented by the defendant attorney. Following his conviction, acting pro se, the claimant filed a petition for post-conviction relief, alleging that he had received ineffective assistance of counsel. Ultimately, the court found that counsel had been ineffective and granted a new trial. The claimant's motion to dismiss all charges with prejudice was granted. After the charges were dismissed, the claimant brought an action against his former counsel. The trial court dismissed the matter on the ground that the action was barred by the two-year limitations period. The appellate court reversed, holding that the suit was timely.

On appeal to the Arizona Supreme Court, in the context of the accrual question, the court discussed the circumstances in which criminal defendants are entitled to assert malpractice claims against their former attorneys. The court concluded that the question of whether a cause of action for a legal malpractice had accrued in favor of a criminal defendant depended in large part on *how* the criminal proceedings were terminated.[21] In this regard, the court stated, "an element of the cause of action for legal malpractice is that the criminal conviction has been set aside, and the cause of action for malpractice does not accrue until that has occurred."[22] As to whether criminal defendants had to show actual innocence, the court commented in dicta:

> At least one jurisdiction, California, requires that a malpractice plaintiff not only have had his convictions set aside as a prerequisite to filing a malpractice suit, but also that he then allege and prove "actual innocence" in the ensuing negligence action. We are not confronted today with any questions about the substantive level of proof required in the malpractice suit, and nothing in our

17. *Id.* at 790.
18. *Id.* at 791.
19. *See* Ang v. Martin, 95 P.3d 352 (Wash. 2004). *See also* Owens v. Harrison, 86 P.3d 1266 (Wash. Ct. App. 2004) (following *Ang*).
20. 83 P.3d 26 (Ariz. 2004).
21. *Id.* at 32.
22. *Id.*

> opinion should be read as adopting such a rule. Even a party unable to prove actual innocence may be injured by attorney malpractice; it is enough for the recovery of damages to require that the plaintiff prove that his conviction was proximately caused by his attorney's negligence and that the underlying criminal proceedings, for whatever reason, have terminated in his favor.[23]

C. *Claims Seeking Damages for Emotional Distress*

Most courts that have considered the question have held as a matter of law that claimants alleging legal malpractice who have suffered harm only to their property interests without physical injury are not entitled to damages for emotional distress.[24] In recent decisions addressing the issue, one court reaffirmed this majority view, while another found a right to recover emotional distress damages in connection with some claims against attorneys.

In *Schafer v. Young*,[25] the defendant attorney moved for partial summary judgment as to that part of a malpractice complaint that sought damages for emotional distress arising from the attorney's alleged negligent representation in connection with a business transaction. The federal district court granted the motion, predicting that the Maryland courts would not permit recovery of emotional distress damages in such cases based on Maryland's prior decisions in analogous circumstances, and in light of the "great weight of authority" from other jurisdictions.[26] The court distinguished a medical malpractice case relied on by the plaintiff on the ground that the plaintiff in that case had suffered physical injury rather than simply "property or commercial damage."[27]

In *Alberts v. Franklin*,[28] the defendant attorneys were lead counsel to the plaintiffs in a class action by 7-Eleven franchisees against their franchisor. The claimants, James and Candace Alberts, were 7-Eleven franchisees and members of the class. They also had a separate action against the franchisor and were represented as to that separate action by the defendant attorneys. James Alberts played a significant part in negotiating a proposed settlement of the class action. This led to a falling out with the defendant attorneys, because they thought that the proposed settlement was inadequate and were vigorously opposed to it. While still representing the Albertses, the attorneys accused James Alberts of self-dealing and collusion, alleging that

23. *Id.* at 33 n.4 (citation omitted).
24. *See, e.g.*, Douglas v. Delp, 987 S.W.2d 879 (Tex. 1999).
25. No. Civ. JFM-03–16, 2004 WL 162961 (D. Md. Jan. 22, 2004).
26. *Id.* at *1 (listing cases).
27. *Id.*
28. No. D040310, 2004 WL 1345078 (Cal. Ct. App. June 16, 2004) (unpublished). Because it is unpublished, the precedential value of this case is limited. Nevertheless, the court's rationale is instructive to practitioners in this area.

he had agreed to an unsatisfactory settlement of the class action in exchange for the franchisor's consideration with respect to the Alberts's separate action against the franchisor. Based largely on these accusations, the claimants sued the attorneys for, among other things, breach of fiduciary duty and negligence. There was a jury trial and the claimants received an award of general and punitive damages on their breach of fiduciary duty claims.

The attorneys appealed, arguing that the plaintiffs' breach of fiduciary duty claims should not have been submitted to the jury because there was no evidence of economic damages or physical injury, and because as a matter of law there is no breach of fiduciary duty claim against an attorney where the only damages claimed are alleged emotional distress.[29] The appellate court disagreed, noting that the authorities on which the attorneys were relying arose from negligence claims against attorneys rather than breach of fiduciary duty claims. According to the court, "[b]reach of fiduciary duty is a tort distinct from professional negligence and [the attorneys'] breaches of fiduciary duty in this case involved *intentional* misconduct, not professional negligence."[30] The court further noted that its prior decisions did not mean that emotional distress damages could *never* be recovered in legal malpractice actions:

> It is possible to envision cases in which the attorneys' conduct—while not necessarily intentional or in bad faith—is so reckless and the resulting damage so foreseeable that imposition of liability is proper.
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> . . .
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> [A]t some point on the continuum between negligent and intentional misconduct, an attorney's breach of fiduciary duty becomes sufficiently blameworthy to support an award of emotional distress damages. Because [the attorneys'] conduct in this case fell squarely on the intentional misconduct and of that continuum, the court did not err in allowing the jury to assess general damages on the cause of action for breach of fiduciary duty.[31]

D. *Statute of Limitations/Continuing Representation Issues*

Many jurisdictions toll the statute of limitations for legal malpractice claims while representation continues either in general, or with respect to the particular underlying transaction. With recent trends in attorney portability and law firm dissolutions and mergers, this doctrine will continue to be tested.

In *Koerber v. Levey & Gruhin*,[32] the claimant in 1997 hired Levey & Gruhin, a general partnership, to represent his interests in a medical mal-

29. *Id.* at *21.
30. *Id.* (citation omitted).
31. *Id.* (citations omitted).
32. No. 21730, 2004 WL 1344834 (Ohio Ct. App. June 16, 2004).

practice and wrongful death case on behalf of his deceased brother's estate. One of the firm's partners, Levey, and a contract employee with the firm filed the complaint and handled the case for the plaintiff. Levey & Gruhin then dissolved. A new partnership, Gruhin & Gruhin, took over the Levey & Gruhin office space and most of its cases.[33] The claimant executed a new contingency fee agreement with Gruhin & Gruhin. Attorney Gruhin, who had not been involved previously, assumed responsibility for the case.[34]

Meanwhile, the defendant doctors filed motions for summary judgment, arguing that the statute of limitations barred the plaintiff's claims.[35] Then another firm, Ochs & Vanik, appeared in the case as co-counsel for the claimant. While the defendants' summary judgment motion was pending, Gruhin and Vanik met with the claimant to discuss the statute of limitations problem with the case. The court ultimately granted summary judgment to the defendants in the underlying case. The claimant appealed and lost. In March 2002, the claimant sued Levey & Gruhin, Levey individually, and the contract attorney, charging that the filing of the suit after the limitations period expired was malpractice.[36]

The attorneys moved for summary judgment, arguing that the suit was time barred. In Ohio, the one-year statute of limitations in a legal malpractice case begins to run upon the later of the following: (1) a cognizable event through which the plaintiff discovers or should have discovered that his injury was related to his or her attorney's conduct, and is put on notice of the need to pursue possible remedies against the attorney; or (2) termination of the attorney-client relationship for that particular transaction or undertaking. Under this rule, the limitations period is tolled while the legal representation continues.[37] The claimant opposed summary judgment on the ground that the statute of limitations had been tolled from 1997, when he first hired Levey & Gruhin, until the Ohio Supreme Court denied his writ of certiorari in the underlying case, because that was when Gruhin & Gruhin's representation of him ceased.[38] The trial court granted the attorneys' summary judgment motion.

The appellate court affirmed. The court reasoned that it was clear that the claimant engaged a *new* law firm and *new* attorneys in 2000 with the switch from Levey & Gruhin to Gruhin & Gruhin.[39] The court found that the claimant's relationship with Levey & Gruhin and Levey did not end later than March 2000, and his relationship with the contract attorney did

33. *Id.* at *1, *6.
34. *Id.* at *1.
35. *Id.*
36. *Id.* at *2.
37. *Id.* *4.
38. *Id.* at *5.
39. *See id.* at *7.

not end after April 2000. Therefore, the statute began to run at the latest in March 2000 as against Levey & Gruhin and Levey, and in April 2000 against the contract attorney.[40] One judge dissented on this point, arguing that given "the circumstances at Levey & Gruhin's dissolution and the manner in which the legal representation of Levey & Gruhin's previous cases was handled administratively, the attorneys in this case unfortunately created a situation in which a client could reasonably conclude that he or she was continuing business in the same legal relationship."[41]

The *Koerber* court also considered whether a cognizable event putting the claimant on notice of the malpractice occurred after the termination of his relationship with Levey & Gruhin, Levey, and the contract attorney. There was evidence that Gruhin and/or Vanik informed the claimant that there was a statute of limitations problem in the underlying case in March and August 2000.[42] The court said that, on that evidence, a reasonable person should have become aware no later than August 2000 that improper legal work occurred in the underlying case, and that there was a need to investigate further and pursue possible legal malpractice remedies.[43] Because the latest possible date that the one-year limitations period began to run was August 2000, the March 2002 malpractice claim was late.

In *Vansickle v. Kohout*,[44] the West Virginia Supreme Court of Appeals rejected a request to continue tolling the statute of limitations while a new attorney attempted to mitigate damages from malpractice in an ongoing case. The court held that a cause of action for legal malpractice accrued prior to the final resolution of the party's efforts to reverse or mitigate the harm through administrative or judicial appeals, and was not tolled during the pendency of those efforts.[45]

Not all courts agree with this approach. In *Wagner v. Sellinger*,[46] the court applied District of Columbia law to hold that any injury to a client could not be ascertained from the mishandling of a suit still in progress and taken over by another attorney unless and until the plaintiff failed to recover in the underlying case.[47] The claimant believed that her former attorney, Sellinger, mishandled discovery in her medical malpractice case.[48] In July 1994, the claimant fired Sellinger and retained another attorney to complete the trial preparation and try the case. The jury rendered a defense

40. *Id.*
41. *Id.* at *13 (Batchelder, J., dissenting).
42. *See id.* at *8.
43. *Id.*
44. No. 31666, 2004 WL 1432411 (W. Va. June 25, 2004).
45. *Id.* at *5.
46. 847 A.2d 1151 (D.C. 2004).
47. *Id.* at 1156–57.
48. *Id.* at 1154.

verdict in favor of the defendant doctors in August 1996, and the claimant sued Sellinger in August 1997.

Sellinger argued that the statute of limitations for his malpractice began to run when the plaintiff fired him in July 1994 and, therefore, the three-year statute of limitations barred the plaintiff's claim against him.[49] The court disagreed: "No injury allocable to Sellinger's apparent negligence could be ascertained unless and until [the plaintiffs]—using competent counsel to resurrect their medical malpractice claim—failed nonetheless to recover damages from the medical defendants, a result that did not occur until late August 1996."[50] The court also noted that negligence in the prosecution of a case may create the potential for injury, and said:

> If that potential is not realized until later—if its occurrence depends on a "contingent or future event"—then the injury is not sustained until the contingent or future event occurs. Typically, therefore, a potential—not actual—injury has occurred when a client claims that an attorney has mishandled a lawsuit still in progress by failing to take appropriate discovery or by making some other error that, however egregious, does not conclude the lawsuit. That is to say, until the lawsuit is resolved (either by verdict or ruling in court or by settlement), the injury remains uncertain or inchoate. It follows that the statute of limitations has not yet begun to run.[51]

The claimant did not have a demonstrable injury until the jury's adverse verdict, so her legal malpractice claim was timely.[52]

E. *Claims by Disappointed Beneficiaries*

Generally, as long as a testamentary beneficiary is named or identified in the testamentary instrument, he or she has standing to bring a malpractice claim against the testator's attorney where the attorney negligently drafts the testamentary instrument in a way that frustrates the testator's intent as expressed in the instrument.[53] A majority of jurisdictions, however, decline to allow an intended but unnamed testamentary beneficiary to assert a claim against the testator's attorney arising from a failure to have the will promptly executed, unless there was a specific request to do so by the client/testator to the attorney.[54] This is so because imposing liability to

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49. *See id.* at 1154–55.
50. *Id.* at 1156.
51. *Id.* (citations omitted).
52. *Id.* at 1157.
53. *See generally* R. Mallen & J. Smith, Legal Malpractice, § 32.4 at 735 (5th ed. 2000). *See also* Lucas v. Hamm, 364 P.2d 685 (Cal. 1961), *cert. denied*, 368 U.S. 987 (1962); Stowe v. Smith, 441 A.2d 81 (Conn. 1981); Hare v. Miller, Canfield, Paddock & Stone, 743 So. 2d 552 (Fla. Dist. Ct. App. 1999); Succession of Killingsworth, 292 So. 2d 536, 542 (La. 1973).
54. *See* Radovich v. Lock-Paddon, 41 Cal. Rptr. 2d 573 (Ct. App. 1995); Krawczyk v. Stingle, 543 A.2d 733 (Conn. 1988); Babcock v. Malone, 760 So. 2d 1056 (Fla. Dist. Ct. App. 2000); Charia v. Hulse, 619 So. 2d 1099 (La. Ct. App. 1993); Miller v. Mooney, 725 N.E.2d

prospective beneficiaries under these circumstances would interfere with the attorney's obligation of undivided loyalty to the client. Recent decisions expand upon these general rules.

Iowa follows the general rule allowing an identified testamentary beneficiary standing to bring a malpractice claim against the testator's attorney where the attorney's negligence frustrates the testator's intent. The Iowa Court of Appeals, however, recently held that extrinsic evidence may *not* be considered in determining the testator's intent. In *Mills v. Jordan, Mahoney & Jordan*,[55] the testator's wife brought a malpractice suit against the testator's attorney, alleging that he drafted her husband's will in a manner that frustrated the testator's intent to avoid federal estate taxes.[56] The *Mills* court found that testamentary intent may be determined solely from the language of the will, and where there was nothing in the will regarding federal estate taxes, the claimant's suit failed as a matter of law.[57]

In a question of first impression, the Wyoming Supreme Court considered whether an attorney retained to draft a will and pursue a divorce on behalf of a client owes a duty to the testamentary beneficiary. In *Drwenski v. McColloch*,[58] the court acknowledged the existence of a limited duty by an attorney to a nonclient in certain circumstances, as well as the strong policy considerations against imposing a duty to a nonclient, where to do so could hinder the attorney's ethical obligations to the client by creating a conflict of interest.[59]

To determine whether an attorney owes a duty to a nonclient/prospective third-party beneficiary, the court used a two-step test: (1) it must be clear that the transaction between the client and the attorney was intended to directly benefit the prospective third-party beneficiary; and (2) there must be a finding as to whether there would be an impermissible conflict of interest if the duty to the nonclient were imposed. If the proposed duty to the nonclient would potentially conflict with the duty that the attorney

545 (Mass. 2000); Sisson v. Jankowski, 809 A.2d 1265 (N.H. 2002). *But see* Hesser v. Cent. Nat'l Bank & Trust Co. of Enid, 956 P.2d 864 (Okla. 1998) (allowing standing to intended testamentary beneficiaries where attorney's negligence caused will to be improperly executed and subject to challenge by heirs at law).

55. 671 N.W.2d 531 (Table), 2003 WL 22086567 (Iowa Ct. App. Sept. 10, 2003).

56. *Id.* at *1 (plaintiff sought to introduce deposition testimony and other evidence to establish testator's intent to avoid federal estate tax liability).

57. *Id.* at **3 (citing Kinney v. Shinholser, 663 So. 2d 643, 645 (Fla. Dist. Ct. App. 1995); Holsapple v. McGrath, 575 N.W. 2d 518, 521 (Iowa 1998)) (explaining that the rule is designed to prevent misinterpretation of testamentary intent and fabrication of unrebuttable false evidence of testamentary intent).

58. 83 P.3d 457 (Wyo. 2004). After learning of his terminal illness in 1999, the client/decedent initiated a divorce and executed a new will in favor of his daughter, but he died before finalizing the divorce. The daughter claimed that she would have inherited more of the client/decedent's estate through the will if the divorce had been properly pursued and finalized.

59. *Id.* at 464.

owes to the testator, the court will not impose a duty to the nonclient.[60] Based on the first step of its test, the court found that, under the circumstances, no reasonable jury could infer that the claimant-plaintiff was the intended third-party beneficiary of the contract for legal representation in the testator's divorce.[61]

In *Harrigfeld v. Hencock*,[62] the Idaho Supreme Court considered whether an intended beneficiary of a testamentary instrument had standing to assert a malpractice action against the attorney who prepared the testamentary instrument. The court followed the majority rule that the attorney "owes a duty to the beneficiaries named or identified in the testamentary document to prepare such instruments, and if requested by the testator to have them properly executed, so as to effectuate the testator's intent as expressed in the testamentary instruments."[63] In the event that the attorney's negligent conduct proximately resulted in the loss, reduction, or failure to realize the beneficiary's interest, then the attorney could be held liable to the beneficiary for that harm.[64] Significantly, the *Harrigfeld* court specifically limited the scope of the decision to testamentary beneficiaries who are named or identified in the testamentary instrument.[65] The court also affirmed that an attorney has no duty: (1) to ensure that any other person who would normally be the object of the testator's affection is included in the testamentary instrument; (2) to ensure that the instrument includes a distribution of assets among beneficiaries in any particular manner; or (3) to notify or consult beneficiaries, or to dissuade a testator in the event of a revocation or amendment of an existing testamentary instrument.[66]

Identifying a more lenient standard for the existence of standing for nonclient legal malpractice claims against an attorney, in *Cave v. O'Bryan*,[67] a Kentucky appellate court considered whether an identified testamentary beneficiary had standing to bring a malpractice suit against the attorney who provided estate planning services to the client/testator. In Kentucky, an attorney owes a duty to a nonclient/plaintiff if the nonclient "was intended to be benefited by [the attorney's] performance despite a lack of privity."[68] Here, the court held that the attorney owed a duty to the intended third-party beneficiary named in the will, and the estate plan as

60. *Id.* at 465.
61. *Id.* at 467.
62. 90 P.3d 884 (Idaho 2004).
63. *Id.* at 888.
64. *Id.*
65. *Id.*
66. *Id.* at 888–89. The Idaho Supreme Court subsequently followed this decision in *Estate of Becker v. Callahan*, 96 P.3d 623 (Idaho 2004).
67. No. 2002-CA-002601-MR, 2004 WL 869364 (Ky. Ct. App. Apr. 23, 2004).
68. *Id.* at *2 (citing Seigle v. Jasper, 867 S.W.2d 476, 483 (Ky. Ct. App. 1993); Hill v. Willmott, 561 S.W.2d 331 (Ky. Ct. App. 1978)).

prepared by the attorney diminished the claimant's beneficial interest in the estate.[69]

In *Belt v. Oppenheimer, Blend, Harrison & Tate, Inc.*,[70] a Texas Court of Appeals considered whether the executrixes of a testator's estate could maintain a legal malpractice suit against the attorney who drafted the testator's will. The claimants said that the attorney's negligence cost the estate more than $1.5 million in unnecessary estate taxes.[71] The court held that there could be no malpractice claim by an estate's executrix against the testator's attorney because the parties were not in privity.[72]

Following and expanding upon the general rule that named beneficiaries may bring legal malpractice claims, in *Stanley L. and Carolyn M. Watkins Trust v. Lacosta*,[73] the Montana Supreme Court considered whether the discovery rule and accrual rule apply to toll the commencement of the statute of limitations on the malpractice claims. In contrast to the Texas court's decision in *Belt*, the *Watkins* court found that the estate of the testator stands in the shoes of the decedent and is, therefore, considered to be in privity with the attorney, thereby providing standing for the estate's personal representative to bring a malpractice claim against the testator's attorney.[74] The court also held that the discovery rule and the accrual rule apply to legal malpractice actions brought by the estate or the identified testamentary beneficiary and toll the commencement of the statute of limitations "until all elements of a claim, including damages, have occurred."[75]

In *Golden v. Cook*,[76] the U.S. District Court for the Western District of Pennsylvania considered whether the identified testamentary beneficiaries of a will had standing to bring a malpractice suit against the testator's attorney for failing to investigate the legitimacy of a subsequent testamentary document that reduced the plaintiffs' interest in the estate. The court held that the claimants did not qualify as intended third-party beneficiaries of the contract between the testator and the attorney, because the second will was admitted to probate, and the instrument prepared by the attorney could no longer serve as the basis for establishing standing.[77] The original trust instrument prepared by the attorney was revocable, and the testator duly exercised her authority to revoke it.[78]

69. *Id.* at *3–4.

70. 141 S.W.3d 706 (Tex. App. 2004).

71. *Id.* at 707.

72. *Id.* at 708–09.

73. 92 P.3d 620, 623 (Mont. 2004).

74. *Id.* at 625–26. Interestingly, the *Watkins* court found that while the estate definitely has standing to assert the malpractice suit against the attorney, the issue of whether the nonclient individual testamentary beneficiary has standing to bring a legal malpractice action against the attorney was a factual issue to be determined at trial. *Id.*

75. *Id.* at 631 (reversing and remanding case for further proceedings).

76. 293 F. Supp. 2d 546 (W.D. Pa. 2003).

77. *Id.* at 555–57.

78. *Id.* at 558.

Notably, the court held that the attorney did not breach any duty to the testator or to the plaintiffs.[79] The court found that the attorney owed no duty to protect the interests created by the testamentary documents, nor did he have a duty to inquire into the circumstances surrounding the testator's exercise of her right to revoke prior documents and change the testamentary scheme.[80]

II. DEVELOPMENTS IN ACCOUNTING MALPRACTICE

Accountants face increased malpractice exposure in the wake of the recent highly publicized corporate scandals. Accounting malpractice litigation has generated an increasing number of published decisions, which may only be the tip of the iceberg, as many more cases lurk at the trial court level.

A. *Statutes of Limitation*

While limitations periods vary substantially from state to state, the commencement of the statute is often a critical question. Two reported cases applied statutes of limitation to cases arising from the preparation of tax returns. Both applied the discovery rule to hold that the statute of limitations starts running when the client knows or should know about the malpractice, not when the taxing authority takes adverse action.

The federal district court in Massachusetts granted summary judgment on these grounds in *Newhall v. Posner*,[81] which arose following the sale of TAD Resources International, Inc. Plaintiff Newhall owned shares in TAD and realized capital gains in excess of $11 million upon its sale. The defendant, Posner, was one of TAD's outside accountants and had told Newhall of his responsibility for income taxes in the various states where TAD conducted operations.

In November 1999, Newhall received a notice from California assessing over $1 million in state taxes, penalties, and interest fees, which he immediately paid. In December 1999, Newhall's personal accountant obtained a copy of Newhall's California K-1, which Posner had prepared and filed for 1997. It showed that his long-term capital gain from the sale of TAD was over $11 million, all allocated to California. In April 2000, the plaintiff received a recalculated tax-due notice from California for almost $2 million. At this point, Newhall retained a new accountant, who determined that the capital gains allocated to California should have only been nineteen percent, not the 100 percent allocated on the 1997 California K-1 that TAD filed. Newhall sued Posner in 2003, alleging that the 1997 California K-1 was faulty. He argued that the three-year statute of limitations did not

79. *Id.* at 558–59.
80. *Id.*
81. No. Civ.A. 03–11279-PBS, 2004 WL 413275, at *4 (D. Mass. Mar. 3, 2004).

preclude his claim because he did not actually know that he had been damaged until he received the April 2000 recalculated tax notice.

The district court granted summary judgment for Posner based on Massachusetts's "discovery rule," under which the statute starts running when the plaintiff has (1) knowledge or sufficient notice of harm and (2) knowledge or sufficient notice of what caused the harm.[82] Massachusetts uses a reasonable person standard, and does not necessarily expect plaintiffs to recognize professional negligence when they see it.[83] The issue was whether a reasonable person in Newhall's position should have known about the facts giving rise to the lawsuit when his personal accountant examined the California K-1 in December 1999.

The court imputed to Newhall knowledge of what his personal accountant learned in December 1999. His personal accountant learned then that the 1997 California K-1 had allocated all of the capital gains to California, even though not all of TAD's business came from California. The court ruled that Newhall "obtained the two critical pieces of the puzzle" in December 1999 and that Massachusetts's three-year statute of limitations therefore barred the lawsuit.[84] Although the court recited Massachusetts's "reasonable person" standard, it did note that Newhall had a degree in accounting and was TAD's former treasurer. The plaintiff and his personal accountant had the expertise between them to discover the malpractice when they saw the California K-1.[85]

The New Mexico Court of Appeals also recently considered the commencement of the statute of limitations in a case involving tax returns.[86] An accounting firm prepared books and tax returns for a physician and his professional corporation. When the accounting firm sued its former clients on a promissory note, the clients counterclaimed for malpractice, alleging that the accounting firm negligently failed to file tax returns for the professional corporation. The accounting firm cited the statute of limitations and moved for summary judgment. The trial court held that the statute of limitations did not start to run until the clients received a notice of deficiency from the IRS and denied summary judgment.

The New Mexico Court of Appeals disagreed and reversed. The statute of limitations in New Mexico begins to run after (1) the client sustains an actual injury and (2) the client knows or should know of the facts essential to the cause of action.[87] Here, the physician retained a new accountant in 1995 and learned that his prior accountants had not filed tax returns for

82. *Id.* at *3.
83. *Id.*
84. *Id.* at *4.
85. *Id.*
86. Haas Enter., Inc. v. Davis, 82 P.3d 42 (N.M. Ct. App. 2003).
87. *Id.* at 44.

the professional corporation since 1984. Nor had they filed personal returns for him for the years 1991–1994. Although the IRS did not send a notice of deficiency until 1996, the appellate court said that it was "struthious" for him to wait for the notice of deficiency.[88] He knew about the problem in 1995, and the statute of limitations barred the malpractice claims asserted in 2000.[89]

In both the Massachusetts case and the New Mexico case, the courts held fast to the discovery rule. What triggered the statute of limitations in these cases was not the action taken by a taxing authority. Instead, it was when the client learned about the problem. Also, both of these decisions imputed to the clients the knowledge that their subsequent accountants acquired.

B. *Audit Interference Rule*

The audit interference rule was first adopted in New York in 1939 and has generated appellate controversy ever since. Essentially, the rule holds that the negligence of a client who hires an auditor is a defense only when it has contributed to the auditor's failure to perform the contract and to report the truth.[90] The rule is a major roadblock to the defenses of comparative or contributory negligence typically raised by auditors. The rationale for the rule is that a client often retains an accountant to identify problems with internal controls or other business practices, and auditors should not avoid liability based on the very problems that they were hired to detect.[91]

The Illinois Supreme Court recently reaffirmed this rule in a case turning on client representation letters.[92] Trustees on the board of a community college sued their auditors for allegedly failing to discover inappropriate investments made by Phillip Luhmann, the treasurer and chief financial officer. During the audit, Luhmann made impermissible investments in violation of Illinois law governing investments by public colleges and in violation of the trustees' resolutions. After the auditors issued their opinion, Luhmann made more improper investments, resulting in heavy losses. The trustees claimed that if the auditors had told them about Luhmann's impermissible investments, they would have put a stop to them, and the board would not have incurred the losses resulting from his later investments.[93]

88. *Id.* at 45.

89. *Id.* at 45–46.

90. *See* Nat'l Sur. Corp. v. Lybrand, 9 N.Y.S.2d 554, 563 (App. Div. 1939).

91. *See*, *e.g.*, *id.* ("Accountants, as we know, are commonly employed for the very purpose of detecting defalcations which the employer's negligence has made possible. Accordingly, we see no reason to hold that the accountant is not liable to his employer in such cases.").

92. Bd. of Trustees of Cmty. Coll. Dist. No. 508 v. Coopers & Lybrand, 803 N.E.2d 460, 468 (Ill. 2003).

93. *Id.* at 462–63.

The auditors asserted comparative fault as a defense. The chairman of the board of trustees saw reports reflecting the impermissible investments, and the board raised no objection. Luhmann falsely assured the auditors that there were no significant changes in the portfolio. Also, the college signed a representation letter saying that it was unaware of violations of laws or regulations, which was also incorrect. The trial court incorporated the audit interference rule into its charge, and the jury returned a verdict in the amount of $23 million, which it reduced to $12.65 million based upon the fault of the board.[94]

The auditors appealed, arguing that the trial court should not have applied the audit interference rule. The trustees also appealed, contending that they should be penalized only if they had knowingly misled the auditors, provided false information, or forged documents. The Illinois Supreme Court reviewed the history of the audit interference rule, surveyed its application nationwide, and held that it should still be the law in Illinois.[95] The court also found the audit interference rule compatible with Illinois's statutory comparative fault scheme.[96] Because the jury found the trustees forty-five percent responsible for the damages, the audit interference rule had not prevented the auditors from benefiting from the comparative fault of the trustees.[97] Two justices dissented, arguing that the audit interference doctrine is inconsistent with Illinois's statutory comparative fault system[98] and that a majority of states have rejected it.[99] They also argued that there was no reason why an accountant's comparative negligence defense should be more restricted than that of other service providers.[100]

At the same time that the majority rejected the auditors' contention that Illinois's comparative fault statute entirely abrogates the audit interference doctrine, it also rejected the trustees' attempt to limit the audit interference rule to outright fraud by the client. The evidence supported a conclusion that Luhmann and the trustees knowingly and falsely represented that there was no violation of the law.[101] The court dismissed the trustees' argument that these representation letters were mere boilerplate.[102]

94. *Id.* at 462.

95. *Id.*

96. *Id.* at 467 (citing Restatement (Third) of Torts: Apportionment of Liability § 7 cmt. m (2000) ("In a case involving negligent rendition of a service . . . a factfinder does not consider any plaintiff's conduct that created the condition the service was employed to remedy.")). The Illinois court noted that other courts around the country have drawn conflicting conclusions. *Id.* at 466–67 (collecting cases from Ohio, Minnesota, Oklahoma, New York, and the Tenth Circuit).

97. *Id.*

98. *Id.* at 473–75 (Garman, J., concurring in part and dissenting in part). Justice Thomas joined in Justice Garman's opinion.

99. *Id.* at 477 (Garman, J., concurring in part and dissenting in part) (citing state and federal cases from Ohio, Minnesota, Michigan, Arkansas, Arizona, Colorado, Florida, Maryland, Iowa, Oregon, New Jersey, Washington, and Kansas).

100. *Id.* (Garman, J., concurring in part and dissenting in part).

101. *Id.* at 469–70.

102. *Id.* at 469.

C. *Liability to Third Parties*

An accountant's potential liability to nonclients is always a matter of great interest, especially in the audit context. This year, several courts have explored the viability of those third-party claims.

In one such case, *Lawrence Insurance Group, Inc. v. KPMG Peat Marwick L.L.P*,[103] a New York court denied summary judgment on audit malpractice claims brought by a holding company that was the sole shareholder of an insurance company that went into liquidation. The accountants had audited the insurance company's reserves from 1986 through 1993, when they discovered a $35 million deficit. The court noted that even a sole shareholder typically does not have standing to sue for injuries to the corporation itself, but held that "where a defendant owes an independent duty to the shareholder and the shareholder and defendant are in privity, the shareholder may sue for damages caused by the defendant's negligence, which results in injury that is personal to the shareholder and independent of the damage caused to the corporation."[104] Here, the accountants did work directly for the holding company, which included assessing the financial health of its liquidated subsidiary.

The court also preserved the plaintiff's right to pursue spoliation claims based upon the destruction of workpapers. The accountants had followed their policy that workpapers are routinely destroyed after six years. The plaintiff alleged that the discovery of the $35 million deficit without any obvious business rationale should have prompted the accountants to put a hold on these workpapers and not to destroy them. The court found a jury question on the spoliation issue.[105]

In another case involving an insolvent insurer, a different department of the same New York court reached a different result when it considered audit malpractice claims brought by policyholders and creditors. In *Serio v. PriceWaterhouseCoopers, LLP*,[106] the court said, with little explanation, that the plaintiff failed to establish "(1) the accountant's awareness that the financial reports were to be used for a particular purpose or purposes, (2) reliance on the reports by a known party or parties, and (3) some linking conduct on the part of the accountant which evinced the accountant's understanding regarding the third party's reliance."[107]

The different relationships between the plaintiffs and auditors may explain the different results in these two cases. In the *Lawrence* case, the defendant had an accountant-client relationship with the plaintiff holding company, part of which may have included assessing the financial health

103. 773 N.Y.S.2d 164 (App. Div. 2004).
104. *Id.* at 166.
105. *Id.*
106. 781 N.Y.S.2d 7 (App. Div. 2004).
107. *Id.* at 9.

of the insolvent insurer. By contrast, there was no accountant-client relationship of any kind in the *Serio* case between the accountants, the creditors, and policyholders of the insolvent insurer. *Serio* is consistent with many cases holding that auditors are not liable to their clients' creditors. After all, auditors are not guarantors of their clients' debts.

The *Restatement* position and majority rule provide that accountants are liable in common law negligence to only those third parties for whose benefit the accountants intend their work or of whose reliance the accountants are actually aware.[108] Many states have adopted this rule through judicial decisions.[109] In 1986, Illinois passed a specific statute that governs accountants' liability to third parties.[110] It provides that accountants and accounting firms are not liable to those with whom they are not in privity unless their acts constitute fraud and intentional misrepresentation or they were aware that a primary intent of the client was for their services to benefit a third party.[111]

The Illinois Court of Appeals considered this statute in *Freeman, Freeman and Salzman, P.C. v. Lipper.*[112] In *Lipper*, investors sued a firm that had audited a family of investment companies for several years. The plaintiffs were both investors and limited partners in the investment companies. The firm audited and certified the value of each plaintiff's capital account and prepared each plaintiff's K-1 tax form. According to the complaint, the auditors knew that the plaintiffs would rely on the audit to determine their tax liability and to make investment decisions. The trial court dismissed the complaint for failure to state a claim.

The appellate court reversed based upon its reading of the Illinois statute. The court held that the proper inquiry under the Illinois statute is whether the auditors knew that it was a primary intent of their client that their audit would benefit or influence the plaintiffs.[113] With relatively little explanation, the court held that the complaint was sufficient to state a cause of action.[114]

108. Restatement (Second) of Torts § 552 (1977). *E.g.*, Badische Corp. v. Caylor, 356 S.E.2d 198, 200 (Ga. 1987) (holding that in the absence of privity, wilfulness, physical harm, or property damage, accountants are not liable for negligent misrepresentation unless the accountants make the representation for the purpose of inducing third parties to rely).

109. *See Badische Corp.*, 356 S.E.2d at 200 n.2 (citing cases from Ohio, Nebraska, Missouri, and Texas).

110. 225 Ill. Comp. Stat. 450/30.1 (2004).

111. *Id.* Like the common law rule, the Illinois statute allows accountants to limit the third parties to whom they might be liable. The Illinois statute says that accountants can limit the third parties to whom they might be liable by (1) identifying them in writing to the client and (2) sending a copy to the third parties.

112. 812 N.E.2d 562 (Ill. App. Ct. 2004).

113. *Id.* at 566.

114. *Id.* at 567.

This is not necessarily inconsistent with the general common law rule. *Lipper* applied a statutory standard. Also, *Lipper* adjudicated a motion to dismiss, where the court had to assume that all of the allegations in the pleadings are true. Whether third parties can substantiate such allegations on an evidentiary record is a different question altogether.

Another case highlighting the importance of the privity rule is *TSG Water Resources, Inc. v. D'Alba & Donovan Certified Public Accountants, P.C.*,[115] an unpublished opinion from the Southern District of Georgia. The court granted summary judgment on claims brought against an audit firm by investors in a private corporation while partially denying summary judgment on claims brought by the auditors' clients. The investors loaned the corporation money, receiving promissory notes and stock options in return. The investors and the corporation sued the auditors, claiming that the financial statements overstated the corporation's net income.

The court granted summary judgment on the investors' claims.[116] Because they were not clients, the investors had to show that their reliance was the "desired result" of the misrepresentations that they alleged.[117] The court found no evidence that the auditors were actually aware that the investors would make the loans, which antedated the audit report by several weeks.[118] He also held that the investors failed to show justifiable reliance.[119] The investors knew the corporation was in dire straights when they made the loans, and some of the investors did not read the financial statements.

The court did allow some of the corporation's claims to proceed to trial. The corporation had an accountant-client relationship with the auditors. As a result, the auditors could not erect the privity rule as a defense.

D. *Fraud*

One way around the privity rule is to assert fraud claims. In some jurisdictions, nonclients can recover from accountants despite the absence of privity if the accountants engaged in fraud or intentional misconduct.[120] Also, state and federal securities fraud statutes may permit claims against auditors with whom investors have no accountant-client relationship.

115. No. CV 402–258 (S.D. Ga. May 10, 2004).

116. *Id.* at 34.

117. *Id.* at 25 (citing Martha H. West Trust v. Mkt. Value of Atlanta, Inc., 584 S.E.2d 688, 691 (Ga. Ct. App. 2003); White v. BDO Seidman, LLP, 549 S.E.2d 490, 494 (Ga. Ct. App. 2001)).

118. *Id.* at 26. The court also quoted language from the engagement letter that said that the audits were not "planned or conducted in contemplation of reliance by any third party or with respect to any specific transaction." *Id.* n.20.

119. *Id.* at 26.

120. *E.g.*, Badische Corp. v. Caylor, 356 S.E.2d 200 (Ga. 1987).

Of course, the difficulty for the nonclient is often proving fraudulent intent. In the *TSG Water Resources* case, the court held that even if the defendants acted with the requisite scienter, the plaintiffs failed to prove that the defendants intended to induce the plaintiffs to act in reliance upon the allegedly fraudulent financial statements.[121]

Exactly what a plaintiff has to prove to show fraudulent intent is difficult to characterize in a general sense. There are a number of cases from the federal courts deciding securities fraud claims against accountants. The results tend to depend on the particular facts of each case.

The Private Securities Litigation Reform Act of 1995[122] imposed a heightened pleading standard on federal securities fraud plaintiffs. Plaintiffs must specify all misleading statements, explain why they are misleading, and state with particularity facts giving rise to a strong inference that the defendant made those statements with the requisite scienter.[123] Negligence is not enough.[124] Many cases say that recklessness satisfies the scienter requirement, although the U.S. Supreme Court has specifically left this question open.[125] Accountants often move to dismiss federal securities fraud complaints on the ground that they fail to assert facts that give rise to a strong inference that the accountants acted with the requisite scienter.

On this basis, in *New Jersey v. Sprint Corp.*,[126] a federal court in Kansas dismissed a complaint against Ernst & Young. The plaintiffs did not allege that the financial statements were materially misstated. Instead, they alleged that the auditors were not independent, complaining that they prepared what later turned out to be a defective and problematic tax shelter for some top executives. The court rejected the auditors' argument that compliance with Generally Accepted Auditing Standards ("GAAS") and Generally Accepted Accounting Principles ("GAAP") is a complete defense.[127] The court, however, did conclude that because the financial statements were admittedly fairly stated, any misstatement about the auditors' independence was immaterial.[128]

The plaintiffs also failed to satisfy the scienter requirement. According to the court, violations of GAAS and GAAP do not alone establish fraudulent intent.[129] The court required the plaintiffs to show at least reckless

121. *TSG Water Resources*, slip op. at 21.

122. Pub. L. No. 104–67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.).

123. New Jersey v. Sprint Corp., 314 F. Supp. 2d 1119, 1139 (D. Kan. 2004). *See also* 15 U.S.C. § 78u-4(b) (2004).

124. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200–01 (1976).

125. Herman & MacLean v. Huddleston, 459 U.S. 375, 379 n.4 (1983).

126. 314 F. Supp. 2d 1119 (D. Kan. 2004).

127. *Id.* at 1147 ("compliance with GAAP does not necessarily immunize an accountant from liability for securities fraud").

128. *Id.*

129. *Id.* The court also said that it is "beyond dispute" that an accountant's interest in earning additional fees through continued engagement with the client does not establish scienter. *Id.* at 1148 n.26 (citing various cases).

misconduct, which it defined as "'highly unreasonable [conduct], involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care . . . . That standard requires more than a misapplication of accounting principles.'"[130] Essentially, the plaintiffs needed to demonstrate that the accounting practices used by the defendants were so deficient that there effectively was no audit at all, "or that the accounting judgments were made such that no reasonable accountant would have made the same decisions if confronted with the same facts."[131] Here, the complaint contained no allegation that the auditors knew or believed that they were not independent. As the alleged lack of independence was not obvious, the complaint failed to allege scienter.[132]

Alleged violations of GAAS and GAAP were sufficiently egregious to survive a motion to dismiss in a case from Florida. In In re *Eagle Building Technology, Inc. Securities Litigation*,[133] the court said that where few transactions occurred during the period covered by the financial statements and where one allegedly fabricated transaction constituted seventy-four percent of the company's business, the pleadings permitted a conclusion that the accountants conducted no audit whatsoever.[134] In short, a drastic overstatement combined with violations of GAAS and GAAP was sufficient to establish scienter.[135]

Violations of GAAS and GAAP justified Securities and Exchange Commission ("SEC") sanctions against an accountant in *Ponce v. SEC*.[136] Reviewing the SEC's factual findings under a somewhat deferential substantial evidence standard, the Ninth Circuit pointed to evidence that an accountant initially disagreed with some of the company's accounting decisions, but went on to certify the financial statements anyway.[137] The SEC's expert testified that the company's method of valuing licensing design was unacceptable given that its stock was thinly traded and given its history of operating losses and virtual insolvency. The accountant also offered no explanation for capitalizing research and development costs other than "substantial discussions with management and management's representations that contracts were on hand for immediate production."[138] The Ninth Circuit characterized his failure to conduct any meaningful investigation as "inexcusable."[139]

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130. *Id.* at 1148 (quoting S.E.C. v. Price Waterhouse, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992)).
131. *Id.*
132. *Id.*
133. 319 F. Supp. 2d 1318 (S.D. Fla. 2004).
134. *Id.* at 1327–28.
135. *Id.* at 1328.
136. 345 F.3d 722 (9th Cir. 2003).
137. *Id.* at 731–34.
138. *Id.* at 732–33.
139. *Id.* at 733.

Sometimes the presence or absence of what the courts call "red flags" carries the day. In *Eagle Building Technology*, for example, the court explained that red flags are facts that would put a reasonable auditor on notice of wrongdoing.[140] They are not so much "rehashes" of GAAP or GAAS violations as they are facts disclosed to an auditor that should stimulate further investigation.[141] They are sometimes "extrinsic" facts or warning signs apart from the evidence on which the auditor should have drawn a different conclusion.[142] The Florida court identified stark discrepancies in the purchase order for the company's single largest contract as one example of a red flag.[143]

The New York case of *Serio*, discussed above, held that the complaint sufficiently stated a common law fraud claim.[144] The amended complaint alleged that the auditors failed to undertake even a minimal audit to verify the insurer's loss reserves and receivables. The auditors also allegedly had notice that the insurer in many cases carried either no reserves or grossly inadequate reserves. The court concluded that the auditors had notice of particular circumstances raising substantial doubt as to the veracity of the information.[145]

Circumstantial evidence of an illegitimate motive appeared to make the difference in a case from Pennsylvania. In *Argent Classic Convertible Arbitrage Fund, L.P. v. Rite Aid Corp.*,[146] the plaintiffs alleged that a new audit partner discovered that prior audits were grossly deficient. Although the auditors typically finished by April, they did not issue their unqualified opinion until Memorial Day weekend. The financial statements allegedly overstated the company's earnings by $1.6 billion. According to the plaintiffs, the auditors' concern that they would be liable for the previous deficient audits led them to issue an unqualified opinion on financial statements with serious flaws, which an outside consultant found in a matter of days. According to the court, these were allegations of a motive and an

140. *Eagle Bldg. Tech.*, 319 F. Supp. 2d at 1328.

141. *Id.* at 1328–29.

142. A good example of a "red flag" is seen in In re *Ikon Office Solutions, Inc. Sec. Litig.*, 66 F. Supp. 2d 622 (E.D. Pa. 1999), *aff'd*, 277 F.3d 658 (3d Cir. 2002). There, the court held that the complaint sufficiently alleged recklessness because the auditors were told at an audit committee meeting that the CFO was altering accounts and had instructed others to "cook the books." *Id.* at 629. Taken in a light most favorable to the plaintiffs, these allegations tended to show that the auditors recklessly failed to investigate serious and specific evidence of wrongdoing. The auditors eventually won on summary judgment because the evidence showed that they took appropriate steps to investigate the allegation.

143. *Eagle Bldg. Tech.*, 319 F. Supp. 2d at 1330.

144. Serio v. PriceWaterhouseCoopers, LLP, 781 N.Y.S.2d 7 (App. Div. 2004). *See supra* text accompanying notes 106–107.

145. *Id.*

146. 315 F. Supp. 2d 666 (E.D. Pa. 2004).

opportunity for the auditors to certify deficient financial statements, and the court held that the complaint alleged scienter with sufficient particularity.[147]

Sometimes accountants are not responsible for the statements of other people. For example, the Kansas court in *Sprint Corp.*, discussed above, dismissed claims arising from the company's proxy statements because the auditors made no representations about the accuracy of the proxy statements and had no duty to speak about them.[148] In different circumstances, however, accountants can be liable if they control others who make false statements at their direction. Federal securities fraud defendants are liable for false statements under Rule 10b-5[149] only if the statements are publicly attributed to them.[150] Thus, a Rule 10b-5 plaintiff must allege that the defendant made a false or misleading statement or participated in a fraudulent scheme.[151] However, the defendants can be liable for false statements not publicly attributed to them if they so substantially participated that they may be deemed to have made the statement and if the plaintiff relies on the defendants' participation in the statement.[152]

The Southern District of New York applied these principles in the case of *In re Global Crossing, Ltd. Securities Litigation.*[153] Noting that it was not enough to allege that an auditor merely helped create financial statements, the court dismissed vague and conclusory allegations that auditors reviewed and approved pro forma unaudited financial statements, because the plaintiffs did not specify which of the financial statements the auditors prepared and directed and which they merely "reviewed and approved."[154] Scrutinizing the plaintiffs' word choices, the court allowed them to proceed with allegations that auditors materially assisted in the preparation of certain public filings and press releases.[155]

There are numerous federal cases judging the sufficiency of pleadings and evidence in securities fraud cases against auditors. It is difficult to generalize about what is necessary to sufficiently allege scienter, as the issue is fact specific and requires consideration of each factor as well as the context as a whole.[156] Practitioners are well advised to read a range of decisions,

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147. *Id.* at 685.

148. New Jersey v. Sprint Corp., 314 F. Supp. 2d 1148–49 (D. Kan. 2004). *See supra* text accompanying notes 126–132.

149. 17 C.F.R. § 240.10b-5 (2003). This regulation is commonly called Rule 10b-5.

150. *In re* Global Crossing, Ltd. Sec. Litig., 322 F. Supp. 2d 319, 330 (S.D.N.Y. 2004) (citing and discussing Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994)).

151. *Id.*

152. *Id.* at 333.

153. 322 F. Supp. 2d 319 (S.D.N.Y. 2004).

154. *Id.* at 333.

155. *Id.* at 334.

156. *See Eagle Bldg. Tech.*, 319 F. Supp. 2d at 1326.

especially from the controlling jurisdiction, to get a feel for what satisfies the scienter requirement.

E. *Expert Opinions on Damages*

The admissibility and value of expert testimony on damages was demonstrated in *Courtland Group, Inc. v. Phillips Gold Co., LLP.*[157] In that case, the jury found that the accounting firm made negligent misrepresentations but no damages resulted. At trial, the plaintiff's expert had calculated damages at over $1 million. The defense expert testified that the loss of a contract had caused no damages because the contract expired every year, making its value at the end of the year zero. The expert also testified that compensation paid over a ten-year period to a key executive, who allegedly would have been fired if the truth had been known, was offset by what would have been owed to that executive in quantum meruit. The jury apparently agreed with the defense expert. The Florida appellate court held the admission of the expert's opinion was appropriate because the jury could not properly evaluate damages in such complicated litigation on its own.[158]

F. *Deepening Insolvency*

Bankruptcy trustees are increasingly the plaintiffs in claims brought against accounting firms. One of the theories by which these claims are brought is that of "deepening insolvency." This theory proposes that even if an accountant's error did not cause lost profits, it may have caused the company to go deeper into debt than it otherwise would have.

The deepening insolvency theory was the issue before a federal district court in Massachusetts in *Branch v. Ernst & Young.*[159] The trustee alleged that the auditors' negligence in issuing an unqualified opinion on a bank's financial health caused it to incur an additional $215 million in debt as a result of a public bond offering. The issue that the court had to decide on cross motions for summary judgment was the appropriate method to use to determine whether the bank was actually going deeper into insolvency. The auditors argued that the relevant question was whether the bank was a going concern, and noted that the bank's assets were greater than its liabilities. They also sought to rely on the findings of examiners from the Office of the Comptroller of the Currency ("OCC"), who had deemed the bank solvent.

The court held the OCC valuation irrelevant because it relied upon a book value approach, while deepening insolvency law requires a fair market

157. 876 So. 2d 629 (Fla. Dist. Ct. App. 2004).
158. *Id.* at 630.
159. 311 F. Supp. 2d 179 (D. Mass. 2004).

valuation of assets.[160] The court also held that a fair market analysis would necessarily encompass the going-concern analysis for which the auditors argued because if the whole were greater than the sum of its parts, then the fair market evaluation of the whole would reflect that.[161] The court left the question of whether the bank was insolvent to the jury.[162]

G. *Proximate Cause*

Accounting malpractice claimants can always demand the refund of the accountant's fee as part of their damages. Where the client demands consequential damages such as lost profits, proximate cause sometimes becomes a contested issue.

In *Orban v. Krull*,[163] the Indiana Court of Appeals found an issue of fact. When one plaintiff's business partner filed a criminal complaint against him for stealing from the partnership, the state investigators subpoenaed the plaintiff's accountant, who produced the confidential information sought. The court held that the accountant had a duty to keep his client's information confidential until he had the client's informed authorization or a court order.[164] Whether his disclosure caused the criminal prosecution and the breakup of the business was a jury question, as was the question of whether the filing of criminal charges was a reasonably foreseeable intervening act.[165]

In the *TSG Water Resources* case, discussed above,[166] the court granted summary judgment in part and denied summary judgment in part on the issue of proximate cause. In analyzing the plaintiffs' fraud claims, the court ruled that because the corporation's former CEO and majority shareholder controlled the corporation's spending and because there was no evidence that he would have made different decisions had the financial statements shown a loss instead of a profit, the plaintiffs' fraud claims failed for lack of proximate cause. However, the court denied summary judgment on the corporation's claims for breach of contract and professional negligence, declining to decide the proximate cause issue on summary judgment.[167]

III. CORPORATE DIRECTORS' AND OFFICERS' LIABILITY

The corporate environment relating to the duties and responsibilities of directors and officers continues to evolve. Directors and officers grapple

160. *Id.* at 182.
161. *Id.* at 183.
162. *Id.* at 184.
163. 805 N.E.2d 450 (Ind. Ct. App. 2004).
164. *Id.* at 454.
165. *Id.* at 454–55.
166. TSG Water Res., Inc. v. D'Alba & Donovan Certified Pub. Accountants, P.C., No. CV 402–258, slip op. at 13–15 (S.D. Ga. May 10, 2004) (discussed *supra* at notes 115–21 and accompanying text).
167. *Id.* at 27–30.

with the implementation of the Sarbanes-Oxley requirements,[168] increased scrutiny from regulatory bodies, sensitive shareholders who have the support of an aggressive plaintiffs' securities bar, and changes in the D&O insurance market. There was a time when an offer to become the next chief executive officer, chief financial officer, or member of the board of a publicly traded company was a dream come true. The dream may have included attractive salary deals, handsome annual fees, and stock packages. Today, life as an executive and board member has changed.

The consequences of bad corporate behavior have never been so severe or so well publicized. The images of executives of major companies hiding the handcuffs as they are led from their corporate offices are stark reminders that fraud does not pay. For many of the companies that have experienced malfeasance at the top, the business's collapse is not the only outcome. Most of these companies live to see the next business day, and the directors' or officers' financial survival may depend on the strength of their indemnification rights and the D&O insurance policies that the company purchases.

A. *Directors' and Officers' Responsibilities and Liabilities Increase in Complexity as Government and the Marketplace Tighten the Reins on Running the Company*

1. Just How Good Are Indemnification Rights?

Indemnification is a cornerstone of the effort to reduce the risk of personal liability that may arise out of conduct by executives and the board. One court described the policies supporting indemnification as the following:

> (a) allowing corporate officials to resist unjustified lawsuits, secure in the knowledge that, if vindicated, the corporation will bear the expense of litigation; and (b) encouraging capable women and men to serve as corporate directors and officers, secure in the knowledge that the corporation will absorb the cost of defending their honesty and integrity.[169]

Historically, the common law of agency and trusts governed the liability of directors and officers. Varied and inconsistent judicial interpretations resulted in state legislatures enacting statutes permitting or requiring indemnification. Indemnification statutes categorize the entitlement as either "mandatory" or "permissive" indemnification. Mandatory provisions re-

168. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (2002) (codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

169. VonFeldt v. Stifel Fin. Corp., 714 A.2d 79, 84 (Del. 1998) (en banc). *See also* Wisner v. Air Express Int'l Corp., 583 F.2d 579, 583 (2d Cir. 1978) ("such protection is necessary or desirable to encourage recruitment of capable management"); Solimine v. Hollander, 19 A.2d 344, 348 (N.J. 1941).

quire the corporation to indemnify the directors and officers when the director or officer has prevailed on the merits of the claims against him or her.[170] Absent corporate bylaws addressing the issue, permissive indemnification provisions grant the company the authority, but not a duty, to indemnify its directors and officers on a discretionary basis.[171] It is important to note that indemnification statutes typically allow corporations to broaden indemnification rights by way of the corporate bylaws, charter, or separate agreement.[172]

Indemnification statutes typically authorize[173] indemnification of persons who serve at the request of the corporation as directors, officers, employees, or agents of related entities such as subsidiaries and joint ventures.[174] The indemnified person is usually entitled to indemnification and advancement of expenses in the defense of an action. In any proceeding other than one by or on behalf of the corporation (i.e., derivative suits), indemnification statutes typically permit corporations to indemnify expenses, including attorney fees, judgments, fines, and settlement payments reasonably incurred by the indemnified person in connection with the action.[175]

a. Indemnification Statute Does Not Allow Corporation to Stop Paying Ex-CFO Who Pled Guilty to Fraud—Despite the "permissive" nature of some indemnification statutes, some courts have made it more difficult for companies to halt indemnification of defense expenses to former executives who have admitted wrongdoing in a criminal proceeding. In *Rite Aid Corp. v. Bergonzi*,[176] the Delaware Chancery Court ruled that a company could not discontinue defense cost payments to its ex-CFO, even after he pled guilty to conspiracy in connection with accounting fraud.

Beginning in late 1999, Rite Aid and many of its officers and directors, including its CFO, Frank Bergonzi, became embroiled in numerous proceedings surrounding the company's accounting practices. The proceedings included an SEC investigation, a grand jury investigation, a derivative action in Delaware, and a civil action in Pennsylvania.[177] Bergonzi retained

170. *See*, *e.g.*, Del. Code Ann. tit. 8, § 145(c) (2004) (a director is entitled to mandatory indemnification if he or she has been "successful, on the merits or otherwise"); Cal. Corp. Code § 317(d) (West 1990 & Supp. 2004); N.Y. Bus. Corp. Law § 723(a) (McKinney 2003).

171. *See* Advanced Mining Sys., Inc. v. Fricke, 623 A.2d 82, 83 (Del. Ch. 1992). *See*, *e.g.*, Del. Code Ann. tit. 8, § 145(b); Cal. Corp. Code § 317 (c); N.Y. Bus. Corp. Law § 722.

172. *See VonFeldt*, 714 A.2d at 81, n.5.

173. In fact, it is required in the case of directors and officers who prevail in the defense of an action.

174. *See*, *e.g.*, Del. Code Ann. tit. 8, § 145(a), (b).

175. *See*, *e.g.*, *id.* § 145(c), (e); Citadel Holding Corp. v. Roven, 603 A.2d 818, 823–24 (Del. 1992).

176. No. Civ.A. 204 53-NC, 2003 WL 22407303 (Del. Ch. Oct. 20, 2003) (unpublished), *appeal refused*, 836 A.2d 514 (Del. Super. 2003).

177. *Id.* at *1.

counsel to represent him in seeking from Rite Aid the advancement of defense costs incurred in connection with his defense in these proceedings. Article Ten of Rite Aid's Restated Certificate of Incorporation set forth the company's indemnification obligations, which included the following:

> The right to indemnification conferred by this Section B shall be a contract right and shall include the right to be paid by the corporation the expenses incurred defending any such proceeding in advance of its final disposition; provided, however, that the General Corporation Law requires, the payment of such expenses . . . shall be made only upon delivery to the corporation of an undertaking . . . to repay all amounts so advanced if it shall ultimately be determined that such director or officer is not entitled to be indemnified . . . .[178]

Bergonzi signed undertakings agreeing to repay defense costs in the event of a court's final judgment that he was not entitled to indemnification. Rite Aid then began to advance him funds.

In June 2002, a federal grand jury indicted Bergonzi and others, and a year later, Bergonzi pled guilty to participating in a criminal conspiracy to defraud Rite Aid. Following Bergonzi's plea, Rite Aid's board decided that Bergonzi was not entitled to indemnification. It notified Bergonzi that it would no longer advance his defense costs, and demanded repayment. Bergonzi sued for the advancement of costs.

In a case of first impression, the court barred the company from discontinuing defense cost payments to Bergonzi, ruling that a guilty plea does not become a final disposition until formal sentencing.[179] Accordingly, the court held, the company was obligated to advance defense costs to the former CFO and other former officers through sentencing.

b. Statutory Indemnification Entitles Directors to Their Legal Expenses as Long as They Did Not Incur Personal Liability—In *In re Internet Navigator, Inc.*,[180] the Eighth Circuit applied Iowa law to hold that a corporation's directors and officers are "wholly successful" within the meaning of a statute[181] requiring the corporation to indemnify them for the legal expenses that they incurred in a lawsuit, as long as they did not incur personal liability.[182] Furthermore, a finding of good faith was not required for a determination that a party has been "wholly successful."[183]

Internet Navigator, Inc., was an Internet service company with six individual shareholders. In early 1997, three of the six shareholders sued Internet, its CEO, and the other shareholders who were also board mem-

178. *Id.*
179. *Id.* at *2.
180. 301 B.R. 1 (B.A.P. 8th Cir. 2003).
181. Iowa Code § 490.852 (1989), *quoted in Internet Navigator*, 301 B.R. at 4.
182. *Internet Navigator*, 301 B.R. at 3.
183. *Id.* at 4.

bers for breach of fiduciary duty, fraud, and misrepresentation ("First Lawsuit"). The plaintiffs sought dissolution of the corporation and money damages. The CEO hired the company's corporate counsel to represent Internet and the individual defendants in the First Lawsuit. The parties to the First Lawsuit were able to reach a settlement of most of the disputed matters and entered into mutual releases whereby the individual defendants and Internet did not incur any liability, and the remainder of the case proceeded under Iowa statutory law as a shareholder valuation suit. Notably, the mutual releases provided that the agreement would be void if Internet filed for bankruptcy.[184]

Despite the mutual releases, the three plaintiffs filed a second lawsuit on behalf of all Internet shareholders against Internet and the same individual defendants ("Second Lawsuit"). The same law firm continued to represent the defendants in the Second Lawsuit. The defendants filed a motion for summary judgment, arguing that the Second Lawsuit was barred by the mutual releases signed in the First Lawsuit. The plaintiffs moved to disqualify the defendants' counsel because the law firm was representing Internet as well as the individual directors in what was essentially a shareholder derivative suit.[185]

The law firm withdrew as counsel to Internet in the Second Lawsuit, but continued to represent the individual defendants, as well as all defendants, in the First Lawsuit. In March 2000, the federal district court in Iowa granted the defendants' motion to dismiss in the Second Lawsuit, holding that the action was barred by the mutual releases. The plaintiffs appealed. The parties then reached a settlement of both the First and Second Lawsuits and signed separate agreements superseding all prior agreements. The defendants were again released from all liability, and the plaintiffs received their stock share value.

Internet, however, could not meet the monetary obligations, and the plaintiffs started a suit to collect the amounts due. Internet admitted to the judgment, but a Chapter 11 bankruptcy proceeding soon followed. Competing reorganization plans were proposed by Internet and On-Line Services, Ltd., a company owned by one of the plaintiffs. The bankruptcy court approved On-Line's plan, and On-Line took over Internet's operations and paid all of Internet's debts, except for the defense bills incurred in defense of the First and Second Lawsuits. On-Line refused to indemnify the individual directors for the attorney fees incurred in the First and Second Lawsuits.[186] The bankruptcy court held that On-Line was required to pay the fees and the circuit court, applying Iowa law, affirmed.

184. *Id.* at 2.
185. *Id.* at 3.
186. *Id.* at 3–4.

Iowa statutory law provides:

> Unless limited by its articles of incorporation, a corporation shall indemnify a director who was *wholly successful*, on the merits or otherwise, in the defense of any proceeding in which the director was a party because that director is or was a director of the corporation against reasonable expense insured by the director in connection with the proceeding.[187]

The court held that directors or officers are "wholly successful" as long as they do not incur any personal liability, and noted there was no admission of liability in any settlement or releases in the First or Second Lawsuits. The court also held that good faith is not a requisite to the "wholly successful" inquiry.[188] On-Line argued that the individual defendants were not "wholly successful" because the corporation incurred liability, the individuals were the principals of the corporation, and the liability of the corporation should be imputed to the individuals. The court disagreed on the ground that a fundamental principle of corporate law is that the corporation is separate and distinct from the individual members.[189] Further, the court noted that On-Line did not claim that the individual defendants were liable under an alter-ego theory or on a theory of piercing the corporate veil.[190]

2. Will a D&O Policy Cover the Director or Officer in the Face of a Rescission Claim?

Courts continue to address the nuances of D&O insurers' efforts to seek rescission of policies purchased by the corporation to protect itself and its directors and officers from litigation. A D&O insurer's rescission action typically alleges that misrepresentations or omissions in the D&O application were material or fraudulent at the time the company applied for the insurance and, had the insurer known the truth, the insurer's decision to place the coverage or set the premium would have been affected. The leading cases in the last year addressing rescission show the varied judicial interpretations of state law requirements, as well as the application of the terms of the insurance policy to the underlying facts.[191]

187. Iowa Code § 490.852 (1989), *quoted in Internet Navigator*, 301 B.R. at 4 (emphasis added).

188. *Internet Navigator*, 301 B.R. at 4.

189. *Id.* at 5.

190. *Id.*

191. *See* Associated Elec. & Gas Ins. Servs., Ltd. v. Rigas, No. Civ.A. 02–7444, 2004 WL 540451 (E.D. Pa. Mar. 17, 2004); *In re* HealthSouth Corp. Ins. Litig., 308 F. Supp. 2d 1253 (N.D. Ala. 2004); Cutter & Buck, Inc. v. Genesis Ins. Co., 306 F. Supp. 2d 988 (W.D. Wash. 2004); Fed. Ins. Co. v. Tyco Int'l Ltd., 784 N.Y.S.2d 920 (Table), 2004 WL 583829 (Sup. Ct. Mar. 5, 2004); *In re* Adelphia Communications, 298 B.R. 49 (S.D.N.Y. 2003).

The standard for policy rescission is well settled and is codified in most states.[192] D&O insurers typically require certain information in the policy application, including financial statements, annual reports, corporate bylaws, and corporate litigation history. The insurer relies on this information to evaluate risk and to determine policy premiums. Some courts have held that "an insurance policy issued in reliance on material misrepresentation is void from its inception."[193] Should the insurer prevail, the rescission will void the coverage ab initio. The elements required for rescission vary from state to state, but generally an insurer must prove the following: (1) a representation, (2) the falsity of the representation, (3) the materiality of the misrepresentation, (4) the insurer's reliance on the misrepresentation, and in some cases (5) the insured's knowledge of the representation's falsity (i.e., scienter).[194] Almost every state affords an insurer a right to rescission if the misrepresentation or omission is material. In general, a misrepresentation or omission is deemed material if knowledge or ignorance of the information would influence the insurer's decision to grant coverage, affect the degree and character of the risk, or affect the pricing of the premium.[195] Many jurisdictions hold that proof of the policyholder's intent to deceive is not essential for a misstatement to be material. In fact, an insurer may seek rescission based on innocent misrepresentations.[196] Some jurisdictions, however, do require an intentional misrepresentation.[197] Materiality is generally a case-specific inquiry.

The decision of a D&O insurer to rescind a D&O policy has a drastic effect on the insureds. Coverage is deemed never to have existed, and the stark reality of funding defense costs and a settlement or judgment without insurance proceeds is daunting. With the intensified scrutiny of corporate

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192. *See* Fla. Stat. Ann. § 627.409 (1996); Del. Code Ann. tit. 18, § 2711 (1989); 215 Ill. Comp. Stat. Ann. 5/154 (West 1997); La. Rev. Stat. Ann. § 22:619 (West 1978 & 1994 Supp.); Mass. Gen. Laws ch. 175, § 186 (1998); R.I. Gen. Laws § 27–18–16 (1979); Tex. Ins. Code § 21.16 (Vernon 1981); Va. Code § 38.2–309 (Michie 2004); Wash. Rev. Code Ann. § 48.18.090 (West 1999).

193. Am. Int'l Specialty Lines Ins. Co. v. Tower Fin. Corp., No. 94 Civ. 2727, 1997 WL 906427, at *7 (S.D.N.Y. Sept. 12, 1997) (citing Shapiro v. Am. Home Assurance Co., 584 F. Supp. 1245, 1249 (D. Mass 1984)) (holding that misstatement of financial condition was material to insurers' decision to issue policy). *See also* Nat'l Union Fire Ins. Co. v. FDIC, No. 03A01–9405-CH-00179, 1995 WL 48462, at *6 (Tenn. Ct. App. Feb. 8, 1995) (holding that misrepresentation made in financial statement materially increased insurer's risk of loss).

194. Dan A. Bailey, *D&O Policy Commentary*, Practising Law Institute, PLI Order No. A0–00JZ (June 2003).

195. *See* FDIC v. Underwriters of Lloyd's, 3 F. Supp. 2d 120, 140 (D. Mass. 1998); FDIC v. Moskowitz, 946 F. Supp. 322, 331 (D.N.J. 1996); Montgomery v. Fed. Ins. Co., 836 F. Supp. 292, 296 (E.D. Pa. 1993).

196. *See* Chicago Ins. Co. v. Halcond, 49 F. Supp. 2d 312, 315 (S.D.N.Y. 1999); Eisenberg v. Allstate Ins. Co., No. CV97–9171 AS CTX, 1998 WL 422653, at *4 (C.D. Cal. Apr. 15, 1998).

197. Bogatin v. Fed. Ins. Co., No. 99–4441, 2000 WL 804433, at *67 (E.D. Pa. June 21, 2000).

practice and public company filings, an increasing number of courts have been asked to determine whether an insurer is entitled to rescind a policy.

a. Recission Is Appropriate When the Insured's Misrepresentations Are Material and Made with the Intent to Deceive—In *Cutter & Buck, Inc. v. Genesis Insurance Co.*,[198] the U.S. District Court for the Western District of Washington held that an insurer's rescission was proper and applied to all insureds under the policy, regardless of their involvement in or knowledge of the misrepresentations. The court further held that an insurer can rescind a D&O policy when misrepresentations are contained in the company's public filings and incorporated into the company's D&O application.[199]

The case involved Cutter & Buck, Inc. ("C&B"), a Washington-based retail sportswear business. In April 2000, C&B engaged in a series of distributor transactions with three companies in which it shipped its products to them and accounted for the shipments as sales. These transactions, however, were not sales. The distributors agreed to hold the products until C&B could find actual buyers. Apparently, C&B did this as a way to artificially increase revenue to meet Wall Street expectations. By April 2001, C&B had not sold the bulk of the goods and the distributors returned the products to C&B. Rather than accounting for these returned products in the appropriate manner, C&B allegedly hid these returns in other sales channels.[200]

C&B had been insured by Genesis Insurance Co. since 1995. C&B's D&O policy was due for renewal in August 2001. In May 2001, a Genesis underwriter met with C&B's then-CEO, CFO, and COO to discuss renewal terms and conditions. The Genesis underwriter specifically inquired about the company's revenue recognition and right of return policies. C&B told the underwriter that it had a conservative revenue recognition policy, recognized revenue only when product was sold to customers, and returns were limited to defective product. The then-CFO completed and signed the D&O renewal application in August 2001, incorporating by reference the required company annual report, SEC filings, and CPA letter. The signor declared that the statements contained in the application were true and complete. Genesis bound coverage for the 2001–2002 policy period.[201]

In April 2002, C&B's CEO and COO resigned. The interim CEO discovered the distribution transactions and launched an investigation through outside counsel and auditors.[202] In early August 2002, as part of the renewal process for the D&O policy, C&B informed the Genesis underwriters of the distribution transactions. In the first week of August 2002, C&B sent

198. 306 F. Supp. 2d 988 (W.D. Wash. 2004).
199. *Id.* at 996–97.
200. *Id.* at 993.
201. *Id.*
202. *Id.* at 994.

a letter notifying Genesis of circumstances that could give rise to a claim against C&B relating to the distribution transactions. C&B also issued a press release indicating that there was evidence that the company's standard accounting practices and controls had been circumvented.[203]

By early September 2002, a series of shareholder lawsuits had been filed against C&B. C&B notified Genesis of the actions and Genesis, through its coverage counsel, investigated the claim and found a pivotal document detailing the accounting scheme and indicating that the then-CFO (signor of the 2001–2002 application) had knowingly and intentionally participated in the scheme. Genesis promptly sent C&B a notice rescinding the D&O coverage as to C&B and all directors and officers on the grounds that C&B had made material misrepresentations with the intent to deceive in the 2001–2002 and 2002–2003 underwriting process. In response, C&B brought a breach of contract action against Genesis, claiming that Genesis had wrongfully rescinded the D&O policy. Genesis moved for summary judgment on C&B's breach of contract claim, arguing that various documents that C&B had submitted as a part of the 2001–2002 renewal process contained material misrepresentations made with the intent to deceive.[204]

The federal court in Washington reviewed the issue under a state law limiting an insurance company's right to rescind a contract.[205] The court noted that C&B's 2001–2002 renewal application listed the annual report, CPA letter, and SEC filings as "additional required application materials" and indicated that Genesis would rely on such documents in issuing the policy. The court held that by including this language, Genesis advised C&B that it would rely on the signor's representation that all of the statements that were a part of the application, including the required documents, were true. Further, the application itself stated that the statements in the application and materials submitted therewith were representations "and that this Policy is issued in reliance upon the truth of such representations."[206] The court concluded that C&B represented to Genesis that the application and additional documentation, although not physically attached but incorporated by reference, were true and accurate. The court then examined the actual statements, concluding that the information provided to Genesis was false.[207]

The next issue that the court addressed was whether these false statements were material to Genesis's decision to issue the coverage. The court returned to the language of the application that stated that the "insurer will have relied upon this application and attachments in issuing any pol-

203. *Id.* at 995.
204. *Id.* at 996–97.
205. *Id.* (citing Wash. Rev. Code § 48.18.090(1)).
206. *Id.* at 997–98.
207. *Id.* at 1002–03.

icy," and that such material "shall be deemed material to the acceptance of the risk . . . ."[208] Further, the underwriter stated that the information contained in these documents was material to her decision to issue the coverage as the documents were the primary source of information regarding the company's management and financial condition.[209]

Finally, the court examined C&B's intent to deceive, noting that such intent is presumed when false statements are knowingly made.[210] C&B's intent to deceive could be inferred from various "smoking gun" documents, including the then-CFO's notes stating that he "made a big mistake [sic] in not squelching the dis[tributor] deals in FY 00 . . . I got away with it . . . ." The court also looked to the then-CFO's invocation of the Fifth Amendment and his pleading guilty for wire fraud.[211] However, an intent to deceive could not be inferred from the facts set forth in the SEC's Cease and Desist Order.[212]

b. Severability Language May Limit an Insurer's Ability to Rescind Policy in Total—In *In re HealthSouth Corp. Insurance Litigation*,[213] a federal district court applying Alabama law held that a severability clause in a D&O policy precluded the insurer from rescinding coverage for all directors and officers.

This action involved the consolidated claims and counterclaims of ten D&O insurers seeking to rescind coverage, or, alternatively, to receive a declaratory judgment that their policies provided no coverage to HealthSouth Corporation and various directors, officers, and employees who were insured under the policies. The insurers alleged that HealthSouth provided materially false and misleading financial information to procure insurance coverage, and that the policies were void ab initio. In support of their claim, they argued that the evidence supported a finding of an intent to deceive based on an SEC investigation of HealthSouth's financial filings and numerous guilty pleas entered by HealthSouth former officers admitting participation in a scheme to alter the company's financial reports. The individual directors and officers requested partial summary judgment on the ground that there was no basis for rescission unless the insurer had a written application that corresponded to the precise policy, and that the policies contractually limit the right of rescission to intentional or knowing fraudulent misrepresentations.[214]

The court held that an insurance company cannot claim rescission rights in its policy that would provide greater protection for the insurance com-

208. *Id.* at 1003.
209. *Id.* at 1004.
210. *Id.*
211. *Id.* at 1004–05.
212. *Id.*
213. 308 F. Supp. 2d 1253 (N.D. Ala. 2004).
214. *Id.* at 1258.

pany than is permitted by the Alabama rescission statute. It can, however, contractually limit the grounds for rescission to a standard that allows more protection for the insured.[215] Under Alabama law, an insurer can rescind a policy or deny coverage if, in the application or "in negotiations therefor[ ]," the insured made misstatements that (1) were intentionally fraudulent; (2) were material to the risk, although innocently made; or (3) affected the insurer's good faith decision to issue the policy.[216]

The severability clause in the primary insurer's policy provided:

> Such written application(s) for coverage shall be construed as a separate application of coverage for each of the Insured Persons. With respect to the declarations and statements contained in such written application(s) for coverage, no statement in the application or knowledge possessed by an Insured Person shall be imputed to any other Insured Person for the purpose of determining if coverage is available.[217]

The court held that the severability clause gave each insured the right to have coverage determined separately, since the representations or knowledge of one insured cannot be imputed to another insured.[218] Accordingly, the insurer could not rescind coverage as to all insureds.

c. Insured Entitled to Advancement of Defense Costs Until Ruling on Rescission—In *Associated Electric & Gas Insurance Services, Ltd. v. Rigas*,[219] the U.S. District Court for the Eastern District of Pennsylvania held that Pennsylvania law required the D&O insurers to advance defense costs to directors and officers until a judicial determination is made on the merits of the insurers' rescission action against the company.[220] The court reviewed the issue of whether, under the terms of the insurance policies, the insurers must pay defense costs before the adjudication of the insurers' claim for denial of coverage. In *In re Adelphia Communications*,[221] in a significant rul-

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215. *Id.* at 1269 (citing Ala. Code § 27–14–7; State Farm Fire & Cas. Co. v. Oliver, 854 F.2d 416, 419–20 (11th Cir. 1988)).

216. *Id.* at 1269–70.

217. *Id.* at 1261 (emphasis omitted).

218. *Id.* at 1279–80 (citing and discussing Shapiro v. Am. Home Assurance Co., 616 F. Supp. 900 (D. Mass. 1984). The court also distinguished *Cutter & Buck, Inc.* (see *supra* text accompanying notes 198–212), holding that the severability language in the HealthSouth policies was drastically different from that in the C&B policy, which had provided that misrepresentations that were material or made with the intent to deceive would void the policy in its entirety. *HealthSouth*, 308 F. Supp. 2d at 1280 (citing and discussing Cutter & Buck, Inc.v. Genesis Inc. Co., 306 F. Supp. 2d 1280 & n.37 (W.D. Wash. 2004)).

219. No. Civ.A. 02–7444, 2004 WL 540451 (E.D. Pa. Mar. 17, 2004).

220. *Id. See also* Fed. Ins. Co. v. Tyco Int'l Ltd., 784 N.Y.S.2d 920 (Table), 2004 WL 583829 (Sup. Ct. Mar. 5, 2004) (holding that a D&O insurer must advance defense costs to the company's former CEO even though the insurer rescinded the policies based on material misrepresentations and omissions made on the D&O application).

221. 298 B.R. 49 (S.D.N.Y. 2003).

ing in a long battle over the directors of Adelphia Communications's access to D&O policy proceeds to pay defense costs, the Bankruptcy Court for the Southern District of New York had stayed the insurer's declaratory judgment action seeking rescission of the D&O policies. The court permitted the Rigas family to seek access to no more than $300,000 in policy limits for advancement of defense costs for the class action lawsuits against the Rigases and the individual directors of Adelphia.[222]

The directors and officers of Adelphia Communications had been sued in numerous class action securities actions, and several had been individually named in criminal prosecutions. They were insured under a D&O program that provided defense costs to its insureds. The directors sought payment of their defense costs from the insurers for the fees incurred in the civil securities actions. The insurers notified them that they were rescinding coverage because the policies were allegedly procured by fraud. The insurers then initiated a declaratory judgment action.

The directors argued that the primary policy required prompt payment of defense costs. Additionally, they argued that the insurers' assertions regarding the fraud exclusion and rescission both required a final adjudication and that Adelphia must pay defense costs until such ruling is final.[223] In response, the insurers argued that the policies could be rescinded without a judicial determination and that the policies do not require advance payment of the defense costs.[224]

The Pennsylvania court held that the bankruptcy court stay prohibited a determination of the rescission issue. However, the court noted that if it were to consider the issue, the record would not allow a finding of rescission. Under Pennsylvania law, rescission is available to an insurer without a judicial determination if the insurer repudiates the contract and provides restitution (i.e., return of the insurance premium).[225] The court held that the Adelphia insurers might find themselves "facing a conundrum," however, in that, at a minimum, the insurers had not yet returned the policy premium that Adelphia paid.[226] The court further held that the advancement of defense costs is not at the discretion of the insurers, and the insureds could not be denied their rights under the policy to advancement of their defense costs.[227]

222. *See In re* Adelphia Communications, 302 B.R. 439 (Bankr. S.D.N.Y. 2003).
223. *Associated Elec. & Gas*, 2004 WL 540451, at *3.
224. *Id.*
225. *Id.* at *4.
226. *Id.*
227. *Id.* at *12.

B. *Bankruptcy Changes Everything*

1. What Jurisdiction Does the Bankruptcy Court Have Over a Securities Class Action?

In *California Public Employees' Retirement System v. WorldCom, Inc.*,[228] the U.S. Court of Appeals for the Second Circuit affirmed the district court's assertion of jurisdiction over bondholders' individual Securities Act claims, despite an apparent conflict between a section of the Securities Act that prohibits removal[229] and provisions in Title 28 that allow removal of claims relating to a bankruptcy.[230]

This case involved the claims of state and private pension funds that had purchased WorldCom bonds. Instead of joining in the class action security litigation that had been consolidated in a New York federal court, these bondholders filed individual claims in state courts under the Securities Act of 1933.[231]

In a case of first impression, the Second Circuit resolved the conflict between the two statutes, holding that the bankruptcy removal statute controlled.[232] To reach its decision, the court compared "the bankruptcy removal statute, which contains no exception for claims arising under an Act of Congress that prohibits removal, with the general removal statute, which applies '*[e]xcept* as otherwise expressly provided by an Act of Congress.'"[233] Accordingly, the court concluded that section 22(a) claims that are "related to" a bankruptcy case may be removed to federal court.

2. Will a Claim for Coverage Under the D&O Policy Be Excluded by the "Insured v. Insured" Exclusion?

In *In re HA 2003, Inc. v. Federal Insurance Co.*,[234] the debtor, formerly known as HA-LO, successfully moved for a partial summary judgment

228. 368 F.3d 86 (2d Cir. 2004).

229. Section 22(a) of the Securities Act provides, with one exception, that "no case arising under this subchapter and brought in any State court of competent jurisdiction shall be removed to any court of the United States." 15 U.S.C. § 77v(a), *quoted in WorldCom*, 368 F.3d at 90 & n.2.

230. 28 U.S.C. § 1452(a), in conjunction with § 1334(b), allows for the removal of claims or actions "arising in or *related to*" bankruptcy cases. *WorldCom*, 368 F.3d at 90 & n.3 (quoting 28 U.S.C. § 1334(b) (emphasis added by the court) and citing and quoting 28 U.S.C. § 1452(a)).

231. 15 U.S.C.A. §§ 77a–77aa (2000). The court noted that the bondholders, unlike the plaintiffs in the class action securities litigation, did not assert claims under the Securities Exchange Act of 1934, 15 U.S.C.A. §§ 78a–78mm (2000). According to the court, the bondholders limited their complaint to claims under the Securities Act of 1933 because of the antiremoval provision contained in section 22 of that statute: "In other words, the Bondholders have crafted their complaints in order to avoid removal of their actions to federal court and consolidation of those actions in a single venue." *WorldCom*, 368 F.3d at 91.

232. *WorldCom*, 368 F.3d at 90.

233. *Id.* (quoting 28 U.S.C. § 1441(a)) (emphasis and alteration provided by the court).

234. 310 B.R. 710 (Bankr. N.D. Ill. 2004).

seeking a declaration that the "Insured v. Insured" exclusion did not bar coverage for John Kelley, its former CEO, with respect to HA-LO's adversary proceeding against him. The court concluded that the exclusion did not apply to claims brought by a debtor-in-possession.[235]

In August 2002, HA-LO filed an adversary proceeding in bankruptcy court against Kelley, alleging breach of fiduciary duty and corporate waste.[236] The insurers refused to acknowledge coverage for HA-LO's claims against Kelley, but the primary carrier, Federal, began reimbursing him for defense costs while reserving its right to contest coverage. In February 2004, Federal and three out of four of the excess insurers settled with HA-LO. Zurich offered to tender its policy subject to certain conditions, which were rejected by HA-LO.[237]

The relevant D&O policy contained an "Insured v. Insured" exclusion, which stated that "the Company shall not be liable for Loss on account of any Claim made against any Insured Person . . . brought or maintained by or on behalf of any insured."[238] The policy also provided an exception to this exclusion for bankruptcy claims.[239] The court found that HA-LO as debtor-in-possession fell firmly within the language of the bankruptcy exception because it was authorized under applicable law (the "Bankruptcy Code" and "Bankruptcy Rules") to act on behalf of the debtor.[240] The court rejected Zurich's argument that HA-LO did not fall within the bankruptcy exception because it was not a human "person." Absent a definition of "person" in the Zurich policy, the court turned to the Bankruptcy Code to determine who was authorized to act for a debtor. Because the Bankruptcy Code defines "person" to include "individual, partnership and corporation" the court concluded that the debtor-in-possession, HA-LO, was a "person" for purposes of the bankruptcy exception[241] If the insurer had not intended the bankruptcy exception to extend to debtors-in-possession, the policy should have specifically excluded them. Finally, the court held that Zurich could not deny coverage and still maintain control over the settlement between HA-LO and Kelley.[242]

235. *Id.*
236. *Id.* at 714.
237. *Id.*
238. *Id.* at 714–15.
239. Endorsement 13 exempted from the "Insured v. Insured" exclusion

> a claim (whether or not brought in the name of, on behalf of, or in the right of the Insured Organization) brought by or on behalf of a bankruptcy trustee, magistrate, or any other person appointed by a bankruptcy court or judge, or authorized under applicable law to act on behalf of a debtor or brought by or on behalf of any creditor of the Insured Organization.

Id. at 715.
240. *Id.* at 717.
241. *Id.* at 718 (quoting 11 U.S.C. §§ 101(42) (2000)).
242. *Id.* at 723.

C. *Other Issues Affecting Directors and Officers*

1. "Insured v. Insured" Exclusion Affecting Claims Outside the Bankruptcy Context

The "Insured v. Insured" exclusion continues to be a potent exclusion for insurers to deny coverage in the event of collusive lawsuits. Courts have differed, however, in their interpretations of what is collusive, and in some recent instances have allowed insureds to speak with class counsel on a limited basis if such communication is not for the insured's economic benefit. Two cases from California and Illinois provide a measure of the degree of communication that is permissible without running afoul of this exclusion.

a. Facts Dictate Whether "Insured v. Insured" Exclusion Can Operate to Deny Coverage for Entire Claim—In *Harris v. Gulf Insurance Co.*,[243] the court considered whether the insurer properly declined coverage pursuant to the "Insured v. Insured" exclusion. When Harris and Stone, the former CEO and CFO, respectively, of U.S. Aggregates, Inc., were named as defendants in a consolidated securities fraud class action, the insurer agreed to provide a defense subject to a reservation of rights. However, after the filing of a consolidated amended complaint, the insurer maintained that references to conversations with confidential informants who were officers of subsidiaries of the company triggered the policy's "Insured v. Insured" exclusion.

The exclusion provided that:

> The insurer shall not be liable to make any payments for Loss in connection with any Claim made against any of the Directors and Officers: . . . (6) brought or maintained by or on behalf of the Insured Company and/or the Directors or Officers or by any security holder of the Insured Company whether directly or derivatively except: (a) a Claim that is brought and maintained by security holders who are acting totally independently of and totally without the solicitation, assistance, participation, or intervention of any Director or Officer of the Insured Company.[244]

The plaintiffs filed a declaratory judgment action, seeking a declaration that the exclusion was inapplicable "where two 'Officers' of U.S. Aggregates . . . made statements in response to questions by a person who contacted each of them by telephone and identified him or herself as a representative of the plaintiffs in the securities fraud class action."[245]

Focusing on the word "assistance" in the exclusion, the court rejected Gulf's argument that coverage should be precluded if a director or officer provided any help or aid to plaintiffs in a securities fraud class action, holding that Gulf's interpretation of the term "assistance" was "patently

243. 297 F. Supp. 2d 1220 (N.D. Cal. 2003).
244. *Id.* at 1222.
245. *Id.* at 1223.

unreasonable."[246] In the court's view, there was no evidence that either plaintiff provided information to obtain an economic benefit.

Conversely, in *Denari v. Genesis Insurance Co.*,[247] that court strictly construed the policy's "Insured v. Insured" exclusion. In *Denari*, the plaintiff sued insurers that had issued D&O liability policies to plaintiff's former employer, Navigant Consulting, Inc., complaining of their failure to pay certain legal fees that he incurred as a result of claims brought against him in a securities fraud class action lawsuit.

The plaintiff served as a vice president of Navigant from 1997 until his employment was terminated in November 1999. In late 1999, Navigant shareholders filed multiple securities fraud class action lawsuits against the company and named the plaintiff as one of the defendants. The individual suits were consolidated into the *Stearns* litigation.[248] In December 1999, the plaintiff retained McDermott Will & Emory ("MWE") to represent him in the *Stearns* litigation. MWE represented plaintiff until late summer 2000.

Navigant, Genesis, and the *Stearns* plaintiffs reached a tentative settlement in early August 2000. On September 22, 2000, Navigant and the *Stearns* plaintiffs filed a Stipulation of Settlement with the court. The plaintiff objected to the settlement and hired Cummins & Cronin ("C&C") to represent his position. The settlement required no payment from the plaintiff and resulted in a complete release of the claims against him. On March 22, 2001, the court approved the settlement. The same day, the plaintiff's counsel filed an action seeking payment of fees.[249]

The court held that the plaintiff was collaterally estopped from seeking coverage of C&C's fees under either the Federal or the Genesis policy, as this issue had been addressed in the settlement of the *Stearns* litigation. Further, C&C's fees were not "defense costs" under the Federal policy or "costs of defense" under the Genesis policy because the plaintiff was affirmatively pursuing his own cause of action.[250]

The Genesis policy precluded coverage for any "Loss" in connection with any "Claim" "brought by or at the behest of, or with the assistance or active participation of, [Navigant] . . . or any Director or Officer of [Navigant] . . . ."[251] The Genesis policy defined "Directors" and "Officers" as "all past, current or prospective duly elected or appointed directors and

246. *Id.* at 1226.
247. No. 01 C 2015, 2003 WL 22964371 (N.D. Ill. Dec. 15, 2003).
248. These cases were consolidated under the caption *Stearns v. Navigant, et al.*, No. 99-C-7617 (N.D. Ill). *See Denari*, 2003 WL 22964371, at *3.
249. *Denari*, 2003 WL 22964371, at *3.
250. *Id.* at *4–5.
251. *Id.* at *2.

officers of the Company . . . ."[252] The court concluded that this language unambiguously stated that Genesis would not cover any loss in connection with the claim brought "with the assistance" of a past Navigant officer.[253] It was undisputed that the plaintiff was a past Navigant officer. Consequently, the focus was on whether the plaintiff assisted the plaintiffs in the *Stearns* litigation.

Genesis successfully argued that the plaintiff gave considerable information to Faye Clayton, counsel for the lead plaintiffs in the *Stearns* litigation. The plaintiff met with Clayton several times between June 2000 and September 2000. In addition, "Clayton testified that [the plaintiff] provided her with a 'road map' of Navigant's inner-workings and 'other assistance' that enabled her to force a more advantageous settlement."[254] The plaintiff attempted to minimize the effect of his assistance to securities plaintiffs by stating that "he probably provided a tiny amount [of information] in comparison to Navigant."[255]

The court concluded that the Genesis policy's "Insured v. Insured" exclusion precluded the plaintiff from seeking fees from Genesis in connection with the *Stearns* litigation after he had become adverse to Navigant by assisting the *Stearns* plaintiffs. But he only became adverse to Navigant once he began affirmatively assisting the *Stearns* plaintiffs on June 6, 2000. Accordingly, the "Insured v. Insured" exclusion did not bar him from seeking MWE fees from May 2000 through June 6, 2000, from Genesis.[256]

The Federal policy provided that Federal "shall not be liable for LOSS on account of any CLAIM made against any INSURED PERSON brought or maintained by or behalf of any INSURED . . . ." In contrast to the Genesis policy, the Federal policy did not on its face exclude coverage for loss in connection with a claim brought "with the assistance or active participation of" a Navigant officer or director.[257] Consequently, the court held that the Federal policy did not, as a matter of law, preclude the plaintiff from seeking MWE fees incurred between May and July 2000.

b. The Presence of an Insured Plaintiff Can Defeat Coverage for the Entire Action—In *Powersports v. Royal & Sun Alliance Insurance Co.*,[258] the court considered the "Insured v. Insured" exclusion in the context of a lawsuit brought against a company by former directors. Powersports was founded in September 1997 by brothers Linn and Lee Heaton. At the time of the filing of a declaratory judgment action for coverage, the Heatons were

252. *Id.* at *6.
253. *Id.*
254. *Id.*
255. *Id.*
256. *Id.* at *7.
257. *Id.* at *8.
258. 307 F. Supp. 2d 1355 (S.D. Fla. 2004).

former directors of Powersports. The Heaton brothers and the Heaton Companies, Inc., sued[259] Powersports and other defendants for alleged breach of contract, tortious interference, injunctive relief, and rescission of ultra vires acts.[260]

Royal denied Powersports's request for coverage on the grounds that as former directors and officers of Powersports, Linn and Lee Heaton were insured persons under the policy, which contained an "Insured v. Insured" exclusion precluding coverage for claims made against "the company [Powersports] brought or maintained by or on behalf of . . . any Insured Person."[261] The insurer argued that the "Insured v. Insured" clause barred coverage for the entire action. Powersports conceded that claims filed by the Heaton brothers were not covered, but argued that the Heaton Company, Inc.'s, claims were covered.[262]

The insurer quoted Exclusion A.4 of the policy that mandated that "the Insurer shall not be liable for Loss resulting from any Claim made against any Insured Person, or with respect to . . . the Company . . . brought or maintained by or on behalf of the Company or any Insured Person in any capacity."[263] In turn, the policy defined "Insured Persons" as "[a]ny one or more persons who were, now are or shall be duly elected Directors or duly elected or appointed Officers of the Company."[264]

It was undisputed that the Heaton brothers were "Insured Persons" as defined by the policy. Consequently, the insurer argued that coverage for the entire action was barred, as the Heaton brothers were plaintiffs in the underlying action.[265] In opposition, Powersports argued that the Heaton Companies, Inc., was also a plaintiff in the underlying action, and argued that the Heaton brothers and the Heaton Companies, Inc., brought distinct claims such that coverage should exist for the Heaton Companies, Inc.'s, claims.

The court examined three cases that addressed the issue of whether the presence of an insured plaintiff defeats coverage for the entire action.[266] In *Level 3 Communications, Inc. v. Federal Insurance Co.*,[267] the insured plaintiffs joined the lawsuit six months after it was filed. The court ruled that the claims of a former director were not covered, but that the claims of the

259. Notably, the complaint and the second amended complaint in the underlying action referred to the plaintiffs interchangeably as "Heaton" or "Heatons" without distinguishing between the Heaton brothers and the Heaton Companies, Inc.

260. *Powersports*, 307 F. Supp. 2d at 1358 n.1.

261. *Id.* at 1358.

262. *Id.*

263. *Id.* at 1359.

264. *Id.* at 1360.

265. *Id.*

266. *Id.* at 1360–61.

267. 168 F.3d 956, 959–61 (7th Cir. 1999).

remaining plaintiffs were covered. A ruling to the contrary would have transformed a completely covered claim into a completely uncovered claim. In *Bernstein v. Genesis Insurance Co.*,[268] the court stated in dicta that an "Insured v. Insured" exclusion would bar coverage in its entirety in such an instance. Similarly, in *Sphinx International, Inc., v. National Union Fire Insurance Co.*,[269] the court held that the "Insured v. Insured" clause barred coverage for the entire action where claims were brought by both insured and uninsured plaintiffs. After discussing these three cases, the court in *Powersports* reviewed both the original and the amended complaint, noting the lack of distinction made between the plaintiffs: the term "Heaton" was used to apply to "every single allegation of fact in the underlying pleading and each count asserted in both complaints."[270] Significantly, Powersports also referred to all plaintiffs as "the Heatons" throughout its pleadings in the underlying litigation.[271]

Consequently, the court concluded that, where the Heaton brothers were parties to all claims in the underlying action, the "Insured v. Insured" clause rendered the entire action uncovered. The court distinguished *Level 3 Communications*, holding that Powersports was uncovered from the inception of the case. The court also rejected the plaintiffs' allocation argument by noting that allocation only applies when coverage is implicated.

2. Insured Was Not Entitled to Recover Unpaid Overtime Wages Because There Was No "Loss" as Defined by the Policy

In *Big 5 Corp. v. Gulf Underwriters Insurance Co.*,[272] the U.S. District Court for the Central District of California rejected the insured's claims for breach of contract and breach of good faith and fair dealing. The insured alleged that the insurer should have paid defense costs and indemnified the insured for the settlement of a lawsuit brought by former employees for payment of overtime wages. The policy at issue in this case specifically excluded indemnification for the wages of former employees in an "employment claim."[273] Alternatively, the policy contained an exclusion for labor-related claims under federal, state, or local labor laws.[274] The insured tried to label the unpaid wages as compensatory damages rather than restitutionary in order to bring them within the definition of "loss" under the policy, but could not refute that the settlement payment covered unpaid overtime wages or costs related to the claim for unpaid overtime wages.[275]

268. 90 F. Supp. 2d 932, 936 (N.D. Ill. 2000).
269. 226 F. Supp. 2d 1326, 1330, 1341 (M.D. Fla. 2002).
270. *Powersports*, 307 F. Supp. 2d at 1361.
271. *Id.* at 1362.
272. No. CV 02–3320WJR(SHX), 2003 WL 22127029 (C.D. Cal. July 14, 2003).
273. *Id.* at *2.
274. *Id.* at *3.
275. *Id.* at *2.

With regard to the insured's claim for attorney fees, the court held that an award of attorney fees could not exist independent of a damages award. Since the lawsuit against the insured did not involve a covered "loss," the insurer was not required to assume responsibility for the insured's defense costs.[276]

3. The Fifth Circuit Strictly Interprets the Personal Profit Exclusion

A recent decision from the Fifth Circuit underscores the importance of including effective severability clauses in a policy to ensure that conduct will not be imputed to innocent directors and officers. In *TIG Specialty Insurance Co. v. PinkMonkey.com, Inc.*,[277] the court affirmed summary judgment in favor of the insurer, holding that it was not liable for a state court judgment against its insureds.

TIG issued PinkMonkey and its directors and officers a D&O liability policy that included a securities claims endorsement for all securities claims against the company. The policy also included a "personal profit exclusion" precluding coverage for "any claim [against any insured] based upon, arising from, or in consequence of an insured having gained in fact any personal profit, remuneration, or advantage to which such insured was not legally entitled."[278]

Greene was the largest shareholder in PinkMonkey, its chairman, and its chief executive officer during the pertinent time period.[279] Kim was a securities dealer representing PinkMonkey. There were five other officers and directors implicated in the allegations. The plaintiffs in the underlying action ("investor plaintiffs") filed a state court action alleging that Greene and Kim solicited them to invest in PinkMonkey and made numerous misrepresentations about the investment. The state court jury returned a verdict for the investor plaintiffs that the defendants had violated state securities laws.

Subsequently, TIG denied the coverage claims of PinkMonkey, Kim, Greene, and two directors who settled prior to trial, and sought a declaratory judgment that the claims were not covered. The court held that the personal profit exclusion precluded all coverage for the claims at issue, as Greene personally profited from the sale of the stock. The investor plaintiffs appealed, arguing that Greene did not gain personal profit, and that, even if he did, the exclusion should not apply to the company or the other D&O defendants.

276. *Id.* at *3.
277. 375 F.3d 365 (5th Cir. 2004).
278. *Id.* at 368.
279. *Id.* at 367.

The investor plaintiffs unsuccessfully argued that applying the personal profit or advantage exclusion would effectively "eviscerate" the securities claims coverage provided under the policy.[280] In rejecting the investor plaintiffs' argument that the exclusion applies only to claims against an insured, the court noted:

> Insureds are separate from the Company. While some securities claims against the Company will be considered a claim against an Insured, when . . . both the Company and the Insured are sued based upon the same wrongful acts, not all claims against the Company will be considered a claim against an Insured. As the personal profit exclusion does not necessarily apply to all Securities claims against the company, it does not eviscerate the Securities Claim Endorsement.[281]

Here, Greene had been convicted of statutory stock fraud, and could have been required to return the capital investment. Therefore, Greene gained a personal profit or advantage to which he was not legally entitled, meeting the requirements of the personal profit exclusion. With regard to the imputation of Greene's illegal gain to the company and other directors and officers, the court held that the language of the exclusion pertaining to "an insured" precluded coverage for all insureds, not merely the insured who profited. Since all of the claims against the directors and officers and Kim arose out of Greene's fraud, the personal profit exclusion operated to preclude coverage for all defendants.[282]

280. *Id.* at 370.
281. *Id.* at 370.
282. *Id.* at 372–73.