Client Alert

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Real Estate Investment Policyholders Prevail in Delaware and New York D&O Coverage Disputes

New York and Delaware courts resolved two coverage issues in favor of directors and officers of real estate investment trust advisory companies in lawsuits against their liability insurers. Both decisions arise out of ongoing coverage disputes related to allegations of fraud and other wrongdoing in connection with accounting irregularities.

In *Westchester Fire Insurance Co. v. Schorsch, et al.*, the New York trial court granted partial summary judgment for Nicholas Schorsch and other individual officers and directors insured under an excess directors and officers liability policy issued by Westchester to RCAP Holdings LLC. RCAP had filed for Chapter 11 bankruptcy pursuant to a restructuring agreement that created a supervised creditor trust for gathering and distributing RCAP's credit assets. The bankruptcy court confirmed the plan of reorganization, including authorizing the creditor trust to pursue litigation to further the interests of the bankruptcy estate.

The RCAP creditor trust later filed a lawsuit alleging breach of fiduciary duty claims against RCAP and other individual defendants. RCAP and the individual insureds sought coverage under its D&O insurance policies. A separate federal action pending in New York subsequently settled, which exhausted $31 million in coverage under RCAP's primary policy and several excess policies. The next excess insurer in the program, Westchester, denied coverage based in part on the policy's insured versus insured exclusion, arguing that the exclusion prevented RCAP from recovering losses caused by its own officers and directors. RSUI adopted Westchester's position in the ensuing coverage litigation.

The individual insureds argued that the insured versus insured exclusion did not apply due to an exception for claims brought by a bankruptcy trustee or examiner, receiver, conservator, liquidator, or "other comparable authority." They asserted that the exclusion must be interpreted narrowly against the excess insurers, that "comparable authority" is ambiguous, and that construing the exclusion in their favor requires deeming the creditor trust a comparable authority because it is the functional equivalent of a creditor committee and was established to obtain funds for RCAP's creditors. The insurers countered that the creditor trust was not independent or disinterested in the same way that a bankruptcy trustee, receiver, or liquidator would be and cannot be construed as a comparable authority.

The court rejected the insurers' argument and agreed with the individual insureds. The court first recognized several fundamental contract interpretation principles, including that ambiguous policy language will be construed in favor of coverage, that exclusions will be construed narrowly and against the insurer, that the duty to defend is exceedingly broad, and that an insurer may only be relieved of its duty to defend if there is no possible factual or legal basis upon which it might be obligated to indemnify the insured. Applying these established principles, the court found that the phrase "comparable authority" was ambiguous and, therefore, had to be construed against the insurer, particularly since it was being invoked to restrict coverage.

In view of the ambiguous policy language, the court held that the insured versus insured exclusion did not apply and granted summary judgment in favor of the individual insureds. Moreover, because the insurers' duty to defend extended to all actions arising out of the covered occurrence and the excess insurers had forced RCAP to litigate its coverage claims by filing a declaratory judgment action, the court applied New York's *Mighty Midgets* rule to order that the insurers pay the insureds' coverage counsel's fees in defending against the declaratory judgment action.

The decision presents two takeaways. The first is that—given the insurer's burden of drafting clear exclusionary language—exceptions to exclusions may still carry the day even where a particular factual situation is not explicitly contemplated. Exclusions often include broader "catchall" items among lists of terms, which insurers often rely on to attempt to construe coverage narrowly. Where such catchalls appear in affirmative coverage grants or exceptions to exclusions, however, policyholders should consider whether analogous situations not expressly accounted for are nevertheless covered. In this instance, RCAP's creditor trust was not a trustee, receiver, or liquidator but functioned like a creditor's committee that could reasonably be considered a comparable authority not subject to the insured versus insured exclusion.

Another takeaway is that the insureds were able to recover their attorneys' fees in defending the declaratory judgment action initiated by the insurers. Not all jurisdictions have similar fee-shifting rules like those that applied under New York law, but policyholders should carefully examine the potential pros and cons of litigating coverage claims under applicable state law. For instance, New Jersey allows a successful claimant under an insurance policy to recover its coverage counsel's fees. The risk of having to pay for an insured's coverage counsel's fees may incentivize an insurer to resolve a coverage claim without having to incur the time and expense of litigating.

In the second lawsuit, *AR Capital, et al. v. XL Specialty Insurance Co., et al.*, a related real estate investment trust entity, AR Capital, and several directors and officers (who were also parties to the Westchester and RSUI New York action), received a partial victory in keeping five D&O insurers in a coverage lawsuit filed in Delaware state court. The insureds sought declaratory relief and damages for anticipated losses and alleged that the insurers failed to meet their coverage obligations under separate insurance programs in connection with claims for losses arising from government investigations.

The insurers argued that the Delaware court lacked personal and subject matter jurisdiction and moved to dismiss. The D&O insurers also argued that the Delaware action should be stayed in favor of the insurers' preferred New York state court actions because those lawsuits were filed first and are entitled to deference over the "reactive lawsuit" filed in Delaware.

The court granted the motion to dismiss one group of insurers on jurisdictional grounds, but denied the D&O insurers' motion, allowing the Delaware action to move forward. The court noted that the New York actions and the Delaware action were filed one day apart and, therefore, the first-filed lawsuits were not entitled to any deference. The other factors relevant to forum selection did not require dismissal where the D&O insurers did not meet their burden of demonstrating overwhelming hardship.

It is unclear what the Delaware court would have done had the two sets of lawsuit not been filed almost contemporaneously, but the policyholders certainly benefited from filing a lawsuit a day after the insurers initiated the New York actions. Policyholders should consider all available options for resolving contested coverage claims, including understanding applicable state laws on coverage issues and recovery of coverage counsel fees and being prepared to quickly file a lawsuit in a favorable forum in the event that the claim cannot be resolved before litigation. Retaining experienced coverage counsel early on in the claim process can help in those efforts and mitigate the risk of being forced to fight an insurer's coverage denial in the insurer's preferred forum.

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