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New York Court Upholds Denial Of Coverage Where Policyholders Breached D&O Policy's Consent-To-Settle Provision

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In *Federal Ins. Co. v. Safe Net, Inc.*, 2011 WL 4005353 (S.D.N.Y. Sept. 9, 2011), a New York federal judge granted partial summary judgment in favor of Federal Insurance Company (Federal), holding that SafeNet, Inc. (SafeNet) and its vice president and chief financial officer failed to comply with the consent-to-settle provision in their D&O policy and were thus precluded from recovering under the policy with respect to their settlement of a securities fraud class action.

The insured, SafeNet, is a public company that provides security technology to public and private customers. Federal issued two successive claims-made directors and officers liability excess policies to SafeNet for the periods March 12, 2005 to March 12, 2006 (the First Federal Policy) and March 12, 2006 to March 12, 2007 (collectively the policies). Of particular significance, the policies included a consent-to-settle provision.

Beginning in 2006, SafeNet began to experience legal problems. In particular, between February and September 2005, it disclosed that it had been subjected to a number of restructuring charges and government investigations, as well as issues involving options backdating. Not surprisingly, a number of civil lawsuits were filed, including a shareholders class action suit naming SafeNet, its Vice President and Chief Financial Officer Carole Argo, and various other directors and officers as defendants. Government enforcement actions also followed, which the defendants settled without admitting or denying the claims against them. Argo also plead guilty to securities fraud relating to the backdating of SafeNet stock options.

During this period, SafeNet and Federal exchanged correspondence with respect to coverage for the various pending litigation and claims. The coverage issues came to a head in late 2010, when SafeNet and its directors and officers agreed to settle the pending class action litigation for $25 million without first seeking Federal's consent.

After dispensing with a number of threshold issues, including that, pursuant to its relation back provision, the First Federal Policy applied to the class action due to the fact that SafeNet provided notice of facts and circumstances that gave rise to the underlying litigations and investigations in a February 2006 Notification, the court found that SafeNet breached the policy's consent-to-settle provision because it failed to request or obtain Federal's consent to the $25 million settlement with the shareholder class members. The court noted that because Federal did not issue a blanket denial of coverage — Federal repeatedly informed SafeNet that it was investigating its obligations, that it believed partial rescission was appropriate, that coverage would remain for certain insureds who lacked the requisite knowledge of inaccurate information in the insurance application, and that it would seek judicial input as to its policy obligations —SafeNet was not excused from complying with the consent-to-settle provisions.

At the same time, the court noted that insofar as Argo admitted having engaged in stock backdating (i.e., fraud), SafeNet's public filings contained material inaccuracies. As such, statements in SafeNet's insurance application necessarily included undisputedly known misstatements. Because of this, the court held that the First Federal Policy

was void *ab initio* as to Argo. Moreover, the court held that Argo's knowledge was imputed to SafeNet, causing the policy to be void *ab initio* as to SafeNet as well. However, the court also declared that it was unable to issue an opinion as to what coverage, if any, was available to other officers and directors, because other potential insureds were permitted an opportunity to establish that they lacked actual knowledge of the improprieties.

Based on the foregoing, the court granted Federal's summary judgment in part, ruling that SafeNet breached the First Federal Policy's consent-to-settle provision and that Federal was entitled to rescission of the policy as to Argo and SafeNet. The issue of whether or not other officers and directors lacked requisite knowledge of the wrongdoings, and thus whether or not they were entitled to coverage, remains open.

The *SafeNet* decision affirms that consent-to-settle provisions will be enforced, and that the failure of an insured to abide by such provisions remains a vital coverage defense. *See also, Napster, LLC v. Rounder Records Corp.*, 761 F. Supp.2d 200 (S.D.N.Y. Jan. 25, 2011) (an advance-consent provision is an express condition precedent to an insurer's duty to indemnify); *Continental Cas. Co. v. Ace American Ins. Co.*, No. 07 Civ. 958 (PAC), 2009 WL 857594, at *3 (S.D.N.Y. Mar. 31, 2009) ("Under New York law, consent-to-settle provisions are a condition precedent to coverage and are routinely enforced"). The decision also establishes that an insured will not be excused from complying with such provisions when an insurer does not issue a blanket denial of coverage.

To discuss any questions you may have regarding the issues discussed in this alert, or how they may apply to your particular circumstances, please contact Richard Bortnick at 610.832.8357 or rbortnick@cozen.com or Greg Delfiner at 610.832.8368 or gdelfiner@cozen.com.

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