

**Ummm, could you front me some
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when I get out of jail.**

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Ummm, could you front me some cash please? I'll pay you back when I get out of jail.

[The Contemporaneous Payment of Attorneys' Fees Under D & O Liability Policies]

There is a question that has plagued many insurance companies, insureds, courts and lawyers over the past several years: Is a D & O insurer required to advance the defense costs to an insured being sued for conduct that may be excluded from coverage under the subject policy? As in any insurance coverage dispute, the policy language is considered paramount. But the parties fighting over the coverage of a D & O policy, quite naturally, always seem to interpret the language differently.

Of course, the best route for all parties is to avoid this scenario altogether by addressing the timing-of-payment issue before the policy is purchased. But if you do find yourself (or your client) in one of these frustrating situations, the stalemate can be broken by a creative attorney who tactfully persuades the judge using available authority. This article will help you solidify your thinking as regards the steps to take to get out– and stay out– of one of these blood-letting disputes.

I. OVERVIEW OF D & O POLICIES AND THEIR RELATED PITFALLS

Fact of life: corporate officers get sued. And these civil and criminal lawsuits filed against directors and officers most often originate from shareholders, shareholder-derivative actions, customers, regulators, or competitors (for unfair trade practice or anti-trust allegations). Corporations commonly purchase Directors and Officers Liability Insurance (“D & O” for short) to protect their corporate decision-makers from the crippling costs associated with defending, settling, and paying judgments in connection with litigation brought against them as individuals. As a practical matter, the corporation generally ends up indemnifying the director or officer for these lawsuit expenses anyway (at least where such person is not found guilty of harming the corporation). So D & O insurance is almost always purchased by the corporation on behalf of its officers and directors.¹

Nowadays, it is getting harder for corporations to attract and hire directors and officers without providing them with D & O insurance. Directors and officers expect this protection because they are increasingly being targeted by both criminal and civil litigation. Peter Goldman, editor of White Collar Crime Reporter said, “White-collar crime is spinning through the roof. It’s spinning new varieties daily and the incidences and amounts of money being stolen are incredible.”² White-collar criminal cases are

¹ See 49 A.L.R. 3d 1250 (1973).

² Labaton, Stephen. *New York Times*, “Downturn and Shift in Population Feed Boom in White-Collar Crime” (June 2, 2002).

often accompanied by civil actions brought by the government and private parties. And the Administrative Office of the United States Courts has reported a marked increase in these types of civil lawsuits. Even though the total number of federal civil lawsuits dropped by over 21,000 from 1997 through 2001, the number of government and private lawsuits for securities fraud and other types of financial violations more than *doubled* in that same period (rising from 1,669 to 3,538)!³ These statistics make it clear why D & O insurance has become such a hot topic.

A. THE BASICS OF D & O COVERAGE

Stated simply, D & O insurance is insurance payable to the directors and officers of a company for when they get sued for something that happened while they were acting within their capacity of their company. But unlike an ordinary liability insurance policy in which the corporate purchaser obtains primary protection from lawsuits, a D & O policy indirectly insures a corporation for its indemnification obligations.⁴ More specifically, a D & O policy covers the individual directors and officers against loss arising from claims against them for wrongful acts in cases where they are not indemnified by the company.⁵ And, although the policies purport to offer coverage for amounts that an insured has become “legally obligated to pay” for loss in connection with wrongful acts committed in their capacities as corporate directors and officers, an entitlement to coverage usually depends on the satisfaction of several requirements and preconditions that are set forth in the policies.⁶

D & O policies also purport to protect an officer or director from payment for the attorneys’ fees incurred in defending a lawsuit. But, importantly, D & O liability policies do not impose a “duty to defend” on the insurer. So the insured typically hires his own counsel and the insurance company (after approving the use of chosen counsel) pays for all “reasonable” and “necessary” legal expenses. A lot of D & O policies are unclear on the timing of payment: whether the insurer has to reimburse these costs at the end of the litigation or at the time the attorney’s monthly bill becomes due. This timing-of-payment ambiguity usually manifests itself when an insured is being sued for conduct that, if proven, would be excluded from coverage under the policy.

These ambiguities vary from policy to policy because D & O insurance is not sold on a common form used by the insurance industry as a whole, rather, each insurance company has developed its own set of forms.⁷ Most D & O policies have an insuring clause that generally provides coverage for “claims” made during the policy period for which the coverage was purchased. “Claims” are generally defined as any (1) civil,

³ *Id.*

⁴ *In re First Cent. Financial Corp.*, 238 B.R. 9, 34 Bankr. Ct. Dec. (CRR) 1210, Bankr. L. Rep. (CCH) ¶77996 (Bankr. E.D.N.Y. 1999).

⁵ *Bank of Commerce and Trust Co. v. National Union Fire Ins. Co. of Pittsburgh*, Pa. 651 F.Supp. 474, 476 (N.D. Okl. 1986).

⁶ See 22 A.L.R. 6th 113 (2007)

⁷ *In re Enron Corp. Securities, Derivative & "Erisa" Litigation*, 391 F.Supp.2d 541, 570 (S.D.Tex. 2005)

criminal or administrative proceeding, or (2) written demand for damages against an insured. But some policies give more specific definitions of “claims” (i.e. a policy may construe a civil proceeding to include arbitration and mediation).

D & O policies insure directors and officers against a “losses” arising out of one of these covered “claims.” The term “losses” is generally defined to include damages, judgments, awards, settlements and defense costs. But fines or penalties, taxes, multiplied damages, and matters uninsurable under law are generally excluded from the definition of “losses” –and are thus not covered by the D & O policy.

B. THE RECURRING PROBLEM WITH D & O POLICIES

D & O policies do have a few common exclusions; the most important of which (for purposes of this article) is the Dishonesty Exclusion. The standard Dishonesty Exclusion prohibits coverage for claims made as a result of the insured’s dishonesty, fraud, or willful violation of the law. Here’s the problem: a final judicial determination is usually necessary to determine whether the insured’s conduct was indeed dishonest, fraudulent or willful. But the defense costs necessary to get to that point can be enormous. So, in the meantime, should the insurance company be expected to fork out cash for the insured’s defense even though there is a good chance the insured’s conduct will end up being excluded from coverage under the dishonesty exclusion –or, on the other hand, should the insured be hung out to dry? Neither option seems fair.

Here’s an example. An insurance company insures a corporation’s officer under a D & O policy. During the policy period, the insured officer gets sued by the corporation’s shareholders for cooking the books. At first glance, this appears to be a covered “claim” under the policy. So it seems the insured officer would be entitled to coverage under the policy for all “losses” he incurs as a result of the “claim.” The term “losses” is defined under the policy to include attorneys’ fees. But the lawsuit alleges securities FRAUD (uh oh. . .this is a carve out under the D & O policy’s Dishonesty Exclusion). So how can the insurer be certain of the fraud claim’s validity until after the trial is completed? It can’t. Hence, the dilemma –should the insurer pay for the insured’s defense expenses as they are incurred or deny payment until after the matter is adjudicated.

In these situations, either the insured or the insurer will be put over a barrel. One option is for the insurer to deny coverage under the Dishonesty Exclusion. But if the insurance company refuses to pay—contemporaneously—for the insured’s defense, the insured may not be able to procure or keep talented (which most often means expensive) defense counsel. And this deprivation is akin to denying a defendant his Constitutional right to counsel. For example, in *U.S. v. Stein*, No. 05 Crim. 0888 (S.D. N.Y), a New York district court rebuked federal prosecutors for strong-arming the KPMG accounting firm into cutting off payment of the defense costs for 12 KPMG partners by threatening to indict the entity itself. The court stated that the tactic amounted to a deprivation of the 12 partners’ 5th and 6th Amendment rights. In a practical sense, such a deprivation defeats the insured’s purpose of buying D & O coverage in the first place. And almost

certainly invites a declaratory judgment action (which itself brings another heap of attorneys' fees for both sides).

On the other hand, the insurers could choose to front thousands of dollars to pay for a white collar defense and risk seeing their insured be convicted and sent to prison. The insured, if convicted, is then theoretically expected to reimburse the insurance company for his defense costs. But it's rare for an imprisoned director to be able to come up with the amount of cash necessary to repay the insurance companies. Of course an insurance company may be able to seize some of the insured's assets after taking appropriate legal action (again, more costs and fees). But solvent convicts are few and far between.

Take, for example, a case deriving out of the scandal and bankruptcy at Tyco, Incorporated. In that case, *Federal Ins. Co. v. Tyco International*,⁸ Federal Insurance Company refused to pay defense costs for Dennis Kozlowski and other defendants pending the outcome of a rescission claim by Federal based on the insured allegedly misrepresenting material facts on the policy application. The court held that Federal's unproven rescission claim did not affect its present obligation to defend Kozlowski or pay his defense costs under the policies; however, if Federal ultimately prevailed in the declaratory action and the policies were declared to be void *ab initio*, it would be able to recover its costs for the defense it had provided Kozlowski. The problem with this became obvious upon Kozlowski's conviction. By the time he was convicted—which triggered him having to pay Federal back the cost of his defense—Federal had paid out millions of dollars for Kozlowski's defense costs.⁹ Now, in theory, Kozlowski is required to indemnify Federal for the millions of dollars they were forced to spend on his defense.¹⁰ This will be a hard task for Kozlowski while earning 11 cents per hour in the prison laundry room! Unless, of course, Federal was able to get their hands on Kozlowski's \$31,000,000 Fifth Avenue Apartment and \$6,000 shower curtain.¹¹

II. AUTHORITY COMPELLING D & O INSURERS TO ADVANCE DEFENSE COSTS IN SITUATIONS WHERE COVERAGE IS INDEFINITE

There have been a slew of appeals and declaratory judgment actions filed around the country in recent years asking courts for guidance on whether insurance companies have to reimburse the defendant/insured for attorneys' fees *as they are incurred*. Most courts, after carefully studying the policies at issue, have held that the insurers were required to contemporaneously pay the insured's defense costs. These courts have relied partly on the reasoning that since D & O policies are "liability" policies (and not "indemnification" policies), the insurers should be required to cover losses as they become due.

⁸ Index No. 600507/03 (N.Y. Supp. Ct. March 5, 2004)

⁹ See Judge Helen E. Freedman's Slip Opinion 30924(U), (April 23, 2007 Sup. Ct. N.Y.); Index No. 601416/04

¹⁰ *Federal Ins. Co. v. Kozlowski*, 792 N.Y.S.2d 397, 404 (N.Y.A.D. 1st Dept. 2005)

¹¹ White, Ben. *Washington Post*, "Ex-Tyco Executives Convicted" (June 18, 2005 Page A01).

The Third, Ninth and Eleventh Circuits have all held that the insurer must pay defense costs as they are incurred.¹² In *Little v. MGIC Indem. Corp.*,¹³ the Third Circuit held that the insurer's duty to pay defense costs arises contemporaneously with the insured's obligation to pay those costs. The Eleventh Circuit affirmed (without opinion) a Florida District Court's holding in *National Union Fire Ins. Co. of Pittsburgh v. Brown*,¹⁴ that the exclusion which prevented the insurer from being liable to insured for payment of losses for claims of fraud, dishonesty or criminal acts did not apply unless there was a final adjudication adverse to the insureds.¹⁵ The *Brown* court held that the defense costs had to be paid at the time they were incurred, and not at the conclusion of the suit because the language of the D & O Policy stated that a "loss" is incurred when the directors or officers "legally must pay" for claims arising from wrongful acts. And, thus, the insurer's duty to pay defense costs accrued when the insureds are billed for defense costs.¹⁶

The *Brown* court also held that even though no duty to defend is contained in the policy, such a duty is distinguishable from the duty to pay the insured's defense costs as they arise during the litigation.¹⁷ Similarly, in *Gon v. First State Ins. Co.*,¹⁸ the Ninth Circuit noted that the absence of a duty to defend was not crucial to the decision that the policy required defense costs to be paid as incurred. So under the rationale of *Brown and Gon*, D & O carriers would be required, absent conflicting policy language, to advance payment of the insured's defense expenses as the expenses are incurred.

The decisions of the Third, Ninth and Eleventh Circuits are backed by a majority of courts around the country that have considered this issue. See *PepsiCo, Inc. v. Continental Casualty Company*,¹⁹ (finding that the D & O policy obligated the insurer to pay defense costs as they are incurred); *McGinniss v. Employer's Reinsurance Corp.*,²⁰ (if action against insured is within coverage of policy, insurer must pay defense costs as they are incurred); *Nu-way Environmental, Inc. v. Planet Ins. Co.*,²¹ (because policy was silent as to payment of defense costs, insurer must reimburse insured its defense costs on a contemporaneous basis); *FSLIC v. Burdette*,²² ("shall become legally obligated to pay" indicates a duty on the insured to pay expenses and costs when they are incurred and fees when they are billed); *Mt. Hawley Ins. Co. v. FSLIC*,²³ (D & O carrier must pay defense

¹² The 11th Circuit affirmed *National Union Fire Ins. Co. of Pittsburgh v. Brown*, 787 F.Supp. 1424 (S.D. FL. 1991) (affirmed 963 F.2d 385 (11th Cir. 1992)) without opinion.

¹³ 836 F.2d 789, 793-96 (3rd Cir. 1987)

¹⁴ 787 F.Supp. 1424 (S.D. FL. 1991) (affirmed 963 F.2d 385 (11th Cir. 1992))

¹⁵ *Id.*, at 1429.

¹⁶ *Id.*

¹⁷ *Brown*, at 1430, citing *Gon v. First State Ins. Co.*, 871 F.2d 863, 868 (9th Cir. 1989)

¹⁸ 871 F.2d 863, 868 (9th Cir. 1989). Likewise, in *Okada v. Capital MGIC Indem. Corp.*, 823 F.2d 276, 280 (9th Cir. 1987) the Ninth Circuit held that the D & O carrier must pay defense costs absent a final adjudication that no coverage exists.

¹⁹ 640 F.Supp. 656, 659-60 (S.D.N.Y. 1986)

²⁰ 648 F.Supp. 1263, 1271 (S.D.N.Y. 1986)

²¹ 1997 WL 462010 (S.D.N.Y. 1997)

²² 718 F.Supp. 649, 661 (E.D. Tenn. 1989)

²³ 695 F.Supp. 469, 475 (C.D. Cal. 1987)

costs as they are incurred); *American Casualty Co. v. Bank of Montana System*,²⁴ (insurer breached contract by failing to advance defense costs); *Pacific Ins. Co. v. General Dev.*,²⁵ (holding that there is no rescission until a final adjudication, therefore, excess carrier must pay defense costs).

More recent decisions show that this trend is continuing. See *Federal Ins. Co. v. Kozlowski*,²⁶ (determining that a carrier of directors' and officers' liability insurance was obligated to advance the cost of defending claims made against an insured officer contemporaneously as the costs were incurred); *In re WorldCom, Inc. Securities Litigation*,²⁷ (finding that, because the policy at issue was a liability policy, as opposed to an indemnification policy, and expressly provided that the insurer was to advance defense costs prior to the final disposition of claims made against insured directors and officers, the insurer had an obligation to pay defense costs *as they were incurred*, prior to the final disposition of the claims made against the insureds, despite the insurer's contention that the insurance contract was void *ab initio* for material misrepresentations made prior to the purchase of the policy, and had been rescinded by the insurer.); *Federal Insurance Company v. Tyco Intern. Ltd.*,²⁸; *Church Mutual Ins. Co. v. Executive Bd. of Missouri Baptist Convention*,²⁹; and *Great American Ins. Co. v. Gross*,³⁰ (granting directors' and officers' motion for a preliminary injunction ordering the insurer to continue to advance defense costs to insureds who had pleaded guilty in criminal actions where the policy expressly required that the insurer make advancements of defense costs until it was established that there would be no coverage under the policy.) This past summer, a Delaware trial court relied on "general legal principle" and held that several excess D&O insurers must advance defense costs to an insured corporation and its outside directors for a securities class action pending "final disposition" of the claim- even though the company's president had pled guilty to a fraudulent conspiracy. *Sun-Times Media Group, Inc. v. Royal & SunAlliance Ins. Co. of Canada*, 2007 WL No. 1811265 (Del. Super. Ct. June 20, 2007).

III. AUTHORITY HOLDING D & O INSURERS WERE NOT REQUIRED TO ADVANCE DEFENSE COSTS PRIOR TO FINAL ADJUDICATION

Despite the majority rule, and in light of the particular coverage provisions of the subject D & O policies coupled with the particular circumstances of the cases, some courts have concluded that the insurance carriers did not have a duty to advance the insured's defense costs at the time they were incurred.

²⁴ 675 F.Supp. 538, 541-44 (D.Minn. 1987)

²⁵ 1992 U.S. Dist. Lexis 22057 (S.D. Fla. April 30, 1992)

²⁶ 792 N.Y.S.2d 397 (N.Y.A.D. 1st Dept. 2005)

²⁷ 354 F. Supp. 2d 455 (S.D. N.Y. 2005) (applying New York law)

²⁸ 784 N.Y.S.2d 920, appeal dismissed, 18 A.D.3d 33, 792 N.Y.S.2d 397, 34 Employee Benefits Cas. (BNA) 2678 (1st Dep't 2005)

²⁹ 2005 WL 1532948 (W.D. Mo. 2005)(applying Missouri law)

³⁰ 2005 WL 1048752 (E.D. Va. 2005)

For example, the court in *National Union Fire Ins. Co. of Pittsburgh, Pa. v. Goldman*,³¹ concluded that, although the policy defined “loss” to include the payment of the insureds’ defense costs, it did not require the insurer to make contemporaneous payments of such costs, where the language was silent as to the timing of payment, and the amount of the covered loss could not be determined without the resolution of factual issues. Similarly, the court in *In re Kenai Corp.*, held, under New York law, that the subject D & O liability policy did not require the insurer to make contemporaneous interim advances of insured’s defense expenses, where the policy’s language defining losses in terms of wrongful acts suggested that reimbursement should occur only after losses had been determined to be covered by the policy.³² See also *Harristown Development Corp. v. International Ins. Co.*,³³ (concluding that the insurer had neither a duty to defend nor a duty to pay defense costs as they were incurred, but rather the policy required the insurer only to reimburse the insuring corporation for indemnification of directors and officers that were covered under the policy.)

A. COURTS HOLDING NO DUTY TO ADVANCE DEFENSE COSTS AS INCURRED WHERE IT COULD NOT BE PRESENTLY DETERMED THAT THERE WAS A “COVERED LOSS” UNDER THE D & O POLICY

At least one court has held that a carrier of D & O liability insurance had no present duty to contemporaneously pay its insured’s costs of defending third-party claims where it could not yet be determined that any of the underlying claims were covered by the policy. See *Bank of Commerce and Trust Co. v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 651 F. Supp. 474 (N.D. Okla. 1986) (apparently applying Oklahoma law)(denying insured’s motion for summary judgment seeking payment of fees prior to final adjudication.)

B. COURTS HOLDING CONTEMPORANEOUS PAYMENT OF ATTORNEY’S FEES NOT REQUIRED WHERE THE POLICY GIVES INSURER THE OPTION TO ADVANCE COSTS

Some D & O policies have a clause which expressly gives the insurer the option to make advance payments. In cases involving these policies, courts have strictly enforced the policy’s language and held that the insurer did not have the obligation to make contemporaneous payments for attorney’s fees. See *Commercial Capital Bankcorp. Inc. v. St. Paul Mercury Ins. Co.*,³⁴ (holding that California’s general rule requiring a liability insurer to pay its insured’s defense costs contemporaneously did not apply where the language of the D & O policy at issue did not provide for a duty to defend or a duty to pay all defense costs as they were incurred, but rather gave the insurer the option to advance defense costs); *Faulkner v. American Cas. Co. of Reading, Pa.*,³⁵; *Enzweiler v. Fidelity & Deposit Co. of Maryland*,³⁶; *American Cas. Co. of Reading*,

³¹ 548 So. 2d 790 (Fla. Dist. Ct. App. 2d Dist. 1989)

³² 136 B.R. 59, 63 (S.D.N.Y. 1992).

³³ 1988 WL 123149 (M.D. Pa. 1988) (applying Pennsylvania law).

³⁴ 419 F. Supp. 2d 1173 (C.D. Cal. 2006) (applying California law).

³⁵ 584 A.2d 734 (Md. App. 1991)

³⁶ 1986 WL 20444 (E.D. Ky. 1986) (applying Kentucky law)

Pennsylvania v. Federal Deposit Ins. Corp.,³⁷; *Zaborac v. American Cas. Co. of Reading, Pa.*,³⁸; *Luther v. Fidelity and Deposit Co. of Maryland*,³⁹; and *Corabi v. CNA Ins. Companies*,⁴⁰ (all finding that while the policies gave the insurers an option to pay defense costs prior to the final disposition of the underlying claim against the officers, the policies did not require the insurer to do so.)

C. COURTS HOLDING THERE IS NO DUTY TO ADVANCE DEFENSE COSTS AS INCURRED WHERE IT WOULD UNDERMINE THE PRIORITY INTEREST OF ANOTHER OBLIGATION UNDER THE POLICY

In another instance, the court in *In re Ambassador Group, Inc. Litigation*,⁴¹ held that insurer had no duty to advance defense costs where making such payments presented a risk that other obligations recognized by the contract to be of greater priority would not be met; (the policy gave claims of people alleging they were injured by the wrongful acts of the insured directors and officers priority over the insured's right to payment of attorney's fees.)

IV. CUSTOMER RELATIONS CONSIDERATIONS

The insurance relationship tends to change rather dramatically once an insured is sued by someone. The insured starts to see the insurance company less as a husband and more as a "baby's daddy." Meaning, the insured doesn't want a "good neighbor" relationship anymore –it just wants its bills paid. Needless to say, insurer/insured relationships get very shaky during this time –especially once a declaratory judgment action is filed. So insurers have to balance this relationship (i.e. prospect of continued business with the insured) with the anticipated cost of the insured's defense. For example, it may not be worth the insurer ruining a relationship with a multi-line insured by refusing to pay attorneys' fees under a D & O policy in connection with a single-plaintiff civil action. But if that same insured's officer or director has been indicted by both the Federal and State Governments, as well as sued by the corporation's shareholders, then the insurer will be more likely to oppose coverage of the attorney's fees. When the insurance policy is ambiguous, however, courts will construe its ambiguity against the insurer. So insurance companies must keep this –and all duties they owe to the insured– in mind when contemplating a denial of coverage.

V. CONCLUSION

There is no perfect way to determine, in advance, how defense costs should be paid in these scenarios where the director's actions made basis of the lawsuit are excluded from coverage under the D & O liability policy. But clearer policy language

³⁷ 677 F. Supp. 600 (N.D. Iowa 1987) (applying Iowa law)

³⁸ 663 F. Supp. 330 (C.D. Ill. 1987) (applying Illinois law)

³⁹ 679 F. Supp. 1092 (S.D. Fla. 1986) (applying Florida law)

⁴⁰ 1988 WL 363612 (S.D. Ohio 1988) (applying Ohio law)

⁴¹ 738 F. Supp. 57 (E.D. N.Y. 1990)

regarding the timing of how these defense costs will be paid will undoubtedly reduce the likelihood that a timing-of-payment dispute will arise. At the very least, corporations need to be familiar with the D & O insurer's stance on scheduling payment of attorneys' fees and, if necessary, negotiate agreeable terms before they purchase the policy. At least by getting it all clear up front the parties can avoid costly derivative litigation needed to establish their rights.

One solution could be for the insurer to offer optional coverage as a rider on the D & O policy to cover defense costs related to litigation based on dishonesty claims. This would give the insured more sure-fire coverage and allow the insurer to better prepare for defense costs by collecting an additional premium.

Even better, new D & O policies should include a "duty to defend." This would improve the policy for all involved. Adding a "duty to defend" would parallel D & O insurance with the other forms of professional malpractice insurance. To be sure, this addition would promote efficiency, and save a boat load of attorney's fees on declaratory judgment actions and appeals. And the awkward contemporaneous financing arrangements made subject of this article would not surface in the future.

If a duty to defend is not included in the policy, however, its absence should be noted during the application process and something else agreed upon in its place. The bottom line is that when corporations purchase D & O coverage, some mechanism should be created that will permit legal fees to be paid as they accrue. Only then will the policy fulfill its function: to assure the corporation access to capable directors and officers by protecting them from overwhelming legal expenses and from the consequences of their negligence, should that be proved.⁴² But, until that happens, both sides will have to use attorneys to protect their interests and courts to determine their rights.

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⁴² For a similar conclusion, see *Practical Aspects of Directors' and Officers' Liability Insurance--Allocating and Advancing Legal Fees and the Duty to Defend*, 32 U.C.L.A. L.Rev. 690, 691 (1985).