

DIRECTORS AND OFFICERS LIABILITY INSURANCE

AN OVERVIEW

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I. INTRODUCTION

Directors and officers liability insurance is now a core component of corporate insurance. As many as 95 percent of Fortune 500 companies maintain directors and officers (“D&O”) liability insurance today. Furthermore, it has become a commonplace of the financial world that disappointed investors will charge corporations and their officers and directors with securities fraud whenever a company’s stock drops significantly in price.

The median securities class action settlement in 2010 was \$11.3 million, and approximately 20% of all securities lawsuits settled for \$25 million or more. Defense costs for these lawsuits routinely involve millions of dollars. In light of these numbers, it should not be surprising that such litigation has become almost routine, and D&O liability insurance plays a large role in handling it. At the same time, the D&O insurance industry has become highly specialized and new products are constantly emerging to meet the needs of specific markets. This article will discuss the historic and current trends in the industry. In addition, this article will address some of the primary legal and coverage concerns that

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must be considered by underwriters, claims handlers, corporations and their executives, and the attorneys who represent them.

A. History of D&O Insurance

In the 1930s, in the wake of the depression, Lloyd's of London introduced coverage for corporate directors and officers. At the time, corporations were not permitted to indemnify their directors and officers. Joseph P. Monteleone & Nicholas J. Conca, *Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues*, 51 Bus. Law 573, 574 (1996). Directors and officers did not perceive a great risk, however, and the insurance did not sell. Well into the 1960s, the market for D&O coverage was negligible. In the 1940s and 1950s, courts, corporations and directors and officers began to see benefits to corporate indemnification and prompted state legislatures to enact laws permitting it. Then, during the 1960s changes in the interpretation of the securities laws created the realistic possibility that directors and officers themselves, and not only corporations, could face significant liability. See Roberta Romano, What Went Wrong with Directors' and Officers' Liability Insurance, 14 Del. J. Corp. L. 1, 21 & nn. 74-77 (1989). Insurers responded to these changes by reviving specialty coverage for the "personal financial protection" of directors and officers.

The historic focus on "personal financial protection" distinguished D&O insurance from other kinds of commercial insurance that cover identified areas of corporate risk. Insurers had defined corporate risks they would insure. General liability insurance provided corporate insurance for bodily injury or property damage claims; fidelity bonds afforded specified first-party coverage for losses corporations incur due to certain acts of their officers, directors, or employees. D&O coverage, on the other hand, was not intended to be corporate insurance, much less an attempt at general corporate insurance for liability caused

the corporation by virtue of the acts of its directors and officers. In recent years, however, D&O coverage has undergone a number of changes.

B. Current Importance

The D&O industry matured and evolved during the 1970s through the 1990s, and continues to do so today. The original focus on “personal financial protection” is no longer the single driving force behind the industry, and D&O insurance is often coupled with coverages designed to protect the corporation, in addition to its directors and officers, from various liabilities.

During the 1980s, the first litigated disputes between D&O insurers and federal regulators (or the former bank officials whom the regulators sued) brought D&O coverage into the forefront in many significant and often highly publicized matters. In recent years, corporations of all kinds and their directors and officers have seen an increasing number of claims and increasingly large settlements. Company directors routinely inquire about the amount and scope of their company’s D&O coverage. Towers Watson, Directors and Officers Liability Survey: 2010 Summary of Results, at pg. 10 (2010) (the “2010 Towers Watson Report”). Thus, D&O insurance remains an important protection for directors and officers. In addition to the traditional protections, the industry has set a trend toward expanding D&O coverage – both in terms of who is protected and against what they are protected. Many underwriters now write coverages that offer protection to the company for its own liability and for specific corporate concerns.

II. CLAIMS AGAINST DIRECTORS AND OFFICERS

As noted above, claims against directors and officers generally have been increasing over time. The most recent Towers Watson survey collects claim information from the past ten years. In 2010, 31% of survey respondents reported experiencing one or more D & O

claims over the last 10 years, up from 17% in 2008. (Note that one claim situation may produce more than one type of claim.) By entity type, 35% of nonprofit organization respondents reported experiencing a claim (up from 16% in the 2008 survey). Twenty-nine percent of public companies and 26% of private organizations also reported experiencing a claim. The most frequent type of claim against public companies involved direct claims from shareholders/investors (66%). Employment practices were the most frequent type of claim against nonprofit organizations (67%) and private organizations (45%). Overall, direct shareholder/investor claims accounted for 46 % of all reported claims, up from 18% in 2008. See the 2010 Towers Watson Report at page 24. The frequency of claims against directors and officers and the susceptibility of officers and directors to claims involve a number of factors, including the size of the company, the company's type of business, whether the company is publicly or privately owned, and the number of shareholders. For example, companies with greater assets are more likely to have claims made against their directors and officers and on average experience more claims per company than smaller companies.

From 2007 to the present, the credit crisis has fueled securities class action filings. In 2008, 103 credit crisis-related securities lawsuits were filed; in 2009, 57 credit crisis-related securities lawsuits were filed. Although the pace of credit crisis-related filings has slowed, there has been an increase in the frequency of other types of filings—such as cases alleging breaches of fiduciary duty and cases filed against companies in the life sciences and technology sectors. Other recent developments such as the Gulf of Mexico oil spill also produced new filings.

III. BASIC COVERAGES

At its most basic, D&O insurance protects directors and officers from liability arising from actions connected to their corporate positions. Due to general expansion in the industry, market pressures and the industry's responses to the development of case law, D&O insurance has expanded beyond its original and basic coverage. Thus, a single policy now may provide multiple and varied options by standard form or endorsement. The individual coverages discussed below typically are subject to distinct terms, conditions and deductibles, and even may be subject to distinct policy limits or sublimits.

However, some common threads run through each coverage offered in a D&O policy. For example, D&O insuring agreements generally specify that coverage is limited to claims first made during the policy period. In addition, the insurer typically does not have a duty to defend but is required to cover the costs of the insured's defense for covered claims.

A. Insuring Agreement A (D&O)

Although each policy will employ its own language, Insuring Agreement A, often referred to as "A-Side Coverage," typically provides coverage directly to the directors and officers for loss – including defense costs – resulting from claims made against them for their wrongful acts. A-Side Coverage applies where the corporation does not indemnify its directors and officers. A corporation may not indemnify its directors or officers because it either (1) is prohibited by law from doing so, (2) is permitted to do so by law and the company's bylaws but chooses not to do so, or (3) is financially incapable of doing so, due to bankruptcy, liquidation, or lack of funds. Many policies include a provision to the effect that the company will be presumed to provide indemnification to insured persons to the fullest extent permitted by law. The laws regarding indemnification differ from jurisdiction to jurisdiction.

Insuring Agreement A additionally may specify that coverage is limited to those claims connected to an insured's capacity as an insured director or officer of the company. This issue of capacity recurs throughout D&O coverage analysis. The limiting language may appear in the insuring clause, in the definitions of "wrongful act" or "insured" found elsewhere in the policy, or in all three clauses. Although a claim sometimes implicates an insured in a single and clear capacity, a claim may well arise out of an individual's multiple capacities. For example, an individual may be sued as a director and a shareholder of a company (perhaps as a purchaser or seller of company stock), or an officer of a homeowner's association may also be a homeowner and it may not be clear whether his or her actions were taken as one or the other – or both. Similarly, a corporation's lawyer may also sit on the board of directors or be a corporate officer.

B. Insuring Agreement B (Corporate Reimbursement)

A typical Insuring Agreement B, or "B-side coverage," reimburses a corporation for its loss where the corporation indemnifies its directors and officers for claims against them. B-side coverage does not provide coverage for the corporation for its own liability.

C. Entity Coverage

Entity coverage provides protection for the corporation for its own liability. The entity coverage in public company D&O policies usually is limited to securities claims, which is a defined term in most policies. Securities claim is typically defined to mean a claim made in connection with the purchase or sale or offer to purchase or sell a company's securities and/or a claim for any actual or alleged violation of the Securities Act of 1933, the Securities Exchange Act of 1934 or any similar federal or state statute.

In private company D&O policies, coverage may be provided for claims for wrongful acts against the company. This means that entity coverage under a private

company D&O policy may be significantly broader than entity coverage under public company D&O insurance policies. Many policies today provide such coverage to the corporation whether or not its directors and officers are also sued; other policies, however, provide such coverage only where the corporation is a co-defendant with its directors and officers. Entity coverage may be part of the policy form as “Insuring Agreement C” or may be added as an endorsement.

D. A-Side Only Coverage

A trend in recent years has been the purchase of A-Side only coverage. A-Side only coverage is available only for a loss that is not paid by any other insurance program or as indemnification or advancement from any source. A-Side only coverage is most commonly implicated in high exposure claims against directors and officers of bankrupt entities. There are some large companies (more than \$10 billion in assets) that are only purchasing A-Side coverage (and no Side B or C coverage). Some industry observers have commented that many large financial institutions facing potential large D&O claims from the current financial crisis are leading this trend. Assuming that these financial institutions avoid bankruptcy, their A-Side only exposures may be limited and could reduce the insurance industry exposure to claims from these organizations. See the 2008 Towers Watson Report at page 5.

E. EPL Coverage

Employment Practices Liability (“EPL”) coverage also has become a common addition to corporate coverage – often by endorsement to the D&O policy or as a stand-alone policy issued to the company. This coverage typically protects directors, officers, employees and/or the company against employment-related claims brought by employees

and, in certain circumstances, specified third-parties. For example, it provides coverage for wrongful dismissals or failures to promote, sexual harassment, and other violations of federal, state or local employment and discrimination laws brought by the company's employees.

F. Fiduciary Coverage

Fiduciary liability insurance, like EPL coverage, is usually purchased as a stand-alone policy or endorsed to an organization's D&O policy (including package policies where the coverage is included in the policy form). Fiduciary coverage generally protects fiduciaries against claims under the Employee Retirement Income Security Act of 1974 ("ERISA"). In 2008, there was a large jump in the percentage of respondents to the Towers Watson survey that purchased fiduciary coverage — split between those that buy stand-alone coverage and those that purchased fiduciary coverage as part of their D&O policy. Forty-five percent of participants reported purchasing fiduciary coverage. See the 2008 Towers Watson Report at page 20.

IV. DEFENSE ISSUES

Most public company D&O policies do not impose a duty to defend on the insurer. They do, however, provide coverage for defense costs and give the insurer the right to associate with the defense and approve defense strategies, expenditures, and settlements. Private company D&O insurance is also often written on a duty to reimburse basis. In addition, however, private company D&O insurance is also sometimes written on a duty to defend basis, under which the insurer selects defense counsel and controls the defense.

A. Right to Select Counsel

A D&O insurer under a duty to reimburse policy cannot impose its choice of counsel on an insured — the insured generally has the right to select counsel, subject to the insurer's

consent. D&O policies typically provide that an insurer may not unreasonably withhold approval of an insured's choice of counsel. This feature is important to the insured corporation, which typically has developed ongoing relations with corporate and litigation counsel that the company would want to use in high-stakes litigation against it.

B. Reimbursement and Advancement of Defense Costs

Although D&O insurers generally do not have a duty to defend, D&O policies do cover defense costs. The primary questions that arise in connection with the payment of defense costs regard (1) control over the costs incurred and (2) when the insurer must make defense payments. In connection with the first question, although insurers do not control an insured's defense, under D&O policies they are required to reimburse only reasonable defense costs arising out of covered claims. Thus, an insured or his chosen counsel does not get a blank check.

Whether a D&O insurer must, or should, advance defense costs – that is, pay them as they are incurred – is a common question. Many of the issues affecting coverage cannot be resolved until the claim has been resolved. Specifically, certain exclusions may only apply after a finding of fact has been made. For example, as discussed below, policies generally exclude coverage for losses arising out of fraud. The exclusion usually only applies, however, where there is a factual finding or final judgment of fraud. Thus, where fraud is alleged, coverage is uncertain until the completion of the claim. In such situations, insurers may have an interest in not advancing defense costs until coverage is certain. However, insurers have an interest in seeing their insureds vigorously defend claims against them. A vigorous defense can be a costly endeavor that may be well beyond the means of an insured. Thus, many policies provide that insurers advance defense costs under the

condition that, should the facts ultimately demonstrate an absence of coverage, the insured is required to reimburse the advanced monies.

C. Duty to Defend

Private company D&O policies that impose a duty to defend on the insurer raise distinct issues. In general, if any part of the claim is covered, the insurer must defend the entire claim, even those parts of the claim that are not covered. This avoids an allocation issue often raised in reimbursement policies when part of a claim is covered and another part is not covered. Under a duty to defend policy, the insurer appoints defense counsel and takes care of managing the claim. An insured may be entitled to independent counsel when the insurer is defending a claim subject to a reservation of rights to deny coverage for any settlements or judgments.

V. KEY PROVISIONS AND EXCLUSIONS

Thirty years ago, underwriters offered D&O policies based on two basic forms, and courts had seen very few cases in which they were asked to interpret those policies. Today, the number of D&O policy forms and cases interpreting them has multiplied. Although there are trends and standards within the industry, the specific language found in these policies differs from insurer to insurer and from policy to policy. Any coverage analysis must take into account the specific language found in the policy at issue. As a general matter, clear policy language will govern the application of coverage to a particular claim.

A. Definition of Claim

Common to all coverages in a D&O policy is that each insuring clause generally provides coverage on a “claims-made” basis. In other words, it provides the coverage described for claims made during the period for which the coverage is purchased.

Additionally, the insured typically must report the claim to the insurer during the policy period or within a reasonable time.

D&O policies generally define claim as any (1) civil, criminal or administrative proceeding, or (2) written demand for damages against an insured. Who is included as an insured will depend on which coverages are implicated and how the term is defined in the policy. That is, if it is a securities claim, and the policy so provides, a claim may be made against the company or against a director or officer. If it is an employment claim, and the policy so provides, a claim may be made against the company, a director or officer, or an employee. If it is an ERISA claim, and the policy so provides, a claim may be made against the plan, the sponsor organization or the plan's fiduciaries.

Many policies now include a more detailed definition of "claim," which includes civil proceedings, criminal proceedings and administrative proceedings commenced by specific actions, such as service of a complaint, indictment, or formal charge. Some policies also expand the definition to include formal investigations, especially where directors and officers are the targets and where there has been a notice of charges, formal investigative order or similar document. Whether a subpoena issued to an insured person by a regulatory body constitutes a claim is a common issue, which often depends both on the specific facts and circumstances surrounding the subpoena and the specific language of the applicable policy.

B. Interrelated Claims

D&O policies often contain an "Interrelated Wrongful Acts" clause that treats as a single "wrongful act" all claims that arise out of the same common set of facts. This is an issue that often arises in connection with large towers of insurance that span multiple years.

For example, an investigation by a governmental agency and a separate private lawsuit that are both based on a common allegation of wrongdoing may be treated as an “interrelated wrongful act” for purposes of D&O coverage, even if the public and private underlying claims are made in separate policy periods. The latter made claim will be intertwined with the earlier made claim and will be deemed made when the earlier “related claim” was made. *See Seneca Ins. Co. v. Kemper Ins. Co.*, 02 Civ. 10088, 2004 U.S. Dist. LEXIS 9159 (S.D.N.Y. May 21, 2004) (containing a detailed discussion of the “Interrelated Wrongful Act” clause); *In re SRC Holding Corp.*, 545 F.3d 661 (8th Cir. 2008) (providing guidance on definition of related claim).

C. Definition of Loss

Loss generally includes damages, judgments, awards, settlements and defense costs. Loss usually excludes fines or penalties, taxes, treble (or other multiplied) damages, and matters uninsurable under law. Where treble or multiplied damages are assessed, a D&O policy generally will cover the base amount, but not the multiplied portion of the loss.

1. Punitive or exemplary damages

Most current D&O policies define loss to include punitive and exemplary damages, where insurable by applicable law. It is common for policies to include a provision to the effect that coverage for punitive damages is available to the broadest extent permitted by law.

Although the law is still developing in this area, punitive damages are insurable in the majority of states. *See, e.g., Omni Ins. Co. v. Jennifer B. Foreman*, 802 So. 2d 195 (Ala. 2001); *State Farm Mut. Auto. Ins. Co. v. Stacey Lawrence Sr. and Tobitha Lawrence*, 26 P.3d 1074 (Alaska 2001); *Byron C. Bailer v. Erie Ins. Exch.*, 344 Md. 515 (Md. 1997);

Shelter Mut. Ins. Co. v. George Dale, 914 So. 2d 698 (Miss. 2005); *South Carolina State Budget & Control Board v. Atlee Prince, et al.*, 403 S.E.2d 643 (S.C. 1991); *American Protection Ins. Co. v. Kenneth McMahan, et al.*, 562 A.2d 462 (Vt. 1989). Those states prohibiting coverage of punitive damages generally base the prohibition on public policy concerns. *City Products Corp. v. Globe Indem. Co.*, 151 Cal. Rptr. 494 (Cal. Ct. App. 1979). The longstanding reasoning is that the assessment of punitive damages is intended to set an example or punish the wrongdoer, and permitting insurance against such punishment would render such punishment ineffective. *Id.*

Several states legislatures have spoken to the issue. *See, e.g.*, Nevada Rev. Statute § 681A.095 (“An insurer may insure against legal liability for exemplary or punitive damages that do not arise from a wrongful act of the insured committed with the intent to cause injury to another.”); Utah Code Ann. § 31A-20-101 (making punitive damages uninsurable); Haw. Rev. Stat. § 431:10-240 (2010) (“Coverage under any policy of insurance issued in this state shall not be construed to provide coverage for punitive or exemplary damages unless specifically included.”); Montana Code § 33-15-317 (2010) (which prohibits insurance coverage for punitive damages unless it is expressly included for in the insurance contract).

2. Restitution and Disgorgement

For decades, insurance case law has consistently held that the restitution or disgorgement of ill-gotten gains by an insured is not insurable loss under an insurance policy even if the policy does not contain an express exclusion for such loss. The rationale for that conclusion is premised on the notion that if the restitutionary damages were paid by the insurer, the insured would be allowed to retain the ill-gotten gain. Such a result would violate public policy and improperly reward the insured for obtaining the ill-gotten gain.

The seminal case is *Level 3 Communications, Inc. v. Federal Ins. Co.*, 272 F.3d 908 (7th Cir. 2001), in which the United States Court of Appeals for the Seventh Circuit held that a settlement payment by the company in a claim in which alleged misrepresentations allowed the company to purchase another company at a price below fair value was an uninsurable loss. As explained by the Seventh Circuit:

[A] “loss” within the meaning of an insurance contract does not include the restoration of an ill-gotten gain.... An insured incurs no loss within the meaning of the insurance contract by being compelled to return property that it had stolen, even if a more polite word than “stolen” is used to characterize the claim for the property’s return.

Id. at 910-11. Similarly, the United States Court of Appeals for the Fifth Circuit has held that employee severance payments that constituted amounts fraudulent as to creditors and had to be repaid due to bankruptcy court order constituted disgorgement not covered under the policy. *Trans Texas Gas Corp. v. U.S. Bank Nat’l Ass’n*, 597 F.3d 298 (5th Cir. 2010).

B. Exclusions

1. Conduct Exclusions

Most D&O policies contain one or more exclusions precluding coverage for certain types of conduct. The conduct exclusions typically preclude coverage for loss relating to fraudulent or criminal misconduct and for loss relating to illegal profits or remuneration to which the insured is not legally entitled. These exclusions typically are followed by a severability clause – that is, a caveat providing that the acts or knowledge of one insured will not be imputed to any other insured for the purpose of applying the exclusion. In other words, the exclusion only bars coverage for the insured(s) whose acts or knowledge are the basis of the claim at issue.

Conduct exclusions can often have subtle wording differences that can significantly affect the availability of coverage. The most important wording variant addresses what is

required in order for the exclusion to be triggered. In recent times, these provisions usually require a final "adjudication" that the precluded conduct has actually occurred in order for the exclusion to be triggered. The adjudication requirement may require the adjudication to take place in the underlying claim, while other exclusions may allow the determination to be made in a separate proceeding (such as a declaratory judgment proceeding). If the final adjudication must take place in the underlying lawsuit, settlement of that lawsuit likely will preclude the application of the dishonesty exclusion.

2. **Insured v. Insured Exclusion**

As the name implies, an Insured versus Insured ("IvI") exclusion bars coverage for claims made by an insured (e.g., a director, officer or corporate insured) against another insured. In addition, the exclusion may bar coverage for claims brought by anyone directly or indirectly on behalf of or at the behest of an insured. Where a lawsuit is brought by or with the "active assistance" of an insured, the exclusion bars coverage. *See e.g. Voluntary Hospitals of America, Inc. v. National Union Fire Ins. Co.*, 859 F. Supp. 260 (N.D. Tex. 1993), *aff'd* 24 F.3d 239 (5th Cir. 1994). The exclusion may be modified with "carvebacks" for certain categories of claims, such as derivative and employment practices claims or claims by a bankruptcy trustee. The exclusion essentially prevents a company from suing or orchestrating a suit against its directors and officers in order to collect insurance proceeds. Questions regarding the application of the exclusion arise in the context of derivative lawsuits, bankruptcies and receiverships.

A significant amount of litigation involving the IvI exclusion relates to claims against companies in bankruptcy or receivership. The question is whether a trustee or debtor in possession stands in the shoes of the corporation. The case law addressing this question is growing but no consensus has emerged. The United States Court of Appeals for

the Ninth Circuit recently held that a D&O policy's IvI exclusion bars coverage for claims that were brought against former directors and officers of a bankrupt company by the post-bankruptcy debtor in possession and later assigned to a creditors' trust. *Biltmore Associates LLC v. Twin City Fire Insurance Company, et al.*, (9th Cir. 2009); *see also Reliance Ins. Co. v. Weiss*, 148 B.R. 575 (E.D. Mo. 1992).

Some courts have also held that where suit is brought by the receiver of a failed bank, an IvI exclusion bars coverage. *Mount Hawley Ins. Co. v. FSLIC*, 695 F. Supp. 469 (C.D. Cal. 1987); *Gary v. Am. Cas. Co. of Reading*, 753 F. Supp. 1547, 1555 (W.D. Okla. 1990); *but see FDIC v. American Casualty Co.*, 814 F. Supp. 1021 (D. Wyo. 1991).

Recently, whistleblower provisions in the Sarbanes Oxley Act and the Dodd-Frank Act have raised IvI exclusion issues, where the whistleblower is an insured person. Carvebacks in the IvI exclusions of new policies may preserve coverage for whistleblower claims.

3. Regulatory Exclusion

Some D&O policies also include a regulatory exclusion, which precludes coverage for claims brought by any governmental, quasi-governmental, or self-regulatory agency. The regulatory exclusion was at the forefront of D&O litigation in the late 1980s and early 1990s in connection with failed financial institution claims brought by the FDIC, FSLIC and RTC arising out of the S&L crisis. With the new wave of failed bank claims in connection with the current credit crisis, the regulatory exclusion may be brought to the forefront again.

4. Prior and Pending Litigation Exclusion

Prior and pending litigation exclusions generally exclude coverage for (1) claims pending prior to the inception of the policy, or another agreed upon date, and (2) subsequent

claims based on the same or related facts or circumstances. Conflicts primarily arise regarding the second component of this exclusion. Specifically, the question arises as to when a subsequent claim is based on sufficiently overlapping facts and circumstances to fall within the scope of the exclusion. Courts have held that the two claims need not be brought by the same plaintiffs to trigger the exclusion. *See e.g., Zunenshine v. Executive Risk Indem. Co.*, No. 97 Civ. 5525, 1998 U.S. Dist. LEXIS 12699, at *5 (S.D.N.Y. Aug. 17, 1998) *aff'd*, 182 F.3d 902 (2d Cir. 1999) (holding that “because the [exclusion] clearly focus[es] on the existence of common facts,” the fact that there were different plaintiffs and “somewhat different legal harms” was irrelevant).

Furthermore, the claims can allege different harms and still be excluded from coverage by this provision. *See, e.g., Acosta, Inc., et al. v. Nat’l Union Fire Ins. Co., et al.*, 39 So. 3d 565 (Fla. Dist. Ct. App. 2010) (The court concluded that the “lack of identical causes of action or damages models is not dispositive of whether the suits are factually related” and noted that the two lawsuits alleged acts that were “part of an overall scheme.”); *Ameriwood Indus. Int’l Corp. v. Am. Cas. Co. of Reading, Pennsylvania*, 840 F. Supp. 1143 (W.D. Mich. 1993) (rejecting argument that allegation of different legal claims prevented operation of exclusion). The exclusion additionally may apply even if the two claims allege different legal violations or are brought in different courts and pursuant to the authority of different jurisdictions. *See, e.g., Bensalem Township v. Int’l Surplus Lines Ins. Co.*, 91-5315, 1992 U.S. Dist. LEXIS 8243 (E.D. Pa. June 15, 1992) (applying exclusion where prior claims sought relief for violations of Pennsylvania law and later claims sought relief for violations of federal law), *rev’d on other grounds*, 38 F.3d 1303 (3d Cir. 1994).

5. Professional Liability Exclusion

As a general matter, D&O policies do not provide coverage for liability associated with the provision of professional services. Thus, where a bank officer is liable for acts as a banker rather than an officer of the bank, a D&O policy with a professional liability exclusion would not provide coverage. Similarly, where a doctor is the president of a professional corporation, the D&O policy would only protect him or her against liability from acts as president of the corporation, and would not provide coverage for professional malpractice claims. The line between professional services and acts outside the scope of this exclusion can be a fine one. Courts often draw a distinction between those acts that require special training or are at the heart of the profession and those acts that are administrative in nature. *See e.g. Harad v. Aetna Cas. and Sur. Co.*, 839 F.2d 979 (3d Cir. 1988).

6. Prior Acts Exclusion

A prior acts exclusion bars coverage for claims arising out of an insured's wrongful acts prior to a specified date. The date may coincide with the termination of coverage under a previous policy. The date may also coincide with a change in corporate status – such as a merger or acquisition. For example, where a subsidiary is acquired, the prior acts exclusion may exclude coverage for the subsidiary prior to the time it became a subsidiary. In such situations, the subsidiary may have run-off coverage from a previous policy to protect against liability arising from those excluded acts.

VI. OTHER KEY ISSUES

A. Rescission/Known Loss

An insurer may seek to rescind a D&O policy if it determines that the company made material misstatements in the application for insurance or the company's public filings

that were relied upon by the insurer in issuing the policy. For instance, if a company overstates its earnings or financial status in the application process and the insurer relies on these statements in issuing a D&O Policy, the insurer may have a claim for rescission of the D&O Policy based on a material misrepresentation. Similarly, a insurer may present evidence of “known loss,” claiming that the company knew at the time it was purchasing the insurance that a claim had been or was likely to be made. Many of the accounting scandals of the late 1990s—such as Enron, Adelphia, and WorldCom—raised these issues.

B. Allocation

Years ago, when D&O policies routinely covered directors and officers but not the company, lawsuits that named as defendants both directors and officers and the company required an allocation of loss, including both settlements and defense costs. This often resulted in disputes between insurers and insureds regarding the percentage of loss allocated to the directors and officers, and thus covered under the policy, and the percentage allocated to the company, and thus not covered under the policy.

In 1995, the Ninth Circuit affirmed a 100 percent allocation of liability to the directors and officers for the settlement of an underlying 10b-5 securities action. *Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1425 (9th Cir. 1995). Ostensibly in the name of expanding directors’ and officers’ insurance protection, the decision resulted in the D&O insurer being liable for the corporation’s exposure. The D&O industry responded to the *Nordstrom* decision in two primary ways. First, as noted earlier, many D&O policies now include entity securities coverage. Entity coverage essentially renders allocation unnecessary for securities claims. Second, D&O policies now include detailed allocation clauses that require the parties to negotiate an allocation agreement. If the parties are unable

to agree, the insurer may be required to advance the percentage of loss not in dispute and submit to arbitration on the allocation amount in dispute.

C. Bankruptcy Claims

A corporation's bankruptcy may have a significant impact on its directors and officers' insurance coverage. First, courts are mixed on the question of whether the proceeds of the D&O Policy are the property of the debtor's estate. *See In re Louisiana World Exposition, Inc.*, 832 F.2d 1391, 1400-01 (5th Cir. 1987) (proceeds of D&O policy which did not provide liability coverage for third-party claims against the debtor not property of the estate); *In re Global Crossing Securities and ERISA Litig.*, 225 F.R.D. 436, 463 (S.D.N.Y. 2004) ("individual insureds...have a right to use the policies' proceeds to cover their defense and settlement costs in litigation"); *In re Adelphia Communications Corp.*, 298 B.R. 49, 52-54 (S.D.N.Y. 2003) (debtor did not have property interest in proceeds of D&O policies where it had made no payments for which it would be entitled to indemnity coverage under the policies); *In re Eastwind Group, Inc.*, 303 B.R. 743, 748 (Bankr. E.D. Pa. 2004) (where securities laws violations were asserted both against the directors and officers and the debtor, the proceeds of a D&O policy providing entity coverage for securities claims were property of the estate); *In re CyberMedica, Inc.*, 280 B.R. 12 (Bankr. D. Mass. 2002) (proceeds of D&O policy which provided coverage to debtor for indemnity and third-party claims were property of the chapter 7 debtor's estate).

If the policy and its proceeds are property of the estate, the insureds may need bankruptcy court approval to obtain proceeds from the insurer. Often, in an abundance of caution, insurers will seek leave from the bankruptcy court before advancing defense costs under a D&O policy.

In addition, as discussed above, when a company seeks bankruptcy protection, corporate indemnification may no longer be available, implicating A-Side coverage. Also, claims by debtors in possession or trustees against directors or officers for the benefit of creditors may implicate the IvI exclusion.

VII. CONCLUSION

Although D&O insurance has now been a fixture in corporate America for the past thirty years, the terms of coverage are constantly evolving and new risks develop that need to be addressed. Congressional legislation such as the Dodd-Frank Wall Street Reform and Consumer Protection Act will create new exposures to directors and officers, which may well lead to new policy terms and conditions. D&O insurance is now a mature market, but there are constant challenges that will lead to changes in the years ahead.

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