DIRECTORS' AND OFFICERS' LIABILITY

RECENT DEVELOPMENTS IN D&O INSURANCE

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Federal and state courts have recently issued noteworthy decisions yielding important lessons about directors and officers liability insurance policies. This column examines decisions addressing: (i) the interaction of an application severability clause in a primary policy (addressing to what extent one insured's knowledge of application misrepresentations can be imputed to other insureds) with a "prior knowledge" exclusion in excess policies; (ii) the scope of a standard-form securities exclusion; (iii) the consequences of failing to give timely notice under a "claims made and reported" policy; and (iv) the effect of an "other insurance" clause in a D&O policy on the D&O insurer's defense cost obligations to a mutual insured also holding a CGL policy with another insurer.

Prior Knowledge Exclusion

An application for D&O insurance typically is filled out by one or two officers of the corporation (usually the CEO and/or CFO) who make certain representations on behalf of all individuals to be insured. In addition to the traditional "warranty statements" made in the application about knowledge of facts which might give rise to a claim, most D&O applications today expressly incorporate certain documents, such as specified company SEC filings and financial statements, and provide that these documents are material to the insurer's evaluation of the risk and expressly serve as a basis for writing the coverage. Allegations of inaccuracy in the documents incorporated into the application frequently form the basis for the very lawsuits for which D&O coverage later may be sought. If the company announces an accounting restatement, it may be argued that the company has admitted the original financial statements -- and the application -- were materially misleading. Without a severability provision in the application, if material representations made to the insurer during the underwriting process turn out to be false, the insurer may be able to return the premium paid and rescind, i.e., void, coverage under the policy as to all insureds. In addition, most D&O policies include

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severability for the conduct exclusions, such as fraud and intentional misconduct, so that the knowledge or "bad acts" of one insured cannot be imputed to innocent D&Os, who remain entitled to coverage.

In XL Speciality Ins. Co. v. Agoglia,[1] Judge Gerald E. Lynch last month assessed under New York the effect law of prior knowledge exclusions on demands for coverage under three excess D&O policies issued to Refco, Inc., once one of the largest brokerage and clearing services providers for international currency and futures markets. The decision illustrates the importance of paying attention to the wording of and relationship between application and exclusion severability provisions at both the primary and excess insurance levels.

Refco collapsed upon disclosure in October 2005 that it had been carrying an undisclosed $430 million receivable from an affiliate controlled by CEO Phillip Bennett (the "RGHI Receivable"), announcing that the receivable consisted of uncollectible debts originating in the late 1990s and that the related-party nature of the receivable had been hidden from the company's auditors. In the litigation fallout, Bennett pleaded guilty to numerous federal criminal charges. In addition, numerous civil lawsuits were filed against the former directors and officers of Refco. Central to these lawsuits are the allegations that, prior to Refco's August 2005 initial public offering, Bennett and others at Refco concealed Refco's true financial position by means of the RGHI Receivable scheme.

Refco's D&O liability insurance program for the relevant period consisted of a U.S. Specialty Insurance Company primary policy, with Allied World Assurance Company ("AWAC"), Arch Insurance Company ("Arch") and XL Specialty Insurance Company ("XL") providing third, fourth and fifth excess layer coverage, respectively. The AWAC and Arch polices expressly followed form to the primary policy, except to the extent they contained limitations or restrictions beyond those in the primary policy. The XL policy did not follow form to the primary policy. These excess insurers sought a declaration on summary judgment that coverage was precluded by prior knowledge exclusions in their policies.

The "Full Severability" clause governing the application for the primary policy stated that the various insured officers and directors "represent that the particulars and statements contained in the Application are true, accurate and complete and are deemed material to the acceptance of the risk assumed by the Insurer under this Policy." The clause further provided that "[n]o knowledge or information possessed by any Insured will be imputed to any other Insured. If any of the particulars or statements in the Application is untrue, this Policy will be void with respect to any Insured who knew of such untruth."[2]

Although both the AWAC and Arch policies followed form to the primary policy, they contained their own endorsements relevant to the imputation of one insured's knowledge to other directors and officers for purposes of applying the prior knowledge exclusion. The endorsements excluded coverage for a claim if "any insured" had knowledge of facts or circumstances that might have rise to a claim. The "any insured" formulation used in these excess carriers' prior knowledge exclusion permitted the carriers to point to the

undisputed knowledge of Bennett, which the court readily concluded embraced the facts (including their potential grounds for claims) underlying the claims for which coverage was sought.

The court rejected the insureds' argument that the application severability provision in the primary policy prevented AWAC and Arch from imputing Bennett's knowledge to others. The insurers argued unsuccessfully that the application severability clause as a matter of law was not a general non-imputation provision, because it extends only to the statements made in the application. Under that view, application severability is irrelevant to any exclusionary language contained in the excess policies. The court disagreed, determining that ambiguities must be construed against the insurer and that while the insurers' view that "the severability provision is limited to the rescission context" may prevail at trial, the insureds had shown "enough ambiguity in the severability provision's scope to preclude a definitive finding that the severability provision is not a general non-imputation clause."

The court nevertheless granted summary judgment to AWAC and Arch because the unambiguous language in their prior knowledge endorsements provided that knowledge by "any insured" of facts and circumstances giving rise to a claim precluded coverage for innocent insureds. This language in the excess polices "unambiguously preclude[d] coverage for innocent insureds," and as a matter of contract "any provisions in the excess polices . . . supercede any contradictory provision, including the severability provision, in the Primary Policy."

As noted, the XL policy did not follow form to the primary policy, but instead contained its own application severability clause providing that one insured's knowledge would not be imputed to other insureds for purposes of determining the availability of coverage. The XL policy itself contained a prior knowledge exclusion (called therein an "Inverted Representation Endorsement") that was congruent with that contained in the AWAC and Arch polices. For XL, the severability clause and the prior knowledge exclusion were found in the same insurance policy. Because the "any insured" prior knowledge exclusion in the XL policy stated that all the other terms of the policy were to remain unchanged, it did not automatically override the severability provision as it did in the AWAC and Arch policies. Consequently, the court could not determine as a matter of law that XL's prior knowledge exclusion should supercede its own severability clause.

This was especially true given the parties' disagreement as to whether the prior knowledge exclusion was properly included in the XL policy at all. No prior knowledge exclusion was included in the binder issued before issuance of the final policy. The insureds contended that because the binder did not contain any mention of a prior knowledge exclusion the appearance of such an exclusion in the final policy should be disregarded. The court rejected this view as inconsistent with Second Circuit precedent holding that because binders are by their nature incomplete, it is often necessary to look to extrinsic evidence with respect to incomplete and unintegrated binder terms. The insureds replied that Second Circuit precedent also holds that extrinsic evidence is not properly considered when a binder's terms are clear and

unambiguous. Because the binder made no reference to a prior knowledge exclusion, the insureds argued, extrinsic evidence that such exclusion was properly included was not permissible. The court disagreed, noting that the absence of a provision in a necessarily incomplete document like a binder is not equivalent to the presence of unambiguous policy language. In any event, it was clear that the XL policy contained ambiguities that the other excess policies did not, so the court denied XL's motion for summary judgment.

Securities Claims Exclusion

In In re SRC Holding Corp.,[3] the Eighth Circuit applying Minnesota law, held that the plain language of a standard form securities exclusion in a D&O policy issued to a securities underwriter barred coverage for actions alleging violations of federal and state securities laws and NASD rules arising out of the underwriter's sale of municipal bonds. The D&O insurer denied coverage, invoking a securities exclusion barring coverage for any claim "in any way involving any actual or alleged violation of . . . (1) the Securities Act of 1933, the Securities Exchange Act of 1934 [and]. . . any other federal law, rule or regulation with respect to the regulation of securities; (2) any state securities or 'Blue Sky' laws . . . ." and (3) any common law provision "imposing liability in connection with the offer, sale or purchase of securities."

Citing both the endorsement's language and the testimony of the broker who placed the policy, Minnesota bankruptcy and district courts on summary judgment held that the securities exclusion was intended to exclude coverage only for loss resulting from the insured's sale of its own securities, not offerings of other entities' securities.

The Eight Circuit reversed, holding that the "broad and unqualified" plain language of the exclusion barred coverage for the securities suits because it was not limited "to a specific category of securities transaction, or type of offering or offeror." The lower courts erred, the court stated, by consulting extrinsic evidence of intent when the policy language was unambiguous, on its face admitting of no limitations. The court also rejected the insureds' argument that a broad interpretation of the securities exclusion would conflict with two other policy endorsements, a General E&O exclusion and another which clarified that the securities exclusion did not preclude coverage for a specified securities placement. The court acknowledged difficulty in reconciling the securities exclusion and the General E&O exclusion, which barred coverage for loss arising out of the insureds' provision of Investment Banking, Broker / Dealer Services or Securities Underwriting, subject to a "Management Carveback," which preserved coverage for claims relating to the management or supervision of any division or subsidiary of the parent company offering any of the three aforementioned services. The court agreed that ambiguity (which would be construed against the insurer) would exist only if the securities exclusion canceled the coverage preserved by the Management Carveback. However, the court read the Management Carveback as serving a different, non-superfluous purpose – it saved coverage for non-securities law claims such as derivative suits alleging director mismanagement in supervising investment banking services, and tortious interference claims. The court acknowledged that its broad reading of the securities exclusion rendered that exclusion partially redundant of the General E&O exclusion, but as long as neither exclusion

was rendered superfluous, the court reasoned, "nothing prevents the parties from using a 'belt and suspenders' approach in drafting the exclusion." SRC is a reminder that the parties expectations, however legitimate, do not control when policy language is unambiguous. If the parties' "understanding" that policy words will be interpreted a particular way is "nowhere to be found" in the plain language, there is no assurance that a court interpreting policy language it determines to be unambiguous will share that understanding.

Reporting Under Claims Made Policies

D&O policies typically are written on a "claims made and reported" basis, meaning that coverage is available only for claims made against the insured during the policy period and about which the insured notifies the insurer during the same period. The policy usually defines the term "claim" as a formal demand for money. A recent opinion by the United States Court of Appeals for the Ninth Circuit, Charles Dunn Co. v. Tudor Ins. Co.,[4] illustrates that the consequence of failing to give the insurer timely notice of a claim ordinarily will be that no coverage is due.

The Charles Dunn Company ("CDCI") purchased successive insurance policies from Tudor covering separate periods of 2004-2005 and 2005-2006. On October 21, 2005, a third party, the DuLaurence Trust (the "Trust") sent CDCI a letter enclosing a draft complaint alleging various claims for damages against CDCI arising out of CDCI's alleged "flipping" real estate.

The Trust filed the complaint on November 7, 2005, after the commencement of the 2005-2006 policy. CDCI first tendered notice of the complaint to Tudor on February 9, 2006. Tudor denied coverage on the ground that Trust's October 21, 2005 letter constituted a "claim," so that, CDCI was required to report it to Tudor during the 2004-2005 policy period in order to obtain coverage. The policies issued to CDCI did not define what constituted a "claim," so the court applied California law, under which a claim "is a demand for something as a right, or as due" and "requires more than inquiry requesting an explanation or the lodging of a grievance without demand for compensation, but less than the institution of a formal lawsuit."[5]

Under California's claim definition, the court concluded that the Trust's October 21, 2005 letter, which raised allegations, sought damages and threatened suit, clearly constituted a "claim," and required CDCI to report its existence when it was first made during the 2004-2005 policy period and not when the complaint was filed during the subsequent policy period.

CDCI argued that any failure to report the claim during the earlier policy period should be excused because the renewal of that policy for the following year was essentially an extension of the same contract. The Ninth Circuit held that renewal of an insurance policy ordinarily does not create one continuous contract, but rather a separate and distinct contract for the policy period specified. Absent clear and unambiguous language evincing an intent to create one continuous contract, the court stated, renewals of prior policies are independent contracts.

Relying on the California Supreme Court's Root v. American Equity Specialty Ins. Co.,[6] CDCI argued that its reporting outside the policy period should be equitably excused. In Root, the insured received unreliable information about a potential claim two days before the expiration of its policy, verified the information two days after the policy expired and then immediately notified the insurer. CDCI, by contrast, received reliable information from the outset by virtue of the Trust's letter and, in any event, failed to promptly notify Tudor once the complaint was actually filed, choosing instead to wait three months to report the suit. The Ninth Circuit determined that such facts did not warrant equitably excusing CDCI's delay.

Finally, the court rejected CDCI's assertion that Tudor breached the implied covenant of good faith and fair dealing in declining coverage, as CDCI could not demonstrate the prerequisite to a bad faith claim, namely that Tudor owned CDCI coverage in the first instance.

Other Insurance

In Fieldston Prop. Owners Ass'n, Inc. v. Hermitage Ins. Co.,[7] the First Department held that an "other insurance" clause did not relieve a primary D&O insurer of an obligation to pay its equitable share of the reasonable costs incurred by a CGL insurer in defending an underlying action against directors and officers, except for the costs that the CGL insurer incurred in defending claims covered by both policies or solely the CGL policy. Hermitage Insurance Company issued an occurrence-based CGL policy to the Fieldston Property Owners Association, which covered, among other things, "bodily injury," "property damage" and "personal and advertising injury." Federal Insurance Company issued a "claims-made" primary D&O policy that covered the CGL policy period and longer, covering Fieldston and its directors and officers for "wrongful acts" and certain specified "offenses," including defamation and eviction. As is customary, the D&O policy included an "other insurance" clause, which provided that if any Loss arising from a claim against the directors and officers is insured under any other insurance policies, then the D&O policy "shall cover such Loss . . . only to extent that the amount of such Loss is in excess of the amount of such other insurance."

Fieldston and its directors and officers were sued in two underlying actions concerning the right of access to property between a land developer and Fieldston. Hermitage notified Federal that only one of myriad claims against Fieldston, a claim for injurious falsehood, might be covered under its CGL policy. Federal did not dispute that its D&O policy provided coverage for certain claims, but asserted that the "other insurance" clause rendered its coverage excess to Hermitage, and Federal declined to contribute to Fieldston's defense costs or otherwise provide coverage. Hermitage thus paid defense costs in both actions, under a reservation of rights. In the First Department, Federal acknowledged that the claims asserted in the underlying actions fell within the coverages afforded to Fieldston under both the Hermitage CGL policy and the Federal D&O policy. It was also undisputed that with the possible exception of the injurious falsehood claim asserted in both underlying actions, the Hermitage CGL policy and the Federal D&O policy do not provide coverage for the same risks. Moreover, there was no dispute that certain of the wrongful acts alleged took place after the expiration of

the Hermitage policy, but while the Federal policy remained operative.

Federal nevertheless argued that its "other insurance" clause relieved it of a duty to pay defense costs, arguing that the clause rendered it an excess insurer as long as the underlying action includes at least one claim that falls within the coverage of another insurer's policy, even if the remaining underlying claims are outside the coverage of the insurer's policy. Reversing a grant of summary judgment in Federal's favor and granting summary judgment to Hermitage, the First Department ruled that the "other insurance" clause applies only where a loss is insured under both the D&O policy and another policy. The court noted that other than the injurious falsehood claims, all the losses (including defense costs) that could result from the other underlying claims were not insured under the CGL policy, but some of them were covered under the D&O policy. Accordingly, the "other insurance" clause was "inapplicable to the risks of all other such losses, and the D&O policy thus provides primary coverage with respect to some of those risks. In other words, putting aside that possible exception, the CGL and D&O policies do not provide concurrent coverage as they do no insure against the same risks." Hermitage thus was entitled to contribution from Federal for Federal's equitable share of all defense costs incurred by Hermitage, except for the costs Hermitage incurred in defending against the injurious falsehood claims, as long as those claims were covered by both policies or covered solely by the CGL policy.

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[1] 2009 WL 513747 (S.D.N.Y. Mar. 2, 2009).

[2] Id. at *3.

[3] 545 F.3d 661 (8th Cir. 2008).

[4] 2009 WL 117868 (9th Cir. Jan. 14, 2009).

[5] Id. at *1 (emphasis added).

[6] 30 Cal. Rptr. 3d 631 (2005).

[7] 2009 WL 466121 (1st Dep't Feb. 26, 2009).