MEALEY'S **EMERGING INSURANCE DISPUTES**

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Directors' & Officers'

And Fiduciary Liability Insurance Claims:

Now Entering A Danger Zone

By

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COMMENTARY

Filing claims for insurance coverage under directors' and officers' ("D&O") and corporate fiduciary liability policies is a process fraught with pitfalls for the policyholder. It may not surprise many officers and directors to learn that over 40 percent of all outside directors of Fortune 1000 companies have been sued in connection with their board service.[1] It may, however, come as a surprise to many that — too often — liability insurance companies become an adversary in addition to the underlying claimant.[2]

Exclusion-laden D&O and fiduciary liability policies lead to often unexpected and, at times, unwarranted denials of insurance coverage.[3] Considering the huge potential for liability facing corporate directors and officers, shortfalls in liability insurance protection present an unacceptable risk to policyholders.

Following is a discussion of some frequent and not so frequent sticking-points which may reduce or eliminate D&O and fiduciary liability insurance coverage. Familiarity with both the insurance claims process and recurring insurance coverage confrontations can place policyholders in a stronger position as they attempt to secure coverage under their insurance policies.

Claims Denials Based On The Application For D&O Insurance

Some insurance companies attempt to defeat insurance coverage on the grounds that certain facts were not fully disclosed on the insurance application.[4] For instance, in *Harristown Development Corp. v. International Insurance Co.*,[5] the policyholder, a municipal corporation, purchased a D&O liability policy. A real estate developer subsequently sued the policyholder (among other

parties). The insurance company denied the policyholder's claim, arguing that coverage for the lawsuit was void because there were misstatements made on the application for the D&O policy. Interestingly, this rationale for denying the policyholder's claim came some years after the claim was initially filed with the insurance company. In the years between the filing of the claim and the denial, the policyholder continued to renew its D&O policy and pay premiums to the insurance company for the D&O coverage.

The policyholder sued the insurance company to secure coverage under the D&O policy. The court found in favor of insurance coverage for the policyholder, concluding that there were no misrepresentations on the application that would nullify insurance coverage under the D&O policy. Nevertheless, the *Harristown Development* litigation is indicative of the practice of some insurance companies to comb through insurance applications for either misstatements or "incomplete" answers to insurance application questions in an effort to defeat insurance coverage for covered claims. This practice typically is employed after the policyholder files a claim for coverage.

In a recent case, *Home Insurance Company of Illinois (New Hampshire), v. Spectrum Information Technologies, Inc.*[6] ("*Spectrum*"), the policyholders sought insurance coverage for a class action lawsuit brought against them for violations of the federal securities laws. To end the litigation, a settlement was negotiated for $10 million. The insurance companies which sold the D&O liability policies refused to provide insurance coverage for the settlement, arguing, among other things, that the policyholders had failed to report a Securities and Exchange Commission ("SEC") inquiry on their applications for insurance. On the basis of this contention, the insurance companies sought to nullify the D&O policies.

Specifically, the D&O insurance companies contended that the application for insurance required the policyholders to reveal "any civil or criminal action or proceeding investigating or charging a violation of any federal or state security law or regulation[.]"[7] The insurance companies argued that the SEC inquiry constituted a "proceeding" within the meaning of the insurance applications.

The federal district court disagreed, and held that an "informal inquiry" by the SEC was not a "proceeding" as that term was used in the applications. Moreover, the court found that use of the term "proceeding" in the applications was ambiguous, and thus, the ambiguity is construed against the applications' drafters — the insurance companies.[8]

The court also discussed the contention made by the insurance companies; that had the insurance companies been aware of the SEC inquiry, this fact would have affected their decision to sell the D&O insurance policies to the policyholder. Interestingly, however, a similar instance of nondisclosure of an SEC inquiry had previously occurred between one of the insurance companies and the policyholder. Though aware that the policyholder had failed to report on the application for D&O insurance the existence of an SEC inquiry, the insurance company nevertheless decided to issue the D&O policy.[9] For this reason, among others, the court found the insurance companies' assertions unpersuasive.

Interrelated Wrongful Acts Exclusion

Another justification frequently offered by insurance companies to defeat D&O insurance coverage has to do with "interrelated wrongful acts" by the policyholder.[10] Interrelated wrongful acts provisions typically read as follows:

> All claims arising from the same wrongful act or interrelated, repeated or continuous wrongful acts of one or more assureds shall constitute a single claim and shall be deemed to be first made and reported to the Insurer in the policy period in which the first such wrongful act is reported to the Insurer in accordance with provisions herein.

In effect, insurance companies use this provision to characterize a claim as being made outside the effective period of the D&O policy or to shift the policyholder's claim to a previous year in which policy limits might have been lower or already exhausted. By invoking the interrelated wrongful acts provision, an insurance company hopes to reduce its coverage obligation, if not avoid it altogether.

In *Burkholder v. Underwriters At Lloyd's, London*,[11] for example, the policyholder sought insurance coverage under a D&O liability policy for a lawsuit brought against its officers and directors. The insurance company denied coverage for the claim, arguing, among other things, that the policy's interrelated wrongful acts exclusion barred coverage. The insurance company argued that the wrongful acts alleged in the underlying complaint against the officers and directors were interrelated to "wrongful acts" which took place before the effective period of the D&O policy.

In the ensuing insurance coverage case, the court disagreed and held that the insurance company had failed to develop evidence to support this position. The court ruled that "mere allegations of related prior acts are not sufficient to trigger the [interrelated wrongful acts] Exclusion under its express terms."[12] The court noted that the insurance company had drafted the interrelated wrongful acts provision as broadly as it could, but that for the provision to have any meaning, it would have to be interpreted in a more narrow and practicable fashion.[13]

In *Anglo-American Insurance Company v. Molin*,[14] the policyholder, an insurance company, sought insurance coverage under a D&O policy for defense costs to address proceedings brought against the policyholder by the Pennsylvania Insurance Commissioner ("PIC"). The insurance company which sold the D&O policy rejected the policyholder's claim, arguing that coverage was barred by the interrelated wrongful acts provision. The insurance company contended that the wrongful acts alleged in the current proceeding were related to wrongful acts alleged in previous proceedings brought by the PIC.

The court, however, disagreed. Finding that the interrelated wrongful acts exclusion could not serve to bar coverage, the court focused upon the fact that the underlying proceedings were initiated for different purposes, and that the "allegations of the two pleadings pose distinct claims alleging different wrongs to different people."[15] Additionally, the court noted that new allegations were raised in the current proceedings which were not raised in the previous proceedings.[16]

As the above cases indicate, some insurance companies may attempt to defeat D&O insurance coverage by applying the broad language of the interrelated wrongful acts provision to the policyholder's claim. This, of course, can present significant difficulties for policyholders since a great many situations, activities, actions and so forth can arguably be "related" to some degree.

ERISA Claims: Exclusions And Gaps In Coverage

Many companies are justifiably concerned over potential Employee Retirement Income Security Act ("ERISA") liability. This concern is exemplified by the fact that many companies aggressively ally themselves with their employees who sue third parties for violations of ERISA.[17] As many corporate policyholders know, D&O policies and other corporate insurance policies frequently exclude insurance coverage for claims stemming from alleged violations of ERISA.[18]

Corporate Fiduciary Liability Insurance policies are available and purchased for protection against liabilities stemming from alleged violations of ERISA. The insurance coverage litigation surrounding the scope of coverage provided by these policies, however, demonstrates just how narrowly insurance companies interpret them at the time a claim is made.[19]

For example, in *American Casualty Co. of Reading, Pa. v. Hotel And Restaurant Employees And Bartenders Int'l Union Welfare Fund*,[20] the policyholders were denied insurance coverage for a claim filed under a fiduciary liability policy. The policyholders, trustees of a union welfare fund, were sued for alleged violations of their fiduciary duties in connection with a merger the union welfare fund had negotiated. The claim against the trustees was settled for $750,000 — this amount was paid by the union welfare fund on behalf of the trustees.

The insurance company argued that it was not obligated to cover the cost of the settlement because the fiduciary liability policy covered only the trustees and not the fund. The insurance company contended that the fund was really the party liable in the underlying suit. The Supreme Court of Nevada, however, disagreed, and held that coverage existed for the trustees under their fiduciary liability policy. The court found that — in fact — the trustees were *primarily* liable for the costs of the settlement in the underlying action, and therefore were entitled to insurance coverage.

In *Sokolowski v. Aetna Life & Casualty Co.*,[21] the policyholders were sued for alleged violations of ERISA, and sought protection under their fiduciary responsibility policy. The insurance company which sold the policy denied insurance coverage for the lawsuit against the policyholders, arguing, among other things, that the underlying plaintiff's claims were for relief that was not within the scope of the "damages" provision of the fiduciary liability policy.

The federal court disagreed with the insurance company's position, holding that the "damages" provision was not free of ambiguity, and that the policyholders' interpretation of the policy language was more compelling than that offered by the insurance company.[22] The court ruled in favor of the policyholders' positions on the issues of defense and indemnification under the policy.[23]

In *Northwest Airlines, Inc. v. Federal Insurance Co.*,[24] the policyholder, an airline, was sued for alleged violations of ERISA, securities laws and breaches of fiduciary duty in connection with a stock option plan that it offered to its employees. The policyholder sought insurance coverage

for the claims against it. Although, initially, providing some of the defense, the insurance company that sold the fiduciary policy subsequently denied coverage, and refused to cover the cost of a settlement that was eventually reached with the underlying claimants.

In the insurance coverage action, the court held that the policyholder was not entitled to insurance coverage under its fiduciary liability policies. Although the policyholder settled the claim against it because of concern over its potential liability under ERISA, the court held that "fiduciary responsibility does not attach to all corporate decisions, but [rather to] only those decisions that the employer makes in its capacity as a plan administrator."[25] The court ruled, among other things, that the policyholder had not committed a "wrongful act" as contemplated by the policy, and thus, there was no coverage for the claimants' lawsuit against the policyholder.

Similarly, in *Gulf Resources & Chemical Corp. v. Gavine*,[26] a federal trial court held that the policyholder had no insurance coverage for actions it took which affected its employees' retirement benefits. In *Gulf*, the policyholder terminated the medical benefits of certain employees of the company. The employees affected by the termination decision then sued the policyholder. The insurance company denied coverage for the lawsuit, arguing that the corporate fiduciary liability policy that it had sold did not provide coverage for what it characterized as corporate decisions to terminate particular retired employees' benefit plans. The insurance company contended that the policy offers very narrow coverage for policyholder actions which are taken in the capacity of a benefit plan fiduciary.[27]

In the ensuing insurance coverage dispute, the court held that the policy provides coverage only for fiduciary acts or omissions in the management and administration of the benefit plan. The court held that the policyholder's decision to terminate medical benefits was an "everyday business decision" that employers make on behalf of their shareholders, and "did not constitute a breach of fiduciary duty under ERISA."[28]

The above cases demonstrate an alarming potential gap in insurance coverage for ERISA liabilities. In effect, the policyholder gets whipsawed, because if the underlying claim alleges ERISA violations, the D&O insurance company argues that the ERISA exclusion obtains. Then, the policyholder seeks coverage under its fiduciary liability policy. But again, the insurance company may argue that coverage is unavailable because the alleged wrongful act was not taken as an ERISA plan administrator, but instead as an officer or director acting in their "ordinary" officer-director capacity.

Importance Of Timely Notice: A Case In Point

Policyholders must be especially mindful of the notice provisions in their insurance policies. Insurance companies routinely argue that coverage is void by reason of untimely or inadequate notice.[29] Thus, a prudent policyholder will provide prompt notice under each possibly applicable insurance policy.

In *Brumfield v. Shelton*,[30] the policyholder was sued in connection with securities purchases made for an employee stock ownership plan ("ESOP") by a former trustee. The new trustee of the ESOP brought a lawsuit against several parties, including the insurance company which sold the fiduciary liability policy.

In the insurance coverage lawsuit, the federal trial court agreed with the insurance company's position that the policyholder failed to give sufficient or timely notice. The policyholder had first given notice of the lawsuit to the insurance company, but gave notice under a D&O policy rather than the fiduciary liability policy. The court refused to find that notice under the D&O policy constituted timely notice under the fiduciary liability policy.[31]

The policyholder then furnished notice in writing under the fiduciary liability policy, but did so eight hours after the policy had expired. The court ruled that providing notice eight hours after policy expiration was a violation of the policy's strict notice provisions. The court also ruled against the policyholder's contention that the insurance company was not prejudiced by the delay in giving notice.[32]

The *Brumfield* case is a prime example of the harsh consequences that can befall a policyholder who fails to strictly abide by the policy's notice provisions. Although the insurance company did in fact receive notice of the lawsuit and its surrounding facts in a timely fashion, coverage was still rejected because the policyholder failed to reference the fiduciary liability policy. Moreover, policyholders are subjected to tougher notice standards in those jurisdictions that do not require insurance companies to demonstrate that they were prejudiced by reason of the late notice of the claim. As such, policyholders can be held to very strict and unforgiving standards when it comes to furnishing notice under their policies.

Conclusion

Liability insurance is, unfortunately, a necessity for almost all businesses. Insurance which insures can save the day and keep a business which faces liability intact. However, insurance companies which litigate legitimate claims can cause severe pressures for the policyholder. Accordingly, policyholders should develop a fundamental understanding of their insurance policies and be vigilant in pursuing insurance coverage.

ENDNOTES

1. 1995 Louis Harris & Associates study commissioned by Executive Risk Management Associates. The potential for large-scale liability does not just threaten the big publicly held companies either. Small closely held corporations are also vulnerable to D&O suits which seek enormous amounts in damages. Charities, religious organizations, governmental and quasi-governmental organizations must, and routinely do, carry D&O insurance.

Besides shareholders and creditors, corporate employees constitute a large source of the lawsuits filed against directors and officers. Indeed, a 1994 study conducted by the Wyatt Company indicated that approximately one out of four claims brought against directors and officers were filed by employees or former employees of the company.

2. See, e.g., Harbor Ins. Co. v. Continental Bank Corp., 922 F.2d 357, 359-60 (1990) (insurance companies repeated allegations of fraud against policyholders to deny D&O coverage, and then completely switched litigating positions to deny coverage by arguing that policyholders were innocent of any misconduct and thus should not have settled litigation against them); Continental Ins. Co. v. The Superior Court of

Los Angeles County, 37 Cal. App.4th 69 (Ct. App. 2d Dist. 1995) (only after policyholders initiated insurance coverage lawsuit did insurance company provide D&O coverage).

See generally Eugene R. Anderson, Laura Jones and Joshua Gold, Directors' & Officers' Insurance: Choose Your Insurance Company Wisely, Ins. Indus. Litig. Rep., May 23, 1996, at 20261.

3. See Eugene R. Anderson and Joshua Gold, Multiple Policies Are False Security, Nat'l L. J., Apr. 15, 1996, at C27.

See also Eugene R. Anderson and Randy Paar, What's Wrong With D&O Insurance?, Risk Mgmt., Jan. 1995, at 29; Eugene R. Anderson and Laura Jones, D&O Insurers: Fair-Weather Friends?, Corp. Board, May/June, 1996, at 10.

4. See, e.g., Oklahoma City Urban Renewal Auth. v. Gulf Ins. Co., Inc., Case No. CIV-94-1760-M (W.D. Okla. 1995).

5. 1988 U.S. Dist LEXIS 12791 (Pa.D.C. 1988).

6. 930 F. Supp. 825 (E.D.N.Y. 1996).
7. Id. at 837-38.

8. Id. at 838.

9. See id. at 840-43.

10. See, e.g., Home Ins. Co. Of IL v. Spectrum Info. Tech., 930 F. Supp. 825, 847-48 (E.D.N.Y. 1996).

11. Slip op., Civ. Action No. 1:95cv413GR (S.D. Miss. 1996).

12. Id. at 14.

13. See id. See also McCuen v. American Cas. Co., 946 F.2d 1401, 1407-08 (8th Cir. 1991) (stating that "interrelated" in a D&O policy was "so lacking in concrete content, that [it] import[s] into the contract, in our opinion, substantial ambiguities.").

14. 673 A.2d 986 (Pa. Cmwlth. 1996).

15. Id. at 993.

16. See Nat'l Union Fire Ins. Co. of Pittsburgh, PA v. Ambassador Group, Inc., 691 F. Supp. 618, 623 (E.D.N.Y. 1988).

17. See, e.g., Jeffrey McConocha v. Blue Cross And Blue Shield of Ohio, 1995 U.S. Dist. LEXIS 18612 (N.D. Ohio 1995) (Employer-company intervened on behalf of employees bringing suit against Blue Cross plan for violations of ERISA).

18. Many D&O policies exclude insurance coverage for claims stemming from ERISA violations under the following provision:

> The Insurer shall not be liable to make any payment for Loss in connection with a Claim made against an Insured:

for violation(s) of any of the responsibilities, obligations or duties imposed upon fiduciaries by the Employee Retirement Income Security Act of 1974, or amendments thereto or any similar provisions of state statutory or common law.

19. See, e.g., Carpenters Dist. Council of New Orleans & Vicinity v. Dillard Dept. Stores, Inc., 15 F.3d 1275 (5th Cir. 1994), *cert. denied*, 115 S. Ct. 933 (1995); Eaton v. D'Amato, 581 F. Supp. 743 (1980).

20. 894 P.2d 371 (Nev. 1995).

21. 670 F. Supp. 1199 (S.D.N.Y. 1987).

22. Id. at 1208.

23. Id. at 1210.

24. 32 F.3d 349 (8th Cir. 1994).

25. Id. at 353.

26. 763 F. Supp. 1073 (D. Idaho 1991), *aff'd*, 980 F.2d 737 (9th Cir. 1992).

27. Id. at 1076.

28. Id. at 1082.

29. See, e.g., Northwest Airlines, Inc. v. Federal Ins. Co., 32 F.2d 349 (8th Cir. 1994).

30. 831 F. Supp. 562 (E.D. La. 1993).

31. Id. at 565.

32. Id. at 566. ■

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