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Does An Innocent Outside Director's D&O Insurance Coverage Sink With The Ship?

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It turns out you were serving the wrong company. Its front page news that the thriving, expanding superpower to which you were providing guidance is alleged to have engaged in financial reporting irregularities. They allegedly concealed information from their stockholders, their employees, the SEC and you. Most unfortunately to your rapidly shrinking bottom line, the inside director in charge of procuring D&O insurance, insurance which is supposed to offer you protection at times like this, is alleged to have concealed information from your D&O insurance company. The result? With alleged liabilities mounting and the press and Congress yelling for blood, the D&O insurance company suggests it will pull the rug out from under you and rescind the D&O coverage for innocent outside directors like you upon which you relied in taking the job in the first place because of alleged "misrepresentations" made at the time of policy purchase or renewal.

Were there misrepresentations made to the insurance company? Maybe. Maybe not. Are misstated earnings during a policy renewal enough to void the policy? Probably not. But that will not stop the D&O insurance companies seeking to avoid $2 billion in losses from saying so. Do alleged misrepresentations in processing the insurance upon which you relied in accepting your position as an outside director mean that you are not entitled to insurance coverage? No.

Innocence is its own reward. More importantly, innocence has been acknowledged by some courts as providing the basis for outside directors to obtain coverage under some circumstances.

The operative doctrine in such situations is known as "severability".

That doctrine stands for the proposition that even if the common law generally would make an insurance policy voidable if the policyholder either affirmatively made material misrepresentations or omitted material facts in his application for insurance, innocent directors can not be denied coverage solely due to the actions of the other "bad" director unless some other language in the policy so requires. *See Shapiro v. American Home Assurance Company*, 616 F. Supp. 900 (D. Mass. 1984) (*Shapiro II*) (holding that former officers and directors of a corporation could not be barred from coverage under Securities Act liability policies solely on the basis of fraudulent acts of other policyholders in procurement of the policy); *see also Wedtech Corp. v. Fed. Ins. Co.*, 740 F. Supp. 214, 218 (S.D.N.Y. 1990) (citing *Shapiro II* for the proposition that when an insurance policy contains a severability provision, some officers and directors still may be entitled to insurance coverage).

In *Shapiro II*, the seminal case on severability, two former officers and directors sought a declaration that they were covered under three Securities Act Liability policies, and the insurance company argued that the policies were void in their entirety because of false SEC registration materials submitted to the insurance company. The Court, in rejecting that argument pointed to a provision in the policies at issue which provided that the "Insurance" was to be:

> construed as a separate contract with each Insured so that except as aforesaid, as to

each Insured, the reference in this Insurance to the Insured shall be construed as referring only to that particular Insured, and the liability of the Insurer to such Insured shall be independent of its liability to any other Insured.

Although this severability provision did not explicitly address whether a false representation by one policyholder in obtaining insurance precluded coverage for other policyholders, the court reached its ruling based upon a reading of the entire policy and consideration that the "manifest intent" of the parties was to provide coverage for each policyholder unless that policyholder participated in the fraud.

In *Wedtech Corp. v. Fed. Ins. Co.*, 740 F. Supp. 214, 218 (S.D.N.Y. 1990), the court determined from the policy language at issue in that case that "[t]he intent of the parties to the insurance policy . . . to bar coverage only for those insureds who participated in the fraudulent inducement is even more apparent than in Shapiro."

The Court then pointed to policy language which indicated that no statement in the application or knowledge on the part of one policyholder was to be imputed to another policyholder in determining the availability of coverage.

The United States Court of Appeals for the Fourth Circuit also addressed the ramifications of a severability clause in *Atlantic Permanent Federal Savings and Loan Ass'n v. American Casualty Co.*, 839 F. 2d 212, cert. denied, 108 S. Ct. 2824 (1988). Given a severability clause as to warranties made in the application, the court held that the policy could only be rescinded as to those individuals who had knowledge of the misrepresentations being made in the application. *See also, FSLIC v. Burdette*, 718 F. Supp. 649 (E.D. Tenn. 1989).

Now of course, it is not always so simple to determine when a court will apply the severability doctrine and trump the common law preference for voidable insurance when there have been material misrepresentations. It seems pretty clear that the presence of an explicit severability clause will be read for the worth of its plain language and enforced in favor of the "innocent" directors. *See Shapiro II*; *see also Mazur v. Gaudet*, 826 F. Supp. 188, 194 (E.D. La. 1992) (holding "innocent" policyholders remain covered even if another policyholder made affirmative misrepresentations to the insurance company). The converse is true as well. The presence of an express anti-severability clause will preclude coverage of the "innocent" directors and officers. *See Shapiro v. American Home Asurance Company*, 584 F. Supp. 1245 (D. Mass. 1984) (*Shapiro I*).

But what if there is no severability clause? In circumstances when the contract is not specific in its handling of the question of severability, courts rely on that old contractual standby, the "intent of the parties" to determine if there should be severability. *See Atlantic Mutual ins. Co. v. Balfour MacLaine Inter. Ltd.*, 85 F. 3d 68, 80 (2d Cir. 1996) (citing *Christian v. Christian*, 365 N.E.2d 849, 856 (NY 1977).

For example, according to New York law, the severability of a contract is a question of the parties' intent, "to be determined from the language employed by the parties, viewed in the light of the circumstances surrounding them at the time they contracted." *Christian v. Christian*, 42 N.Y.2d 63, 396 N.Y.S.2d 817, 824, 365 N.E.2d 849, 856 (1977) and as a general rule, "the contract is considered severable and divisible when by its terms, nature, and purpose, it is susceptible of division and apportionment." *See First Sav. & Loan Ass'n of Jersey City v. American Home Assur. Co.*, 29 N.Y.2d 297, 327 N.Y.S.2d 609, 610, 277 N.E.2d 638, 639 (1971). Even New York, however, has not yet addressed whether a D&O policy inherently is severable in the absence of an anti-severability clause.

Despite the absence of a significant amount of case law on this subject one thing remains clear. Courts are loathe to make "innocents" forfeit coverage.

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