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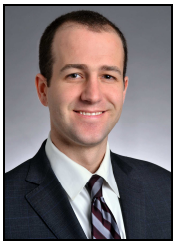

NEGOTIATING CONDUCT EXCLUSIONS IN D&O AND E&O POLICIES

By: Nicholas Maxwell*

Virtually all D&O and E&O policies include what are often called "conduct" exclusions, which bar coverage for certain losses arising out of a determination that the policyholder acted criminally, fraudulently, dishonestly or maliciously. Unlike typical substantive D&O/E&O exclusions (bodily injury, insured vs. insured, etc.), conduct exclusions typically only take effect if and when the policyholder is judged liable for the specified type of conduct. This generally enables policyholders to retain their initial right to an insurance company–funded defense until there is a finding of wrongdoing.

The conditional nature of conduct exclusions implements two key interlocking principles of liability insurance: (1) that a policyholder should have the right to a funded defense of the allegations against him or her, no matter how egregious; but (2) that a policyholder should not be able to use insurance to deflect liability for intentionally wrongful conduct.

Despite the ubiquity of conduct exclusions, the language of the exclusions varies significantly, leaving ample opportunity for policyholders to negotiate for the best coverage. Conduct exclusions run the gamut, from proscribing a discrete and explicit universe of intentional conduct to vaguely imperiling coverage for many acts or omissions that policyholders likely believe are covered. As is often the case in insurance policy interpretation, the devil is in the details.

Criminal. Fraudulent. Dishonest. Illegal. Malicious.

In the hands of an insurance company adjuster examining a new claim, the words listed above can have very different meanings, and they are rarely defined terms in a policy. While "criminal" and "fraudulent" are terms of art with specific definitions in law, "dishonest" is an inherently subjective term not governed by any formal legal standard. "Illegal," though perhaps more concrete, could be problematic because, in theory, any judgment against a policyholder could suggest the policyholder did something illegal. An exclusion for "malicious" conduct lies somewhere in between—malice has an explicit meaning in certain areas of law, but also lends itself to subjective interpretation.

Policyholders should pay close attention to the particular language insurance companies propose for conduct exclusions. Phrasing like "deliberate criminal acts," for example, is particularly advantageous for policyholders, for two reasons. First, criminal refers to a concrete category of legal violations pursued by state or federal prosecutors, decreasing the likelihood that an insurance company would attempt to construe the exclusion overly broadly. (Fraudulent theoretically also provides certainty, since some underlying claims allege fraud while others do not, but it is not as concrete.) Second, "deliberately" imposes the burden upon the insurance company to show that the crime in question includes a knowledge standard not present in every single crime.

In negotiating a new policy or renewal, policyholders should seek concrete and narrowly tailored conduct exclusions. Although, at first glance, the various adjectives used in conduct exclusions can all seem vaguely similar, when it comes time for a coverage determination, the reality may be exactly the opposite.

Determination in Fact. Adverse Admission. Adjudication. Final Adjudication. Final Nonappealable Adjudication.

Independent from the substantive scope of conduct encompassed by a conduct exclusion, the next question is what type of adverse legal finding triggers the exclusion for indemnity coverage. This too can significantly affect the scope of a conduct exclusion. Many lawsuits end in settlement, and nearly all conduct exclusions are not triggered by settlement, incentivizing policyholders to settle before motion practice or trial. Assuming the case does not settle, however, the exclusion's trigger language, which can differ vastly, becomes of central importance.

The most advantageous conduct exclusions are those that trigger only in the event of a "final nonappealable adjudication." In other words, the exclusion only takes effect at the end of the line, after a judicial finding on the merits and the exhaustion of all possible appeals.

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Meanwhile, references to "determinations in fact," "adverse admissions," or other potentially nonfinal determinations can lead to ambiguity and earlier triggers. For example, triggers such as "written admission by the Insured" or "plea of nolo contendere or no contest regarding such conduct" make it easier for the insurance company to apply the exclusion. An insurance company might latch onto a statement by the policyholder's representative at deposition or a preliminary finding of fact by the court. Even an exclusion that lacks only the no-appealable component could leave the policyholder holding the bag if the trial court reaches the incorrect result, even if that result is later overturned on appeal.

Accordingly, D&O/E&O policyholders should beware of the different possible phrasing in this key component of a conduct exclusion. Insisting on final, nonappealable adjudication language ensures the policyholder gets its full day in court and pushes the coverage decision further into the future, increasing the likelihood of a settlement that avoids the conduct exclusion altogether.

Severability

To preserve the rights of individual insured persons not involved in the conduct at issue, policyholders should negotiate for severability language ensuring that the acts of one insured person are not imputed to another insured person. Without this key carve-out, the criminal, fraudulent, dishonest, illegal or malicious act of one individual could preclude coverage for all insured persons and the organization. Severability language may be more readily available in D&O policies than E&O policies since D&O policies are designed to protect key individuals and are often nonrescindable. That said, E&O carriers have become more flexible to include severability language that only imputes conduct by a "control group" of key individuals to the organization.

Recoupment

The final key issue with any conduct exclusion is whether the exclusion (or another policy provision) requires the policyholder to retroactively reimburse the insurance company in the event of an adverse determination triggering the conduct exclusion. Recoupment provisions are of major importance to policyholders and insurance companies alike in the modern era, where defending a claim can cost millions of dollars independent of any eventual settlement or judgment.

Policyholders must be aware that recoupment language is not always obvious. In many policies, recoupment is addressed in a separate section of the policy concerning the conditions of the insurance company's defense obligation. The provisions are often ambiguous and encompass situations other than just the conduct exclusion (for example, recoupment where the policyholder "shall not be entitled under the terms and conditions" of the policy to coverage). And in some cases, there is no recoupment provision at all, which offers significant peace of mind to the policyholder.

In some policy/renewal discussions, insurance companies may make the recoupment provision nonnegotiable. Nonetheless, it is a key and sometimes underconsidered provision that all policyholders should keep in mind when negotiating policy language.

Conclusion

The foregoing discussion demonstrates not just the centrality of conduct exclusions in D&O/E&O policies, but the extent to which they differ from one another. The best exclusions are concretely phrased and narrow in scope; the worst are vaguely phrased and broad in scope. Policyholders should always seek a conduct exclusion that clearly delineates what is and is not subject to the exclusion.

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