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***CURRENT ISSUES AND TRENDS IN D&O COVERAGE***

**PRESENTED BY:**

**MAURA Z. PELLETERI  
DIANE LLOYD MATTHEWS  
PREAUS, RODDY & KREBS  
650 Poydras Street  
Suite 1650  
New Orleans, LA 70130**

## I. INTRODUCTION TO D&O INSURANCE

Directors and Officers Insurance, or D&O Insurance, provides coverage for loss resulting from the wrongful acts of directors and officers acting in their capacity as such.<sup>1</sup> D&O Insurance provides considerable protection to directors and officers against gaps in corporate indemnification. For example, it can provide coverage for liability arising from derivative actions and certain securities laws where corporate indemnification may not be permissible.<sup>2</sup> Moreover, it provides protection where corporate indemnification is not possible because of the insolvency of the corporation.<sup>3</sup>

D&O coverage, perhaps more than any other type of policy form, is subject to changes as a result of the market, including the types of claims presented, policyholder concerns, court decisions, and profits and losses sustained by the companies.<sup>4</sup>

D&O insurance was initially offered by domestic insurers in the 1960's.<sup>5</sup> Many insurers made changes to their policy forms starting in the mid-1980's during the "insurance crisis" and several endorsements were added to deal with specific problems as they arose.<sup>6</sup> Presently, there is no standard form D&O policy making it difficult to provide an analysis of current trends and issues.

Despite the lack of uniformity in policy forms, however, most D&O policies share certain common characteristics. The typical D&O policy actually provides two separate coverages within the same policy.<sup>7</sup> First, the personal or direct coverage insures directors and officers

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<sup>1</sup> Fidelity & Deposit Company of Maryland, Responsibilities & Liabilities of Bank Directors, p. 19-20 (1985).

<sup>2</sup> Id. at 19; citing Johnston, Corporate Indemnification and Liability Insurance For Directors and Officers, 33 Bus. Law. 1993 (1978).

<sup>3</sup> 33 Bus. Law. at 2011.

<sup>4</sup> The Wyatt Company, Wyatt D&O MAPS, Vol. 1, Introduction, p. 1 (1992 & Supp. 1993-1995).

<sup>5</sup> Id.

<sup>6</sup> W. Knepper and D. Bailey, Liability of Corporate Officers and Directors, Vol. 2, § 23-2 (5th ed. 1993).

<sup>7</sup> The Insuring Clauses contained in Fidelity and Deposit Company of Maryland's Directors and Officers Liability Insurance Policy Including Bank Reimbursement S8550bj SPEC. (Ed. 6-84) provides as follows:

In consideration of the payment of the premium and in reliance upon all statements made and information furnished to the Company, including

against loss which results from claims arising out of acts, errors or omissions which occur in the discharge of their duties to the extent they are not indemnified by their corporation.<sup>8</sup> The second form of coverage, described as the corporate reimbursement part of the policy, insures the corporation for the amount it expends indemnifying its officers and directors for their losses. Most claims are made under the latter form of coverage.<sup>9</sup> It is important to bear in mind, in the analysis of any issue under the typical D&O policy, that coverage is not provided to the corporation for its own liabilities.

A second feature common to most D&O policies is the fact that they are claims-made, as opposed to occurrence policies. Consequently, for coverage to exist the claims against the director or officer must be made during the policy period. The use of claims-made policies in the field of professional liability insurance developed because of the failure of the occurrence type policy to measure up to realistic actuarial standards as a result of the lapse of time between the negligent act or omission and the filing of the claim.<sup>10</sup> The claims-made policy on the other hand provides the insurer with a degree of actuarial certainty which allows it to offer insurance at significantly lower premiums.<sup>11</sup>

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the statements made in the Proposal Form and subject to all the terms, conditions and limitations of this policy, the Company agrees:

(a) with the Directors and Officers of the Bank that if, during the policy period, any claim or claims are made against the Directors and Officers, individually or collectively, for a Wrongful Act, the Company will pay, in accordance with the terms of this policy, on behalf of the Directors and Officers or any of them, their heirs, legal representatives or assigns all Loss which the Directors and Officer or any of them shall become legally obligated to pay, except for such Loss as to which the Bank shall indemnify the Directors and Officers;

(b) with the Bank that if, during the policy period, any claim or claims are made against the Directors and Officers, individually or collectively, for a Wrongful Act, the Company will pay, in accordance with the terms of this policy, on behalf of the Bank, all Loss as to which the Bank may be required or permitted by law to indemnify the Directors and Officers.

<sup>8</sup> W. Knepper & D. Bailey, supra.

<sup>9</sup> Id.

<sup>10</sup> Kroll, The Professional Liability Policy "Claims Made", 13 Forum 842, 845 (1978).

<sup>11</sup> Burns v. International Ins. Co., 709 F. Supp. 187, 191 (N.D. Cal. 1989), affirmed, 929 F.2d 1422 (9th Cir. 1991).

The typical D&O policy provides coverage for "Loss" resulting from the "Wrongful Acts" of directors and officers arising from claims made during the term of the policy.<sup>12</sup> These terms are usually defined within the policy. "Loss" is defined in terms of the amount which directors or officers are required to pay for claims made against them for their wrongful acts. It includes damages, judgments, settlements, and costs.<sup>13</sup> "Loss" is limited by certain exclusions, including punitive or exemplary damages, taxes, matters deemed uninsurable because of public policy, and criminal or civil fines or penalties imposed by law. Typically, a "Wrongful Act" is defined as any error, misstatement, misleading statement, act or omission, or breach of duty by directors or officers in their capacity as such.<sup>14</sup>

The typical D&O policy excludes coverage for (1) dishonest, fraudulent or criminal acts, (2) personal profit, (3) claims for bodily injury, sickness, disease, death or emotional distress, (4) damage to property including loss of use, (5) personal injury including libel, slander or wrongful termination of employment. Such policies also contain many exclusions such as the

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<sup>12</sup> W. Knepper & D. Bailey, *supra* at § 23-2.

<sup>13</sup> The definition of Loss in Fidelity and Deposit Company of Maryland's Directors and Officers Liability Insurance Policy Including Bank Reimbursement S855Obj SPEC. (Ed. 6-84) reads as follows:

The term "Loss" shall mean any amount which the Directors and Officers are legally obligated to pay for a claim or claims made against the Directors and Officers for Wrongful Act(s) and shall include damages, judgments, settlements and costs, charges and expenses (excluding salaries of Officers or Employees of the Bank) incurred in the defense of legal actions, suits or proceedings and appeals therefrom, and cost of attachment or similar bonds; provided however, such Loss shall not include fines or penalties imposed by law, punitive or exemplary damages or matters which may be deemed uninsurable under the law pursuant to which this policy shall be construed.

<sup>14</sup> The definition of "Wrongful Act" in Fidelity and Deposit Company of Maryland's Directors and Officers Liability Insurance Policy Including Bank Reimbursement S8550bj SPEC. (Ed. 6-84) reads as follows:

The term "Wrongful Act" shall mean any actual or alleged error, misstatement, misleading statement, act or omission or breach of duty by the Directors and Officers, based on negligence, in the discharge of their duties solely in their capacity as Directors and Officers of the Bank.

regulatory, insured v. insured, pollution and ERISA exclusions. The regulatory and insured v. insured exclusions have been litigated extensively in connection with the financial institution failures of the past several years. More recently, employment related litigation has raised new issues regarding the scope of coverage provided by D&O policies. This paper will focus on some of these issues as well as review recent D&O Insurance cases.

## II. EMPLOYMENT PRACTICES LIABILITY COVERAGE

During the past 32 years, the United States has witnessed significant statutory expansions of the rights of employees. A plaintiff who claims he or she has been wrongfully terminated, or discriminated against in a hiring, compensation, or promotion decision, can file a lawsuit alleging one or more federal or state causes of action for discrimination, almost all of which were nonexistent prior to the 1960's.<sup>15</sup>

The principal legislation in this area is Title VII of the Civil Rights Act of 1964 (Title VII)<sup>16</sup> which created a federal cause of action for employment discrimination on the basis of race, color, religion, sex or national origin. Title VII was followed by the Age Discrimination in Employment Act of 1967 (ADEA),<sup>17</sup> the Americans With Disabilities Act of 1990 (ADA)<sup>18</sup> and the Civil Rights Act of 1991 (CRA 1991),<sup>19</sup> which makes it easier for employees to bring suit and recover damages for employment-related claims under Title VII. These federal statutes are mirrored by numerous state statutes which may even expand the protections of the federal statutes.<sup>20</sup>

Frequently, state tort claims such as defamation and invasion of privacy are tacked on to federal and/or state claims for employment discrimination, which are generally not preempted by federal or state statute.

Consequently, litigation alleging wrongful employment practices is growing at an astounding rate. This has resulted in the development of new insurance products such as employment practices policies which, unlike D&O policies, provide entity coverage and are distinct from the standard D&O policy.<sup>21</sup> Other insurers, for an additional premium, have been willing to

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<sup>15</sup> Scheuermann, *Insurance Coverage for Employment-Related Claims*, Tort and Insurance Law Journal, at 778 (Summer, 1993).

<sup>16</sup> 42 U.S.C. § 2000e, et seq.

<sup>17</sup> 29 U.S.C. § 621, et seq.

<sup>18</sup> 42 U.S.C. § 12101, et seq.

<sup>19</sup> 42 U.S.C. § 1981, et seq.

<sup>20</sup> Scheuermann, *Insurance Coverage for Employment-Related Claims*, supra, at 779.

<sup>21</sup> Hearn, *Employment Litigation: Will the Insurer Respond?*, Professional Officers' and Directors' Liability Law Committee, at 13, (Winter 1995).

supplement existing D&O forms to add employment practice coverage,<sup>22</sup> but whether such endorsements provide entity coverage for employment practice claims is questionable and some commentators have suggested they do not.<sup>23</sup> Still other insurers have modified the insured v. insured endorsement so that coverage for wrongful termination claims is not excluded.<sup>24</sup> Such modifications, however, only provide coverage to directors and officers, not the entity.

Generally, the employment practices endorsement to D&O policies extends coverage not only to directors and officers of the company but to any past or present regular salaried or hourly employees of the company, but only for an "Employment Practices Wrongful Act" as defined by the policy.<sup>25</sup> The coverage does not extend the definition of "Insured" to include the company. The definition of "Employment Practices Wrongful Act" includes wrongful termination, employment discrimination, sexual harassment and retaliatory treatment against an employee. The definition of Loss is expanded to include payment for salaries, wages or other employment-related benefits.<sup>26</sup>

An interesting issue has surfaced in connection with employment practices coverage, particularly the endorsements to the D&O policy and the modifications to the insured v.

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<sup>22</sup> Id.

<sup>23</sup> Id. at 14.

<sup>24</sup> The following insured v. insured endorsement was quoted in Mary v. The Lupin Foundation, 1993 La. App. LEXIS 3498 (4th Cir. April 2, 1993):

The Insurer shall not be liable to make any payment for Loss in connection with any claim made against the Directors or Officers . . . which are brought by any Insured or the Company; or which are brought by any security holder of the Company, whether directly or derivatively, unless such claim(s) is instigated and continued totally independent of, and totally without the solicitation of, any Insured or the

Company; **provided, however, this exclusion shall not apply to wrongful termination of employment claims brought by a former employe[e] who is or was a Director of the Company. \*3**

(emphasis added).

<sup>25</sup> See USF&G's Employment Practices Liability (Directors, Officers and Employees) Endorsement FID 521.2(FI 11-94) Paragraph (1) D.1. and 2.

<sup>26</sup> See id. which amends the definition of "Loss" to include any salary, wages or other employment-related benefits which the Company or the Insureds are liable to pay an employee.

insured exclusion. Although an additional premium is collected for employment practices coverage for directors and officers, a majority of the Circuits of the United States Court of Appeals, have held that directors and officers of corporations cannot be held individually liable under Title VII, the ADEA, the ADA or state statutes with definitions of "employer" similar to those federal statutes.<sup>27</sup> Consequently, if only the corporate entity can be held liable, the coverage provided by the employment practices endorsement to the D&O policy and the modification to the insured v. insured exclusion is considerably limited to the extent that no entity coverage is provided.

A related issue is whether the cost of defending a claim in which individual liability is denied will be covered. Resolution of this issue turns on the wording of the D&O policy. If the policy contains a duty to defend, the insurer will be obligated to finance the defense, subject to its right, if reserved in the policy, to repayment in the event it is established that the insurer has no liability. If, on the other hand, the policy contains no duty to defend, the insurer should not be obligated to provide defense costs. In Olympic Club v. Those Interested Underwriters at Lloyd's London, 991 F.2d 497 (9th Cir. 1993), the D&O insurer was held not liable for defense costs incurred by a private club in defending a claim brought by the City of San Francisco against the Club and Doe defendants for race and gender discrimination. In so holding, the court affirmed the lower court ruling which interpreted the D&O policy, which contained no duty to defend, as conditioning the insurer's obligation to pay defense costs on the existence of claims against the directors for their wrongful acts. The court concluded that the allegations asserted by the City arose from the Club's own policies, not the "wrongful acts" of its directors and employees. Consequently, no coverage for defense costs existed.

### III. RECENT DIRECTOR AND OFFICER INSURANCE CASES

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<sup>27</sup> EEOC v. AIC Sec. Investigations, Ltd., 1995 U.S. App. LEXIS 12139, slip op. at p. 8 (7th Cir. May 22, 1995) (ADA); Lenhardt v. Basic Inst. of Tech., No. 94-3149, 1995 U.S. App. LEXIS 10885 (8th Cir. May 16, 1995) (Missouri statute based on the ADA); Smith v. Lomax, 45 F.3d 402, 403-4 & N. 4 (11th Cir. 1995) (Title VII and ADEA); Birkbeck v. Marvel Lighting Corp., 30 F.3d 507, 510 (4th Cir. 1994) (ADEA), cert. denied, 115 S. Ct. 666, 130 L. Ed. 2d 600 (1994); Grant v. Lone Star Co., 21 F. 3d 649, 651-53 (5th Cir. 1994), (Title VII), cert. denied, 115 S. Ct. 574, 130 L. Ed. 2d 491 (1994); and Miller v. Maxwell's Int'l Corp., 991 F.2d 583, 587-88 (Title VII and ADEA) (9th Cir. 1993), cert. denied, Miller v. La Rosa, 114 S. Ct. 1049, 127 L. Ed. 2d 372 (1994); Sauers v. Salt Lake County, 1 F.3d 1122, 1125 (10th Cir. 1993); and Busby v. City of Orlando, 931 F.2d 764 (Title VII) (11th Cir. 1991)). But see Chicago v. Matchmaker Real Estate Sales Ctr., 982 F.2d 1086 (7th Cir. 1992); Paroline v. Unisys Corp., 879 F. 2d 100, 104 (4th Cir. 1989), vacated in part on other grounds, 900 F.2d 27 (4th Cir. 1990) and 1989 U.S. App. LEXIS 13074 (4th Cir. Aug. 18, 1989) and Jones v. Continental Corp., 789 F.2d 1225, 1231 (6th Cir. 1986), where the courts recognized that an individual may be individually liable under Title VII or other anti-discrimination statutes.

A completed application form for D&O insurance is attached to and considered a part of a D&O policy.<sup>28</sup> Representations made in the application (or proposal) for the policy are relied upon by underwriters, especially with regard to the insured's knowledge of existing claims. Quite often, after issuance of the policy, questions arise as to representations made in the application. Misrepresentations in applications must generally be material to be actionable.

In First National Bank Holding Co. v. Fidelity & Deposit Co., 885 F. Supp. 1533 (N.D. Fla. 1995), the court interpreting Florida law, held that even an unintentional misstatement will prevent recovery if it materially affects the risks or if the insurer would have altered the policy's terms if the insurer had known the true facts. In this case, the bank President, who was also Chairman of Board as well as the controlling stockholder, President and Controlling Executive Officer of the holding company signed the application. In the application, the bank President answered that he had no knowledge or information of any act, error or omission which might give rise to a claim. He made fictitious loans to cover up violations of loan to one borrower limit, pled guilty to bank fraud, and other charges. The insurer submitted evidence that the correct answer would have, at a minimum, caused a different premium to be charged and that it may not have even issued a policy. The court held that because of the misrepresentations, the policy was void *ab initio*.

Numerous issues arise in the course of a policy's renewal, especially when changes are made in the policy terms and coverage. Insureds have successfully argued that a renewal of a policy with different terms is a constructive non-renewal or cancellation of the policy. If an insurer does not provide notice of the changes in the policy, an insured may claim that it was denied the opportunity to exercise the option of paying an additional premium and extending the policy's discovery period.<sup>29</sup>

In Resolution Trust Corp. v. American Casualty Co., 874 F. Supp. 961 (E.D. Mo. 1995), following McCuen v. American Casualty Co., 946 F.2d 1401 (8th Cir. 1991), reh'g en banc denied, 1991 U.S. App. LEXIS 27987 (8th Cir. Nov. 26, 1991), which applied Iowa law, the court found that offering a policy with a significant change in the amount of coverage<sup>30</sup>

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<sup>28</sup> St. Paul Mercury Insurance Company Application for Directors and Officers Liability and Corporate Indemnification 50263, Ed. 1-90, a conventional application for D&O insurance, states, in pertinent part, that "[a]lthough the signing of this Application does not bind the undersigned on behalf of the Corporation, to effect this Insurance, the undersigned on behalf of the Corporation, agrees that this form and the said statements shall be the basis of any insurance contract or agreement which may be made. . . . IF AN ORDER IS RECEIVED, THE APPLICATION WILL BE ATTACHED TO AND FORM A PART OF THE POLICY."

<sup>29</sup> Sedgwick, Detert, Moran & Arnold, *Directors and Officers Liability Insurance Desk Book*, at 37 (Fall 1995).

<sup>30</sup> The policy declaration changed the aggregate limit of liability from \$10 million each policy year for each director and officer to \$10 million as an aggregate

constituted a constructive non-renewal, requiring notice and triggering the right of the insured to extend coverage.

Actual notice is the key in any renewal when more restrictive provisions are included. A reduction in coverage by the addition of the regulatory exclusion at renewal was held to be valid when the insured, through its president, received actual notice of the changes before acceptance of the renewal quote. American Casualty Co. v. FDIC, 39 F.3d 633 (6th Cir. 1994), reh'g denied 1994 U.S. App. LEXIS 37223 (6th Cir. Dec. 21, 1994). Applying Michigan law, the Sixth Circuit rejected the claim that the failure of the insurer to offer a policy on the same terms as was in effect constituted a refusal to renew, triggering the discovery clause.

Likewise, in American Casualty Co. v. Baker, 22 F.3d 880 (9th Cir. 1994), the Ninth Circuit, applying California law, found that the acceptance of a successor policy with full notice of its terms precludes a claim of non-renewal. Thus, the discovery period option of the previous policy could not be triggered.

An attempt by the insurer to reform a policy was recently discussed in Giant Eagle, Inc. v. Federal Insurance Co., 884 F. Supp. 979 (W.D. Pa. 1995). In that case, Federal issued a D&O policy to the directors and officers of Giant Eagle. Six members of the Board of Giant Eagle constituted a majority of the Board of Phar-Mor, a subsidiary of Giant Eagle. Federal issued a separate D&O policy to Phar-Mor. Each policy had a \$20 million limit of liability.

Giant Eagle and a number of its directors and officers became embroiled in litigation emanating from a fraud that occurred at Phar-Mor. Although timely notice was given on the D&O policy issued to Giant Eagle, Federal denied the claim contending that the policy excluded coverage of claims for conduct which related to Phar-Mor. Federal claimed that the parties, by oral agreement and by endorsement, intended that the limits of liability under both policies would not be stacked on top of each other for common claims or common wrongful acts relating to Phar-Mor. Federal claimed its maximum exposure under both policies was limited to \$20 million collectively. Alleging mutual mistake of the parties, Federal attempted to reform the policy. The court held that reformation of a document based on mutual mistake required a showing, by clear and convincing evidence, that the parties had a precedent common intent not reflected by the instrument and that the actual intent of the parties. The court discussed the reasonable expectations of the insureds considering the payment of increased premiums and the fact that Federal provided inadequate notice of its intention to cap the limit for common claims even though Giant Eagle twice requested clarification of the endorsement in question. Federal's attempt at reformation was rejected.

Virtually all D&O policies are claims made policies, as opposed to occurrence policies. Many D&O policies are claims-made and reported policies. This literally means that, not only must the claims arise during the policy period, they must be reported to the insurer during the policy

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limit for each policy year for all directors and officers.

period. Notice to the insurer is required in all D&O policies.<sup>31</sup> Precisely what constitutes notice of a claim has been the subject of numerous court decisions. In American Casualty Co. v. Sentry Federal Savings Bank, 867 F. Supp. 50 (D. Mass. 1994), the court rejected the insurer's argument that the notice was insufficient, indicating that the notice provided was within the policy period and was specific in providing potential defendants, plaintiffs and the circumstances under which the claims might arise.<sup>32</sup> The court also held that the term "Claim," when read in the context of the entire policy, included a claim arising after termination of the policy as to which notice of the occurrence giving rise to such claim was given during the discovery period.

Interpreting Kansas law, the Tenth Circuit held that, in a claims made policy, it is notice which triggers coverage and to hold otherwise would constitute an unbargained for expansion of coverage, gratis. LaForge v. American Casualty Co., 37 F.3d 580 (10th Cir. 1994). The insureds must regard the information they possess as a potential claim and formally notify their insurer that a claim may be asserted. In that case, the renewal application listed certain loans as substandard, but gave no notice of any occurrence or wrongful acts. The court held that mere changes in coverage at renewal would not indicate knowledge by the insurer of claims.

Whether a Supervisory Agreement between a bank and the Federal Home Loan Bank Board (FHLBB) constituted notice of an occurrence which might give rise to a claim was at issue in American Casualty Co. v. Rahn, 854 F. Supp. 492 (W.D. Mich. 1994). The court held that the Supervisory Agreement, which noted that the bank had violated laws and regulations and engaged in unsound business practices, did not sufficiently identify any specific acts which had claim potential nor was there evidence that the insured or insurer had any information regarding the specific wrongful acts by the directors which were the subject of the RTC's suit. Accordingly, there was no claim or sufficient notice of an occurrence which might subsequently give rise to a claim received within the policy period. The court also found that,

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<sup>31</sup> A typical Notice of Claim provision reads as follows:

The Directors and Officers shall, as a condition precedent to their rights under this Policy, give the Insurer notice, in writing, as soon as practicable of any Claim first made against the Directors and Officers during the Policy Period or Discovery Period, but in no event later than ninety (90) days after such claim is made, and shall give the Insurer such information and cooperation as it may reasonably require. *Wyatt D&O MAPS*, Vol. 1, Claims Provision, p. 2.

<sup>32</sup> The Court distinguished the facts of American Cas. Co. v. Wilkinson, 1990 WL 302175 (W.D. Okla. 1990), *aff'd* American Cas. Co. V. FDIC, 958 F.2d 324 (10th Cir. 1992) wherein a bank's submission of a "laundry list" of 50 potential claimants without any discussion of the circumstances or types of claims was deemed an inadequate notice.

in addition to the notice being insufficient substantively, no notice had been provided to the insurer as required by the policy.

However, in Resolution Trust Corp. v. American Casualty Co., 874 F. Supp. 961 (E.D. Mo. 1995), a letter written during the policy period did constitute sufficient notice of a claim. In that case, the letter advised of statements made by the FHLBB Supervisory Agent regarding real estate projects of the institution's service corporations that, because of missing documentation, if losses resulted he would try to place responsibility on the board of directors. The court found the policy's notice provision to be ambiguous and rejected the insurer's argument that the notice did not provide enough specific information.

The regulatory exclusion continues to be the topic of numerous court decisions. In Slaughter v. American Casualty Co., 37 F.3d 385 (8th Cir. 1994), the Eighth Circuit, applying Arkansas law, overturned the district court's ruling and held the regulatory exclusion enforceable. The district court had held that the regulatory exclusion added to the policy on renewal was void for that and succeeding policy years for want of consideration. Because the policy was a renewal policy issued on the basis of a new quotation and there was no provision for automatic renewal, additional consideration was not required.

American Casualty Company of Reading, Pa. sought a declaratory judgment that it had no coverage for the defendants in American Casualty Co. v. Sentry Federal Savings Bank, 867 F. Supp. 50 (D. Mass. 1994). In considering motions for summary judgment, the court first considered whether issue preclusion applied as to the regulatory exclusion and concluded that it did not. The court, however, found that the regulatory exclusion did not violate public policy and was not ambiguous and that the RTC was the type of agency to which the exclusion applied.

Further, in American Casualty Co. v. FDIC, 39 F.3d 633 (6th Cir. 1994), the court found that a shareholder's derivative action against bank officers and directors was brought on behalf of a federal regulatory agency and thus fell within the regulatory exclusion of the bank's D&O policy. The FDIC had not originally brought the action, but intervened at a later date. In that case, the court also found that the regulatory exclusion did not violate public policy.

Other cases which have recently upheld the validity of the regulatory exclusion include American Casualty Co. v. Baker, 22 F.3d 880 (9th Cir. 1994), American Casualty Co. v. Rahn, 854 F. Supp. 492 (W.D. Mich. 1994), American Casualty Co. v. Beranek, 862 F. Supp. 322 (D. Kan. 1994).

Another typical exclusion in D&O policies is the insured v. insured exclusion. That exclusion was discussed in American Casualty Co. v. Sentry Federal Savings Bank, 867 F. Supp. 50 (D. Mass. 1994). Accepting the argument that the purpose of the exclusion was to prevent collusive lawsuits, the court found that coverage of the insureds for the claims asserted by the RTC would not be precluded.

In Voluntary Hospitals of America, Inc. v. National Union Fire Ins. Co., 859 F. Supp. 260 (N.D. Tex. 1993), aff'd without opp., 1994 U.S. App. LEXIS 14246 (5th Cir. 1994), the court found

the insured v. insured exclusion to be unambiguous. In that case, the exclusion operated to bar claims for reimbursement of damages and costs incurred in a shareholder's derivative action<sup>33</sup> brought by shareholders who were actively assisted by a former officer and director of the company. "To read the language otherwise would be to adopt the textual methodology of the protodeconstructionist Humpty Dumpty, for whom words meant what he wanted them to."<sup>34</sup>

Virtually all D&O policies exclude coverage for dishonest acts. Not only did the court declare the D&O policy void in First National Bank Holding Co. v. Fidelity & Deposit Co., 885 F. Supp 1533 (N.D. Fla. 1995), it held that the policy's dishonesty exclusion was a secondary grounds for granting Fidelity & Deposit's summary judgment dismissing the complaint.

A recent "family" exclusion barring any claims made against any Insured Person(s) by any members of their family was ruled unambiguous and upheld in Isroff v. Federal Insurance Co., 1994 U. S. App. LEXIS 14416, 1994 WL 253021 (6th Cir. June 8, 1994).

A "Prior Acts" endorsement containing a provision that the "policy provides coverage for loss . . . arising from claims by reason of Wrongful Acts . . . occurring only after June 1, 1987" was upheld to exclude claims arising from wrongful acts which occurred before that date. RHI Holdings, Inc. v. National Union Fire Ins. Co., Fed. Sec. L. Rep. (CCH ¶ 98.315) (E.D. Pa. 1994). The court refused to hold the exclusion void as against public policy, noting that it was negotiated between two sophisticated corporations which were competent and understood the agreement and all its implications. Also, the claims arose out of wrongful acts that occurred before the policy was purchased.

The question of settlement and allocation was at issue in Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424 (9th Cir. 1995). Shareholders of Nordstrom filed a securities fraud class action suit, against both Nordstrom and its officers and directors. The parties agreed to a settlement with the corporation and individual directors and officers jointly and severally liable. Federal consented to the settlement, but reserved its right to litigate the allocation issue. The relevant part of Federal's D&O policy provided that the insurer agrees to pay for all loss for which the Insured Person has become legally obligated to pay on account of any claim first made against him, individually or otherwise for a Wrongful Act committed by such insured persons. The policy did not specifically provide for allocation of a settlement sum when a suit involves both covered and noncovered claims although the policy provided that if payments were made, the insurer became subrogated to the extent of that payment.

Nordstrom sought payment for the settlement sum and defense costs against Federal. Federal argued that it should not have to pay for the full amount of the settlement because the policy provided no coverage for the liability of the corporation. Federal maintained that the settlement sum should be allocated to the relative exposure of the responsible parties

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<sup>33</sup> Some D&O policies except shareholders derivative suits from the insured vs. insured exclusion.

<sup>34</sup> 859 F. Supp. at 263.

("independent theory rule").<sup>35</sup>

Recognizing that allocation was an issue of first impression in Washington, the court declined to adopt, as generally applicable, either the "independent rule" advanced by Federal or the "larger settlement rule"<sup>36</sup> urged by Nordstrom. The court concluded that, under Federal's policy, the larger settlement rule best effectuated the reasonable expectations of the parties. Accordingly, the court would allocate only if there was corporate liability both independent of and not duplicated by the directors' and officers' liability. Finding that the corporate liability was concurrent with the directors' and officers' liability, the court rejected Federal's claim for allocation.

Caterpillar sued its D&O insurer for reimbursement of sums paid in settlement of a securities fraud suit against the corporation and covered officers and directors. Caterpillar, Inc. v. Great American Insurance Co., 864 F. Supp. 849 (C.D. Ill. 1994), modified, aff'd, 62 F.3d 955 (7th Cir. 1995). The matter was under consideration based upon a motion for summary judgment filed by Caterpillar. The court found that the insurer bound itself to pay for claims made against the insured directors and officers and held that to the extent the settlement amount would have been lower but for the activities of other officers and directors besides those against whom the claims were made that Caterpillar would not be entitled to reimbursement. The court rejected the insurer's contention that the notice provisions of its policy were violated. The matter was certified for immediate appeal.

On appeal, the Seventh Circuit affirmed, but with modifications. Caterpillar, Inc. v. Great American Insurance Co., 62 F. 3d 955 (7th Cir. 1995), reh'g en banc denied, 1995 U.S. App. LEXIS 26140 (7th Cir. Sept. 15, 1995). The court referred to Harbor Insurance Co. v. Continental Bank Corp., 922 F.2d 357 (7th Cir. 1990), reh'g denied, 1991 U.S. App. LEXIS 1223 (7th Cir. Jan 29, 1991), as the first in the circuit to address the allocation issue. In that case, the policy contained no allocation clause and the court adopted the "larger settlement rule." The court concluded that the policy did not limit coverage because of the activities of others that might overlap the claims against the officers and directors. It stated that the differentiation between direct and derivative liability may well be a distinction without a difference; however, not in that case. The court decided that to the extent that the trier of fact determined that Caterpillar disposed of any direct action against it in settling the complaint

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<sup>35</sup> Under this theory, even if the Court determined that the directors and officers would be found liable on all claims, the settlement sum should be allocated between the corporation and the directors and officers where there is some independent basis, not derivative of the officers' and directors' liability, for holding the corporate entity liable. Smith v. Mulvaney, 827 F.2d 558, 561 (9th Cir. 1987).

<sup>36</sup> Responsibility for any portion of the settlement should be allocated away from the insured party only if the acts of the uninsured party are determined to have increased the settlement. Harbor Ins. Co. v Continental Bank Corp., 992 F.2d 357, 368 (7th Cir. 1990).

and that the disposition increased the settlement figure, Caterpillar should not be entitled to recover from its D&O insurer. In an appeal from a summary judgment, the Ninth Circuit affirmed in part and reversed in part. Safeway Stores, Inc. v. National Union Fire Insurance Co., 64 F.3d 1282 (9th Cir. 1995). An early dividend claimed to constitute a loss covered by the policy at issue was found by the district court for the Northern District of California not to be a covered loss, and the Ninth Circuit affirmed. As to settlement costs constituting a loss, the Ninth Circuit again affirmed the district court. The district court had allocated one quarter of the settlement costs to Safeway. The Ninth Circuit reversed, finding that Nordstrom was controlling. It also awarded prejudgment interest.

Many D&O policies include for the insurer an option to advance defense costs but with a provision that should the underlying claim not be covered, the insurer is entitled to reimbursement of those costs. The issue of defense costs hinges on a determination of whether the underlying claim is covered. In American Casualty Co. v. Rahn, 854 F. Supp. 492 (W.D. Mich. 1994), reh'g denied, 1995 U.S. App. LEXIS 39528 (5th Cir. Dec. 18, 1995), the court held that the insurer had no duty to defend even though the policy required costs of defense to be advanced as they became due. The court reasoned that the insurer would not have covered the claims asserted by the RTC.

#### IV. CONCLUSION

The current trend in D&O insurance is to expand the coverage either by eliminating standard exclusions or by offering options in the policy to cover claims or damages previously not covered in a standard D&O policy. Many insurers have dropped from D&O coverage the regulatory exclusion, defined "Loss" to include punitive and exemplary damages if public policy permits insurance for those element of damages, expanded the coverage to include acts of employees if there is an allegation that the employees are solidarily liable with the directors and officers, or expanded coverage to include claims against the spouse of a director or officer to the extent such claim is also made against the director and officer.<sup>37</sup> Given the ever changing products offered by insurers in the area of D&O insurance, litigation is virtually guaranteed.

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<sup>37</sup> See Fidelity and Deposit Company of Maryland, Colonial American Casualty and Surety Company Directors and Officers Liability Insurance Policy S-9126 (ed. 12/95).