

Developing Issues in Insurance Coverage for Corporate Directors and Officers

By [Mike Gorby, Esq.](#)

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Mike Gorby has been practicing law for more than 30 years. He has tried more than 100 cases in a dozen different states around the country. Mr. Gorby literally wrote the book on premises liability in Georgia, [Premises Liability in Georgia](#), Harrison Company, 1998. Since 1994, he has chaired the annual Premises Liability Seminar put on by the Institute of Continuing Legal Education in Georgia. Mr. Gorby lectures frequently on legal topics, and is a sought-after mediator and arbitrator. Mike Gorby represents both plaintiffs and defendants (including long-time clients Marriott and Hilton).

mgorby@gorbyreeves.com

404-239-1150

Corporate director and officer (“D & O”) insurance coverage affords liability insurance coverage to officers and directors of a corporation against lawsuits which are internally generated by stockholders of the corporation, and externally generated by members of the public who contend they have sustained a loss as a result of the actions of the corporation’s officers and directors. D & O coverage does not insure officers and directors with respect to any activity other than activity which is done on behalf of the corporation.

For the past several years, there has been an evolving body of law which specifically deals with the scope of coverage provided by (D & O) liability insurance policies. Most of the litigation surrounding these policies involves how standard exclusions are applied in the context of claims against corporate directors and officers and the effect that material misrepresentations or material omissions will have on the enforcement of the policy.

I. Interpreting What is Covered Under D & O Policies

Insurance policies are not easy to read. Even the ‘plain language policies’ are not easy to understand. A typical policy may be analyzed by looking first at the endorsement of coverage, then the exclusions which limit coverage as well as the conditions to determine if the insurer will cover a particular claim. In cases where corporate directors and officers have been sued, the insurance company contends that the

event that caused the damage was not insured, or that the actions or statements of the insured voided the policy.

Georgia has adopted the "reasonable expectations theory" of interpreting insurance policies. That is, policies are to be interpreted as would a layperson and not as a lawyer, judge or insurance expert would do so. Words are to be given their normal everyday meaning and if a word is not defined in the insurance policy, it would be appropriate to resort to a dictionary for guidance.

An important consideration to keep in mind is that any clause of an insurance policy is capable of two different interpretations; the one most favorable to the insured is the one that is to be used. Another important consideration is that the endorsement of coverage will take precedence over the standard language of the policy generally speaking. Courts generally attempt to harmonize the language of the endorsement with the policy itself but only if doing so can be done without straining the interpretation.

Most D & O liability policies exclude coverage for losses arising out of proceedings brought by regulatory agencies. This exclusion typically provides:

It is understood and agreed that the insurer shall not be liable to make any payment for loss in connection with any claim made against the directors or officers based upon or attributable to: any action or proceeding brought by or on behalf of any national or state regulatory agency, including any type of legal action where such agency has the legal right to bring as receiver, conservator, liquidator or otherwise, whether such action or proceeding is brought in the name of such agency or by or on behalf of such agency in the name of any other entity or solely in the name of any third party.

This is a very important exclusion in terms of D & O coverage because not only may regulatory agencies bring actions against directors and officers and corporations growing out of criminal infractions, but often times regulatory agencies can actually sue corporations, directors and officers for monetary damages and civil fines. See e.g. *Treasure Valley Transit v. Philadelphia Indemnity Insurance Company*, (Idaho, March 25, 2004) (administrative investigation of possible Medicaid billing fraud is not within the definition of "claim" under a directors and officers liability insurance policy) It should be noted that several courts across the country have refused to uphold the regulatory exclusion as against public policy.

Another exclusion typically found in D & O liability policies are exclusions for violations of securities' laws. This exclusion normally bars coverage for a claim:

where all or part of such claim is, directly or indirectly, based on, attributable to, arising out of, resulting from, or in any manner related to any actual or alleged violation of the Securities Act of 1934, Investment Company Act of 1940, the Public Utility Act of 1935, and any state's, blue sky or securities law, all as may be amended, or any law relating to securities, transactions, or any other amendments. Obviously, this exclusion is extremely broad and could conceivably apply to any claim which even remotely involves a security transaction.

Another common exclusion in D & O liability policies is the dishonesty exclusion. This exclusion in a typical D & O policy provides:

The company shall not be liable to make any payment for loss in connection with any claims made against any of the insured persons brought about or contributed to by the dishonesty of such insured person if a judgment or other final adjudication adverse to such insured person establishes that acts of active and deliberate dishonesty were committed or attempted by such insured person with actual dishonest purpose and intent and were material to the cause of action so adjudicated.

It should be noted that courts have construed this exclusion to be effective only after a final judgment or other final adjudication implicates the directors. See Pepsi Co., Inc. v. Continental Casualty Company, 640 Fed. Supp. 656 (S.D.N.Y. 1986). The "final adjudication" requirement is satisfied where the implicated officer or director enters a guilty plea to criminal conspiracy and fraud charges. See First National Bank Holding Company v. Fidelity and Deposit Company of Maryland, 885 Fed. Supp. 1533 (N.D. Fla. 1995).

Another exclusion found in D & O policies is the "insured versus insured" exclusion. This exclusion excludes coverage for claims against insured directors and officers brought by an insured person or organization. Typical language for this exclusion states: It is understood and agreed that the insurer shall not be liable to make any payment for loss . . . which is based upon or attributable to any claim made against any director or officer by any other director or officer or by the institution . . . except for a shareholder derivative action brought by a shareholder of the institution other than an insured." Although courts have generally upheld this exclusion, one major

exception is in the context of a bank failure case. A majority of courts have found that the exclusion does not bar coverage for actions brought by bank regulators.

II. Misrepresentations During Application Process May Void Coverage

For the insurer, detailed information on the corporation is required before issuing a D & O policy including financial information for use by the company in evaluating the risk of providing coverage. The insurance company is obviously interested in knowing of any potential class action lawsuits or other issues which might give rise to litigation at some point in the future.

Universally, the courts have held that the company has the right to rescind D & O coverage based upon material misrepresentations and omissions in the application process. In National Union Fire Insurance Company v. Sahlen, 999 Fed. 2d 1532 (11th Cir. 1993), the 11th Circuit ruled that the attachment of inaccurate financial statements by the insured to an application for a D & O liability policy constituted a material misrepresentation which rendered the policy issued on the basis of that application void.

Some of the issues which may surface in a situation where there has been a material misrepresentation or omission by the "corporation" are how this material misrepresentation might affect an "innocent" officer or director who had nothing to do with the application process. There have been no Georgia cases dealing with this particular issue, however, this issue has been litigated in other jurisdictions. In Byrd v. Penn Central Company, 334 Fed. Supp. 255 (E.D. Penn. 1971), an insurer brought suit seeking rescission of a D & O policy on the grounds that the insured who signed the application had falsely stated therein that he knew of no fact which would indicate the possibility of a future claim. Several "innocent" outside directors filed motions for summary judgment on the grounds that they were not involved in the application process and had no knowledge of any representation or omission made by the corporation. The court denied the motions for summary judgment holding that the corporate official who made the false statement appeared to be acting as an "agent" for the other directors and officers when he signed the false application.

In Automotive Wholesalers of Illinois v. National Union Fire Insurance Company, 501 Fed. Supp., 1205 (N.D. Ill. 1980), the court granted summary judgment dismissing the claim of an insured that the

insured's denial of coverage under a D & O liability policy was "vexatious and unreasonable". The insurer's refusal to pay was based on the contention that the corporate staff attorney who signed the insurance application had falsely denied having knowledge or information of any fact, error or omission which might give rise to a claim under the proposed policy. Perhaps the most authoritative case which has discussed this matter is Shapiro v. American Home Assurance Company, 584 Fed. Supp. 1245 (Mass. 1984). In that case, the trial judge held that a material misrepresentation made by one corporate official in an application for D & O liability coverage can operate to relieve the insurer of liability under the policy as to all directors and officers, including those who had neither made misrepresentations nor had knowledge of the misrepresentations made by the person who signed the application.

III. Conclusion

The growing popularity of insurance policies for corporate directors and officers has met matched by increased litigation over the coverage and conditions of these policies. While such policies may afford important protections for a corporate director or officer against personal liability, these policies must be read carefully to determine what is and what is not covered by the such a policy and what events may void coverage altogether.

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