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Why Purchasing D&O Insurance Is No Longer Enough

By Donald W. Kiel and Faisal M. Zubairi

The media is rife with references to high-profile corporate scandals. Although the fate of those responsible for corporate misconduct is well publicized, the innocent corporate officials impacted by such scandals are rarely mentioned. In an effort to protect directors and officers, corporations allocate significant capital to buying directors' and officers' ("D&O") liability insurance. However, in today's environment of increasing numbers of corporate scandals, even innocent directors and officers sometimes find themselves stripped of the very protection such policies are meant to afford by insurance companies seeking to avoid large exposures. Allegations of corporate fraud have lead insurance companies to invoke exclusionary provisions and increasingly to seek the remedy of rescission. Although procuring D&O insurance coverage reflects a corporation's realization of and appreciation for the risk faced by directors and officers, corporations must ensure that the policies they purchase actually provide the protection sought. This article examines recent trends in court decisions regarding D&O insurance in cases of corporate fraud and suggests methods by

continued on page 5

Ill Wind: Selected Insurance Issues After Hurricane Katrina

By Seth A. Tucker and Ann-Kelley Kemper

By virtually any measure, Hurricane Katrina ranks as one of the worst natural disasters in American history. It will surely be months if not years before the full toll of the storm and its aftermath, including long-term effects on the Gulf Coast, are known. It is equally sure that Hurricane Katrina will spawn an array of disputes concerning insurance coverage for losses or damage caused by the storm. Indeed, barely 2 weeks after the hurricane hit land, at least two major insurance coverage lawsuits, one in Mississippi and one in Louisiana, had already been filed.

The range of disputes promises to be wide, given that the hurricane directly affected policyholders in multiple jurisdictions and has affected or will affect policyholders in other jurisdictions indirectly; given that policy language may vary from one insured to the next; and given that damage or loss stemmed from a variety of hazards. In light of the range of potential legal issues — and the consequences of a misstep — policyholders with significant claims should consider retaining coverage counsel with whom they may at least consult as they evaluate, classify, present, and pursue their claims.

A comprehensive review of all the issues that may arise is beyond the scope of this article. This article will instead address two of the issues that have emerged or are reasonably likely to emerge as residents, local businesses, and others affected by the hurricane look to their insurers for help in rebuilding their lives and their livelihoods. These are: 1) what happens when an insured suffers losses due to both a covered cause and an excluded cause; and 2) what coverage may be available to insureds located outside of the area hit by Hurricane Katrina but whose businesses have nonetheless been disrupted because of property damage to suppliers, customers, or others important to their business.

Causation Confusion: The Problem of Mixed Causes of Loss

The extensive property losses caused by Hurricane Katrina arose from a multitude of perils, including, at a minimum, high-velocity winds, storm surges, flooding,

continued on page 2

In This Issue

Hurricane

continued from page 1

levee breaches, wind-driven rains, fire, sewage overflow, toxic contamination, and looting. The storm also caused substantial interruptions in business throughout the affected area and beyond, some of which were caused by direct physical damage to the business's own buildings or equipment, and some of which were caused by other factors, such as impaired access (commonly referred to as "ingress" and "egress" in insurance policies), evacuation orders, power outages, curfews, and interruptions in the chain of supply which were themselves caused by one or more of the above factors.

Given this confluence of events, as well as the fact that any particular insurance policy may expressly or implicitly provide coverage for loss due to one or more of these perils while purporting to exclude coverage for loss caused by another such peril, or may establish separate and quite different deductibles or sublimits depending on how a given loss is classified, millions if not billions of dollars in potential insurance coverage will surely turn on questions of causation. Indeed, homeowners and their insurers are already battling over whether damage to properties along the coastal regions was caused by hurricane-force winds (typically covered under homeowners' policies) or by the flooding accompanying the storm (typically excluded under homeowners' policies).

To be insured under a first-party policy, a claimed loss must be caused by a covered peril or, in the case of "all risk" policies, a peril that is not expressly excluded. The question of causation becomes complicated where multiple factors, some covered and some not, contributed to the damage. Such factors may have worked together to cause the loss, one may have followed directly from the other, or the two may have arisen independently, and the relation between the perils lends a further twist to the legal issues.

The courts have developed various tests for situations in which an excluded peril and a non-excluded peril contributed to the loss, with the most prominent being the "efficient proximate cause" doctrine and the "concurrent causation" doctrine. Generally speaking, the efficient proximate cause doctrine allows recovery so long as the non-excluded cause was the efficient and dominant cause of the loss, notwithstanding that an excluded peril may have contributed to the loss. Under this doctrine, "[t]he cause to which the loss is attributed is the efficient, dominant cause, the one that sets the others in motion, although other and incidental causes may be even nearer in time and place to the result and may operate more immediately in producing the loss." Sidney I. Simon, "Proximate Cause in Insurance," 10 AM. BUS. L.J. 33, 37 (Spring 1972). By contrast, under the concurrent causation doctrine, recovery is allowed so long as one of two or more contributing causes is insured, even if other contributing causes are not.

The precise application of either doctrine will depend on both the facts of the claim and the case law in the pertinent jurisdiction. As a general proposition, and notwithstanding some federal court decisions to the contrary, the efficient proximate cause doctrine has been adopted by the highest courts of Mississippi, Louisiana, and Alabama, the three states most affected by Hurricane Katrina. *See, e.g., Western Assurance Co. v. Hann*, 78 So. 232, 236 (Ala. 1917); *Glens Falls Ins. Co. of Glens Falls, N.Y. v. Linwood Elevator*, 130 So. 2d 262, 270 (Miss. 1961); *Evana Plantation, Inc. v. Yorkshire Ins. Co.*, 58 So. 2d 797, 798 (Miss. 1952); *Roach-Strayhan-Holland Post No. 20, American Legion Club, Inc. v. Continental Ins. Co. of N.Y.*, 112 So. 2d 680, 683 (La. 1959). Courts in

continued on page 3

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Hurricane

continued from page 2

these three states have interpreted the doctrine to allow policyholders to recover for hurricane-related losses where the evidence showed that wind was the efficient proximate cause of the damage, notwithstanding that flooding contributed to the loss.

In the aftermath of Hurricane Camille, for example, which struck in 1969, the Mississippi Supreme Court heard three cases involving a dispute between a policyholder and its insurer as to whether the claimed loss was caused by wind or flood. In each case, an exclusion provided that the policy did not insure against loss "caused by, resulting from, contributed to, or aggravated by ... flood, surface water, waves, tidal water, or tidal wave, overflow of streams or other bodies of water ... whether driven by wind or not." In each case, the court upheld a jury verdict for the insured finding that the efficient proximate cause of the damage at issue was the initial high-velocity winds, not, as the insurers argued, subsequent flooding. *See, e.g., Commercial Union Ins. Co. v. Byrne*, 248 So. 2d 777, 781 (Miss. 1971) (upholding verdict for insured under all-risks policy).

Louisiana and Alabama courts likewise have had occasion to address whether hurricane damage in a given case was caused by wind or by flooding. *See, e.g., Picone v. Manhattan Fire & Marine Ins. Co. of N.Y.*, 50 So. 2d 188 (La. 1950); *Urrate v. Argonaut Great Central Ins. Co.*, 881 So. 2d 787, 790-91 (La. Ct. App. 5th Cir. 2004), *writ denied*, 891 So. 2d 686, 690 (La. 2005); *Ebert v. Pacific Nat'l. Fire Ins. Co.*, 40 So. 2d 40, 45 (La. Ct. App. 1949); *Allstate Ins. Co. v. Fitzsimmons*, 429 So. 2d 1059, 1062 (Ala. Ct. App. 1983). Although in most instances the courts have upheld coverage on the ground that high wind directly damaged the property in question before any subsequent damage was inflicted by flood, the fact that the high court of each state has adopted the efficient proximate cause test should support coverage claims by insureds who argue that the flooding in their particular case was itself caused by the high winds of a hurricane or by another covered peril.

What is clear from these cases is that the mere fact that substantial flooding occurred as a result of Hurricane Katrina, or even that a given property sustained damage that was indisputably attributable to flood waters, does not necessarily mean that coverage may properly be denied under a flood exclusion. With the proper factual basis, an insured might be able to establish coverage on the ground that the flooding in question was the last link in a chain of events whose efficient proximate cause was a covered peril such as high winds, or that significant damage occurred to the insured's property from those winds (or some other covered peril) before or independently of damage caused by flooding. In light of the variety of perils that have caused loss or damage in the wake of Hurricane Katrina, these same issues of how to deal with mixed causation presumably will arise with an array of other covered and excluded perils as well. Because of the complexities that can arise in mixed causation cases, any policyholder that arguably sustained damage from a covered peril and an excluded peril would be well advised to study the case law in the applicable jurisdiction and make a full factual inquiry, with expert assistance if necessary, in order to present its coverage claim to its insurer (or a trial court) in the most favorable light.

A final point on the issue of mixed causation. Perhaps the most contested issues in the mixed-causation arena will be the interpretation and the enforceability of so-called anti-concurrent-causation clauses now included in many policies. One common clause provides that a loss resulting from an excluded cause is not covered "regardless of any other cause or event contributing concurrently or in any sequence to the loss." Already, the Attorney General of Mississippi has filed a suit asking that such provisions be held to be unenforceable to restrict coverage on a variety of grounds, including that they are ambiguous and confusing, that they confound a policyholder's reasonable expectations, and that they are contrary to the public policy of Mississippi as expressed in prior judicial decisions. It is reasonably likely that similar litigation will be filed in other jurisdictions, at least if, as expected, insurers rely on this prefatory language in conjunction with exclusions in order to deny or substantially restrict claim payments.

The fate of the anti-concurrent-causation clauses, and their effect on Katrina-related losses, remain to be seen. The courts that have addressed this question are divided on the issue. Courts in some jurisdictions have enforced the clauses even where a covered peril is the efficient proximate cause of the loss, reasoning that insurers may choose to contract around any applicable causation rule. *See, e.g., Alf v. State Farm Fire & Cas. Co.*, 850 P.2d 1272, 1277 (Utah 1993). However, courts in other jurisdictions have held that insurers may not contract around the efficient proximate cause doctrine as a matter of public policy. S*ee, e.g., Safeco Ins. Co. of Am. v. Hirschmann*, 773 P.2d 413, 414, 416 (Wash. 1989) (en banc). Other courts have held that such clauses are ambiguous and to read them as precluding coverage for damage proximately caused by a covered peril is inconsistent with the reasonable expectations of the policyholder. S*ee, e.g., Murray v. State Farm Fire & Cas. Co.*, 509 S.E.2d 1, 14 (W. Va. 1998).

The highest courts of Mississippi and Louisiana have not yet had occasion to examine the effect of these clauses. Although the Alabama Supreme Court has upheld such a clause, *see State Farm Fire & Cas. Co. v. Slade*, 747 So. 2d 293 (Ala. 1999), it is unclear whether that case will prove to be the governing law for Alabama courts examining the very different facts of Hurricane Katrina, given that the causal relationship between hurricane winds and coastal flooding is much clearer than the causal relationship between a lightning strike and subsequent earth movement alleged to have existed in *Slade*. Moreover, even if such clauses are held to be enforceable with

continued on page 4

Hurricane

continued from page 3

respect to Katrina-related losses in Alabama or the other applicable states, a policyholder nevertheless may be able to obtain coverage in a particular instance by showing that the loss at issue would have occurred even in the absence of the contributing excluded cause. *See*, *e.g.*, *O'Neill v. State Farm Fire Ins. Co.*, No. Civ. A 94-3428, 1995 WL 214409, at *3 (E.D. Pa. Apr. 7, 1995).

Contingent Business Interruption: Coverage Based on Damage to Other People's Property

The destruction caused by Hurricane Katrina had an immediate and obvious impact on hundreds of thousands of residents of the Gulf Coast and countless businesses located there. Less obvious, perhaps, is the effect of that destruction on businesses located outside the area. Although they were spared a direct hit from the hurricane, many such businesses lost suppliers or customers, at least temporarily, as a result of the storm and its aftermath. Moreover, many have lost, at least for now, the ability to ship their products through the Port of New Orleans, one of the country's busiest before the hurricane. Businesses that find themselves affected by Hurricane Katrina notwithstanding a lack of damage to their own property should review their policies to determine whether they have a viable claim for coverage of their economic losses.

The coverage in question is often called "contingent business interruption," although that term is not used in most policies. In the standard-form policy promulgated in 2001 by the Insurance Services Office ("ISO") titled "Businessowners Coverage Form," for example, the pertinent coverage is called "Business Income From Dependent Properties." A quick review of some of its features reveals this to be a potentially very useful coverage for a properly situated policyholder.

An insurer using the ISO form promises to pay for lost "Business Income" (a defined term that roughly translates as continuing operating expenses plus net profit) due to "physical loss or damage" at the premises of a "dependent property" resulting from a "Covered Cause of Loss." The policy goes on to define "dependent property" as property owned by others on whom the insured depends to (a) deliver materials or services (excluding water, communication, or power supply services); (b) accept the insured's products or services; (c) manufacture the insured's products for delivery to customers of the insured under contract for sale; or (d) attract customers to the insured's business.

Depending on the circumstances of a given policyholder's claim, it is foreseeable that a variety of issues may arise.

Cause of Loss. Most if not all contingent business interruption policies require that the cause of the property damage or loss to the "dependent property" be a covered cause, that is, one that would have been covered under the policy if damage had instead taken place at the insured's own premises. A policyholder that has suffered an economic loss because an entity in its supply or distribution chain was physically damaged by Hurricane Katrina will therefore need to explore the physical mechanism by which the other entity's property was damaged — for example, wind, flood, or fire — and to review its own policies to see whether that mechanism is clearly covered or excluded.

As discussed above, there is already litigation, and there is sure to be more, concerning the interplay of standard grants of coverage for damage due to wind and standard exclusions for damage due to water. For many policyholders whose policies contain these fairly routine provisions, the Mississippi litigation and any similar litigation in other states directly affected by Hurricane Katrina will, at a minimum, be instructive. That said, an insured may find that its coverage turns on the legal rules of a jurisdiction far from the site of the storm's damage. Moreover, a policyholder such as a grain wholesaler in the upper Midwest that cannot move its product into the export market because of damage to the Port of New Orleans — roughly 60% of the raw grain exported from the United States last year passed through that port — may find that it (or its insurer) seeks the application of the policyholder's home state's law. So, even an on-point opinion from the Louisiana Supreme Court may not provide the dispositive answer to an out-of-state policyholder. Fully understanding the coverage will therefore require an analysis of the law in all potentially applicable jurisdictions as well as any choice-of-law rules that might govern.

Moreover, in contrast to many homeowners, many insured businesses carry flood coverage. If the insured's policy does not exclude flood or water as a covered cause of loss, the insured should be able to sidestep much of the fighting that is taking place concerning flood exclusions and mixed causation even if its supplier or customer has been shut down due to flood, and even if that supplier or customer did not itself have flood insurance.

Obligation to Mitigate. To put it mildly, contingent business interruption policies typically encourage the insured to resume operations promptly. For example, under the ISO form, if the policyholder does not resume its operations, or does not do so quickly enough, the insurer will pay based only on the length of time that "it would have taken" to resume operations "as quickly as possible." In addition, the insurer will reduce the amount payable to the insured to the extent that the insured can resume operations, in whole or in part, by using any other available sources of materials or outlets for its products.

It is not difficult to imagine that disputes may arise concerning how quickly an insured reasonably could have resumed its operations, and policyholders with substantial claims might experience second-guessing by insurers. Any insurer that wishes to rely on these provisions to reduce its payment to the insured should present options to the insured on a timely basis, rather than waiting until well

continued on page 5

Hurricane

continued from page 4

after the fact and then arguing with hindsight that the insured could have taken a different course of action. For its part, a policyholder facing a contingent business interruption claim should document its efforts to find alternate sources of materials or outlets for its products so that, in the event of a dispute with the insurer, it can prove that it acted responsibly and that any "roads not taken" were not, in fact, viable alternatives.

Time Period. Typically, contingent business interruption insurance can outlast the policy period. Put differently, the termination of the policy will not cut off the coverage. Nor is the coverage typically limited to a fixed amount of time set forth in the policy. However, there is a cutoff of the coverage, and one that is reasonably likely to lead to disputes between insurers and their insureds: The coverage period for this coverage frequently ends when the damaged property at the "dependent" location "*should be* repaired, rebuilt or replaced with reasonable speed and similar quality." (Emphasis added.) Because the repair of the dependent property is outside the control of the insured, the insured could easily find itself still suffering the economic effects of a damaged supplier or distributor and yet facing an argument from its insurer that the damage at the other business' site should have been repaired already.

Repairs following Hurricane Katrina, especially in New Orleans, can reasonably be expected to take longer than usual. Given the widespread damage as well as the massive relocation of the population of the city, one imagines that contractors, repairmen and women, plumbers, roofers, and an array of other necessary service providers will be in short supply for a long time. Many of these tradespeople, who may have lost their own businesses or homes in the hurricane, may simply decide not to return to New Orleans. Although it strikes the authors that a court would take these circumstances into account when evaluating a claim that a dependent property "should" have been repaired more quickly than it actually was, we have seen enough insurance disputes that we will not be surprised if insurers nonetheless test the waters with this defense if it turns out that they are paying large contingent business interruption claims over a long period of time. In that event, we also foresee litigation over whether it is bad faith to advance an argument that "reasonable speed" may be determined without regard to the facts on the ground or the unique circumstances of Hurricane Katrina and its aftermath.

There have been surprisingly few reported judicial decisions involving contingent business interruption coverage. However, based on the catastrophic effects of Hurricane Katrina, we expect to see a diverse assortment of policyholders availing themselves of such coverage, and we also expect to see a sharp increase in the number and nature of disputes concerning contingent business interruption insurance.

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D&O

continued from page 1

which corporations can attempt to maximize the protection provided by their D&O policies, particularly for innocent corporate officials.

D&O Policies

D&O Insurance Coverage

D&O insurance was originally issued to protect solely individual corporate directors and officers ("Side A" coverage). Policies were subsequently broadened to insure the corporation for its own liability for securities claims and its responsibility to indemnify directors and officers for their liability arising out of their corporate positions ("Side B" coverage). By the end of the 1990s the scope of D&O insurance was broad and the cost relatively low. However, in the wake of recent events, all of this has changed. Insurance companies increasingly seek to deny coverage under newly expansive exclusionary clauses, and, in certain instances, even attempt to rescind coverage altogether.

Applying for D&O Insurance Coverage

In addition to requesting information typical of institutional policies (*eg*, nature of business; any plans for merger or acquisition; details of stock ownership; and names of officers and directors), D&O insurance applications often request and purport to incorporate a public company's latest annual report, financial statements, proxy statements, prospectus, and SEC filings (including Form 10-K, Form 10-Q, Form 8-K, etc.). While some applications simply incorporate these documents by reference, other applications require the actual submission of such records. The policyholder (and usually an officer) must verify the truth of the information in the application.

Exclusionary Language

Two D&O policy exclusions often invoked by insurers in their attempts to avoid coverage of large securities claims are the "fraud" and the "insured v. insured" exclusions. The "fraud" exclusion has been employed, according to some D&O insurance companies, to exclude coverage for all policyholders because of the willful fraud of a single director or officer. According to D&O insurance companies, the "insured v. insured" exclusion seeks to thwart collusion among the policyholders (*ie*, the company and individual officers and directors) by purporting to exclude coverage for claims asserted collusively by one policyholder against another.

The Remedy of Rescission and Its Impact on the Innocent Director Or Officer

Rescission

While insurers invoke the remedy of rescission far less than exclusionary language to deny coverage, they are using the threat of this remedy with increased frequency. While rescission is a drastic and harsh remedy — particularly against innocent

continued on page 6

D&O

continued from page 5

directors and officers — several courts have embraced it as a justified remedy against certain policyholders in particular circumstances. The remedy of rescission voids the policy *ab initio*, and requires the insurer to refund all premiums. An increasing number of rescission claims has arisen in connection with companies' restatements of financial statements and other misrepresented financial information, two of the most notable of which have been Enron and Tyco. The insurers essentially argue that they relied on false financial statements that were attached to and/or incorporated into the application for D&O insurance.

Misrepresentation

The remedy of rescission is predicated upon a misrepresentation, which can loosely be defined as the misstatement or omission of a material fact that was requested by an insurance company. When presented with an alleged factual misstatement or omission, the insurance company may assert that it would not have issued the policy at the agreed upon premium but for the misrepresentation.

Alleged misrepresentations in the application for insurance, intentional or unintentional, typically arise in two contexts. First, the prospective policyholder may provide incorrect information in response to a question. Second, there may be errors — or even intentional misstatements — in the company's financial statements included in the documents attached to (and often incorporated by reference in) the application. Insurance companies are more than just cognizant of the fact that information relied upon in assessing insurance risks may be incorrect. They are becoming increasingly aggressive in using such inaccuracies as a basis for rescission. Polices often define the term "application," and some include "any" of the corporate applicant's publicly filed documents in the definition. Some insurance companies argue that they rely on documents that are not even submitted to them in determining whether to issue a D&O policy. Whether an insurance company can demonstrate actual reliance on such documents is quite often an insurmountable burden for a D&O insurance company. Nevertheless, according to some insurance companies, any mistake, even if innocent, in any one of the several aforementioned corporate documents could potentially serve as a basis for an attempt to rescind.

The elements of a misrepresentation claim vary by jurisdiction. Insurance companies typically argue that the essential elements include (1) a misstatement of (2) a material fact (3) relied upon by the insurance company in issuing the policy. Some courts have determined that in particular circumstances an insurance company that relies upon an innocent, but material, misstatement may have grounds to rescind the policy. Other courts, however, require that the misstatement have been intentional in order to be considered material enough to warrant rescission. *See, e.g.*, *Cutter & Buck, Inc. v. Genesis Insurance Company*, 306 F. Supp. 2d 988, 997 (W.D. Wash. 2004).

Some courts have employed more sophisticated analyses specifically tailored to misrepresentations in the context of insurance applications. For example, New Jersey courts draw a distinction between answers to subjective and objective questions contained in D&O insurance applications, while New York courts draw a distinction between items the policyholder is, and is not, required to disclose in the application. In other instances, legislatures have taken it upon themselves to define the elements of a misrepresentation that warrants rescission.

In New Jersey, some insurance companies argue that even an innocent misrepresentation to an objective question may, under certain circumstances, constitute equitable fraud, justifying rescission of an insurance contract. They further argue that equitable fraud, unlike legal fraud, does not require the showing of an intent to deceive or knowledge of the falsity. They contend that the only elements necessary to prove equitable fraud to rescind an insurance policy are: 1) the policyholder made a material factual misrepresentation; 2) the policyholder intended for the insurance company to rely on the misrepresentation; and 3) the insurance company detrimentally relied on the misrepresentation. The insurance company has the very significant burden of proving that "but for" the misrepresentation(s), it would not have issued the same policy with the same premiums. On the other hand, if the insurance company seeks rescission based on the answer to a subjective question, then it must also prove that the "answer was knowingly false." *Liebling v. Garden State Indemnity*, 337 N.J. Super. 447, 454 (App. Div. 2001).

While New York law also requires the insurance company to prove it relied on a misstatement of material fact in issuing the policy, New York case law draws a distinction between items the policyholder is specifically requested to disclose and items the policyholder is not requested to disclose. For items required to be disclosed, insurance companies often argue that intent is irrelevant. *See Home Insurance Company v. Spectrum Information Technologies, Inc.*, 930 F. Supp. 825, 835-36 (E.D.N.Y. 1996). Thus, according to some insurance companies, an innocent misrepresentation of information specifically requested in a New York application may serve as a basis for the rescission of an insurance policy. However, "[i]n general, 'an applicant for insurance [in New York] is under no duty to volunteer information where no question plainly and directly requires it to be furnished.'" *See id.* at 835-36. Therefore, intent to deceive

continued on page 7

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D&O

continued from page 6

must still be shown where there is no duty to disclose. New York courts make exceptions to these rules with respect to certain special kinds of insurance policies; however, at least one New York federal court has confirmed that these rules do apply to D&O policies. *See id.*

In Alabama, the basis for rescission are delineated by statute, and although insurance companies cannot rescind on grounds other than those provided by statute, the policyholder may contractually limit the statutory grounds for rescission. Under Alabama Code §27-14-7, insurance companies typically argue that the elements of a misrepresentation claim warranting rescission include misstatements that either: 1) were fraudulent, meaning they were made intentionally with knowledge, 2) were material to the risk, even if innocent, or 3) affected the insurance company's good faith decision to issue the policy for which the policyholder applied. *See In re Healthsouth Corp. Insurance Litigation*, 308 F. Supp. 2d 1253, 1269-70 (N.D. Ala. 2004). The Florida rescission statute mirrors the Alabama statute. As in Alabama, insurance companies typically argue that the Florida statute provides that an incorrect statement made in an application for insurance will prevent recovery under the policy, even if the misrepresentation was unintentional and unknown by the applicant, so long as the insurance company would have altered the terms of its policy had it known the facts or if the misstatement materially affected the risk assumed. *See National Union Fire Insurance Company v. Sahlen*, 807 F. Supp. 743, 745 (S.D. Fla. 1992).

Despite minor differences in their analyses, a number of courts have concluded that rescission is warranted in particular cases where the insurance company can prove a material misstatement upon which it specifically relied. However, the fair and equitable nature of such a harsh remedy is not so readily apparent where it affects the coverage of parties who had no part in, let alone knowledge of, the misrepresentation. Because rescission is an equitable remedy, policyholders are well advised to argue that absent an intent to deceive, the rescission remedy is inappropriate.

Lack of Protection for the Innocent Policyholders

In a few decidedly pro-insurance company decisions that fail sufficiently to recognize the inequity of the circumstances, courts in a number of jurisdictions have rescinded D&O insurance policies, even against independent directors who were not aware of and did not participate in the misstatement. Although the rescission analysis employed by these courts varies and the remedy was limited to the specific facts of each case, the result was equally harsh, especially for the innocent directors and officers.

In an early case, *Bird v. Penn Central Company*, 341 F. Supp. 291 (E.D. Pa. 1971), the Pennsylvania District Court denied summary judgment to innocent outside directors, holding that the corporate official who was responsible for the false statement was acting as an "agent" not only for the entity, but also for the other officers and directors. While criticizing the *Bird* court's logic as "fictional," *Shapiro v. American Home Assurance Company* ("*Shapiro I*"), 584 F. Supp. 1245 (D. Mass. 1984), also allowed the insurance company to rescind a D&O policy even with respect to innocent directors. The court ordered rescission against the innocent directors "[b]ecause of the likelihood of joint and several liability being imposed on all directors for the wrongdoing of one, [and] the facts known to Shapiro [who signed the application] were highly material not only to his potential liability, but to that of all other directors. Since Shapiro's answer [on the application] misrepresented the risk incurred in insuring all those covered by the policy, it follows that American Home can avoid responsibility to all the insureds on the basis of that misrepresentation." *See id.* at 1252.

Although *Shapiro I* rejected the *Bird* court's agency theory, the result was equally harsh and inequitable on the innocent officers and directors. The *Bird* opinion has been cited by other courts in support of decisions to rescind D&O policies, and other similar insurance policies, even as to innocent policyholders. Despite recognizing the inequitable nature of the rescission remedy to the innocent policyholders, a more recent New York federal court reiterated the *Bird* court reasoning in the context of a D&O insurance policy. In *American International Specialty Lines Insurance Company v. Towers Financial Corporation*, No. 94 Civ. 2727 (WK) (AJP), 1997 U.S. Dist. Lexis 22610, *30 (S.D.N.Y. 1997), the court explained that it "realizes that leaving an allegedly innocent outside director without D&O coverage may seem harsh. … Whichever way a court rules on this question, it will cause hardship to an innocent party: either the innocent insureds who did not make any misrepresentations, or the innocent insurance company which was deceived."

Not All Courts Are Inclined to Fault Innocent Policyholders

Some courts have appropriately recognized the inequitable result of rescinding an insurance policy against innocent policyholders, and exercise greater caution when considering such a harsh remedy. For example, the New Jersey Supreme Court in *First American Title Insurance Company v. Lawson*, 177 N.J. 125, 143 (2003), recently refused to rescind against an innocent policyholder because such a "harsh and sweeping result would be contrary to the public interest." Although the *Lawson* court did not deal with a D&O insurance policy, it was addressing coverage under an analogous professional liability policy, which provided entity coverage for a law firm and separate coverage for each of its individual partners.

Other courts have refused to permit insurance companies to unilaterally rescind coverage and avoid their obligation to fund the defense of the underlying claims. For example, in *Federal Insurance Company v. Tyco International Ltd.*, No. 600507/03,

continued on page 8

D&O

continued from page 7

slip op. at 1, 6 (N.Y. Sup. Ct. March 5, 2004), the insurer sought to rescind coverage as to all directors and officers despite the existence of a severability clause in the application itself and regardless of the directors' knowledge and involvement in the misrepresentations. Although the outside directors and the company settled their claims with the insurance company, former CEO Dennis Kozlowski and other inside directors challenged the insurance company's unilateral attempt to rescind the policy. The court held that an insurance company may not unilaterally rescind the policy against the policyholder until the rescission claim has been adjudicated. In other words, the insurance company was held to its duty to defend the policyholders until there was a final adjudication regarding whether a material misrepresentation was in fact contained in the application and relied upon by the insurance company.

Similarly, in *Associated Electric & Gas Insurance Services Ltd. v. Rigas*, No. 02-7444, 2004 U.S. Dist. Lexis 4498 (E.D. Pa. 2004), several officers of Adelphia sought a judgment declaring that the D&O insurers were responsible for reimbursing and paying defense costs incurred by corporate officials until the insurance companies' claims for rescission as to various policyholders were resolved. As in the *Tyco* matter discussed above, the Eastern District of Pennsylvania held that D&O insurers were obligated to advance defense costs pending final adjudication of the rescission claims.

Equitable Considerations When Dealing with the Remedy of Rescission

Rescission is an equitable remedy and, as illustrated by the discussion in *Shapiro I* and its progeny and *Lawson*, courts are split on whether to balance these equities in favor of the insurance company or the innocent policyholders. As noted above, the Southern District of New York noted in *American International Specialty Lines Insurance Company v. Towers Financial Corporation*, No. 94 Civ. 2727 (WK) (AJP), 1997 U.S. Dist. Lexis 22610, at *30 (S.D.N.Y. 1997), that any decision it made would cause a hardship to an innocent party. Nevertheless, and without providing any other reason, the court chose to impose the "harsh," but supposedly equitable remedy of rescission, upon the innocent policyholders. Not only does this outcome leave the innocent director or officer without coverage, it also inhibits the ability of corporations to attract qualified directors and officers. As the rescission remedy is one that is based in equity, and because insurance companies, unlike the innocent individual directors or officers, do have the ability to spread their risks, the equities should favor a presumption of coverage. This was part of the rationale of the court in *Lawson*, which balanced the equities in favor of the innocent policyholder.

The remedy of rescission is a response to corporate fraud. The very reason corporations seek outside directors is to attempt to preempt any such fraud. Proliferation of the rescission remedy as to innocent directors and officers will discourage qualified outside directors from accepting such positions, thereby increasing the very conduct the rescission remedy seeks to discourage.

Severability Provisions and the Impact, Or Lack Thereof, on Innocent Policyholders

The Severability Clause

With the increasing number of decisions allowing rescission and significant changes in the D&O insurance marketplace, insurance companies introduced severability clauses into D&O policies and later into D&O insurance applications themselves. Standard severability provisions typically seek to isolate directors and officers from the misconduct and potential lack of coverage of other directors and officers by stating, for example, that "the facts pertaining to and knowledge possessed by any insured shall not be imputed to any other Insured Person." Other insurance policies use even more specific protective policy language specifying that "no statement in the application or knowledge on the part of one insured is to be imputed to another insured in determining the availability of coverage," and/or that "the written application for coverage is to be construed as a separate application by each insured."

Case law addressing the rescission of insurance policies is itself sparse, let alone case law addressing rescission against innocent policyholders. Cases discussing the rescission of insurance policies that contain severability clauses are even more rare. The case law that does exist, however, makes clear that a properly worded severability clause in a D&O policy application should protect the innocent policyholder from misstatements contained in the application signed by an individual other than the innocent policyholder. Because insurance companies argue that a severability clause in the policy itself does not protect the innocent policyholder from misstatements in the policy application, policyholders are well advised to bargain for a severability clause in the application itself.

Rescission Where a Severability Clause Is in the Policy But Not in the Application

Even after paying higher premiums for policies with severability provisions, some entities have found themselves without coverage for their innocent policyholders because a severability clause was not included in the application for insurance. For example, in *Home Insurance Company v. Dunn*, 963 F. 2d 1023 (7th Cir. 1992), the president and sole shareholder of a law firm materially misrepresented in an application for a legal malpractice insurance policy that he was not aware of any situation that could result in a malpractice claim despite his own illegal conduct. The policy provided coverage for him and 12 other attorneys. The insurance company attempted to rescind the policy as to all attorneys regardless of whether they knew about the wrongdoing. Defendants argued that a severability clause included in the fraud exclusion prevented the insurance company from

continued on page 9

continued from page 8

rescinding the policy against the innocent attorneys at the firm. The insurance company argued that the severability clause was ineffective and the policy was void *ab initio* because of the misrepresentation in the application. The court found that the severability clause cited by defendant policyholders was not of the type that applied to misrepresentations made on the insurance application, but was instead a severability provision that only applied to the policy exclusions, and "would only come into play *after* the policy is in force." *See id.* at 1026. The court found that the misrepresentation benefited all attorneys and that the policy was void in its entirety.

Similarly, in *INA Underwriters Insurance Company v. Forde*, 630 F. Supp. 76 (W.D.N.Y. 1985), the insurance company sought to rescind an accountants' professional liability policy with respect to all policyholders, including the firm, its owner, and employees, despite the fact that only the owner had misrepresented material facts in the application. The innocent defendants argued that they had not made a misrepresentation and the policy's severability clause precluded the insurer from rescinding as to them. The court noted that the severability clause was contained in the "Waiver of Exclusions and Breach of Conditions" section of the policy, and, therefore, did not apply to misrepresentations made in the application process. *See id.* at 77. The court cited other New York case law, holding that material misrepresentations rendered the insurance policy void *ab initio*. The only reason cited by the *Forde* court for extending this rule to support its decision to rescind the policy as to the innocent policyholders was that a contrary decision would result in a hardship to the insurance company. The court's rationale failed to appropriately balance the equities between the innocent corporate officials and the insurance company, which had the ability to spread its loss. This logic was later followed by another New York federal court in *American International Specialty Lines Insurance Company v. Towers Financial Corporation*, No. 94 Civ. 2727 (WK) (AJP), 1997 U.S. Dist. Lexis 22610 (S.D.N.Y. 1997).

Recently, yet another federal court, in a case with unusual and particular facts, followed the lead of *Dunn* and *Forde* by rescinding a D&O policy as to all policyholders despite the existence of a severability clause in the policy but not in the application. *See Cutter & Buck, Inc. v. Genesis Insurance Company*, 306 F. Supp. 2d 988 (W.D. Wash. 2004). The rescission was predicated upon misrepresentations contained in the policyholder's Annual Report, CPA letter, and SEC filings, which were all incorporated as part of the insurance application. The policy specifically noted that the insurance company would rely upon the materials attached to the application in underwriting the policy. The court found that rescission of the policy as to innocent officers and directors would be appropriate despite the fact that the policy specifically stated that misrepresentations made by the individual signing the application with the actual intent to deceive or material misrepresentations of fact would not void the policy as to all policyholders otherwise entitled to coverage, and that material information known to the person who signed the application could not be imputed to other policyholders.

Rescission Rejected Where Severability Clauses Are in the Application for Insurance

Notwithstanding the case law rescinding policies against innocent policyholders despite the existence of severability clauses in the policy itself, properly bargained for severability provisions in the application for insurance can protect innocent directors and officers. Broadly worded severability clauses in a D&O policy that address statements made in the application for insurance may also protect the innocent policyholder from rescission claims.

For example, in *Wedtech Corporation v. Federal Insurance Company*, 740 F. Supp. 214 (1990), the Southern District of New York acknowledged that New York law generally permits rescission against innocent officers and directors; however, the court refused to rescind the policy against the innocent policyholders where a severability clause was included in the insurance application itself. In reaching this conclusion the court relied heavily upon the decision of *Shapiro v. American Home Assurance Company* (*Shapiro II*), 616 F. Supp. 900, 903-05 (D. Mass. 1984). Although *Shapiro II* did not address the rescission of the policy at issue, it concluded that the operable severability clause precluded the insurance company from denying plaintiff's claims for coverage because of the fraud of others. The operable severability provision provided that the policy "is to be construed as a separate contract with each Insured … and liability of the Insurer to such Insured shall be independent of its liability to any other Insured." *See id.* at 902.

The Circuit Court in *Atlantic Permanent Federal Savings & Loan Association v. American Casualty Company of Reading, Pennsylvania*, 839 F.2d 212 (4th Cir. 1998), similarly refused to rescind a D&O policy despite the insurance company's assertion that it was procured by a material misrepresentation, because the policy's severability clause was broad enough to encompass misrepresentations in the application for insurance. The operable severability provision specifically noted that "this policy shall not be voided or rescinded and coverage shall not be excluded as a result of any untrue statement in the [application] form, except as to those persons making such statements or having knowledge of its truth." *See id.* at 215. This language is in stark contrast to the severability provision contained in *Cutter & Buck, Inc.* discussed *supra.*

The U.S. District Court for the Northern District of Alabama also recently refused to rescind a D&O policy as to individual policyholders based on misrepresentations contained in the corporation's financial statements. *See In re Healthsouth Corporation Insurance Litigation*, 308 F. Supp. 2d 1253 (N.D. Ala. 2004). Interestingly, the decision turned more on the definition of "misrepresentation" than on

continued on page 12

CASE BRIEFS

New Jersey's Verbal Threshold Standard Clarified, at Least for Now

The New Jersey Supreme Court recently resolved the longstanding controversy over the proper interpretation of the 1998 Automobile Insurance Cost Reduction Act ("AICRA" or "Act"), N.J.S.A. 39:6A-1.1 to 35. *See DiProspero v. Penn*, 183 N.J. 477, 874 A.2d 1039 (2005), and *Serrano v. Serrano*, 183 N.J. 508, 874 A.2d 1058 (2005). AICRA basically provides policyholders with the choice of lower insurance premium payments in exchange for limiting their right to sue for non-economic damages. The Act's relevant "limitation on lawsuit" threshold prevents recovery unless the injured claimant sustains a bodily injury that results in death; dismemberment; significant disfigurement or significant scarring; displaced fractures; loss of a fetus; or a permanent injury within a reasonable degree of medical probability, other than scarring or disfigurement. *See* N.J.S.A. 39:6A-8a. It further provides that such injury will be regarded as permanent only when the involved body part has not healed, and will not heal, to function normally with further medical treatment. *Id.* To satisfy the Act's requirements, a claimant who has filed a bodily injury suit must, within a specified time frame, provide a physician's sworn certification that objective clinical evidence demonstrates that the claimant has sustained a permanent injury of the type specified in the Act. *Id.*

Before the Act's passage, the New Jersey Supreme Court interpreted an analogous "verbal threshold" provision — contained in the 1988 New Jersey Automobile Reparation Reform Act — as requiring not only evidence that a claimant's injury fit within one of the categories described in that earlier statute, but also that the claimant had suffered a "serious life impact" as the result of the injury. *See Oswin v. Shaw*, 129 N.J. 290, 318, 609 A.2d 415 (1992). Following AICRA's passage, the continued viability of the "serious life impact" analysis was challenged with mixed results. *See James v. Torres*, 354 N.J. Super. 586, 808 A.2d 873 (App.Div.2002) (holding the serious impact requirement of *Oswin* survived the passage of AICRA and was implicitly incorporated within it). *But see Compere v. Collins*, 352 N.J. Super. 200, 799 A.2d 721 (Law Div. 2002); *DiProspero v. Penn*, 2004 WL 439350, Slip Op. (App.Div. 2004) (Weissbard, J. dissenting).

In *DiProspero v. Penn*, 183 N.J. 477, 874 A.2d 1039 (2005) and *Serrano v. Serrano*, 183 N.J. 508, 874 A.2d 1058 (2005), the New Jersey Supreme Court ruled that there is no "serious life impact" test under the current auto insurance laws. It found that nothing in AICRA's text, preamble, legislative history, or policy objectives suggests that the legislature intended the court to write in a serious life impact standard. *DiProspero*, 183 N.J. at 506, 874 A.2d 1039; *Serrano*, 183 N.J. at 514-16, 874 A.2d 1058. The court held that the Act's silence demonstrates that state lawmakers did not intend to carry forward the serious life impact test. The court ruled that new legislation would be required to impose this requirement. As a result, injured verbal threshold policyholders retain the opportunity to sue for losses such as pain and suffering.

The Supreme Court's decision has been, to put it plainly, attacked by insurer proponents, such as The Insurance Council of New Jersey, a nonprofit, insurance research, information and advocacy organization sponsored by New Jersey's property/casualty insurers. Critics of the ruling predict that it will open the door to more suits, increase automobile insurance losses, drive automobile insurers out of New Jersey, and, ultimately, substantially increase automobile insurance rates. The critics also claim that the court's interpretation of AICRA is contrary to the legislature's intent. Others, however, hail the ruling as a policyholder victory. They contend that the legislature never intended verbal threshold policyholders give up their rights to sue under all circumstances, only when their injuries were not permanent.

New Jersey legislators will have an opportunity to express their current thinking on a serious life impact requirement. Following the Supreme Court's decision, Assembly bill A-4227, which would reinstate the serious impact standard, was introduced. The bill was referred to the Assembly Financial Institutions and Insurance Committee. Additional bills may be introduced as well.

Unless and until the legislature acts, the Supreme Court's *DiProspero* and *Serrano* decisions remain binding. Indeed, in *Beltran v. DeLima*, 379 N.J. Super. 169, 877 A.2d 307 (App. Div. 2005), an appellate court ruled that the *DiProspero* and *Serrano* rulings have "pipeline" retroactivity. That is, they apply to all prejudgment matters pending in the trial courts and to those matters on appeal. The *Beltran* court acknowledged that addressing, and perhaps re-reviewing, AICRA cases in light of the Supreme Court's recent decision may, for a time, overwhelm the trial courts' calendars. But, the *Beltran* court concluded that giving the Supreme Court's decisions "pipeline" retroactivity was, nonetheless, the appropriate result. *Accord Pungitore v. Brown*, 379 N.J. Super. 165, 877 A.2d 305 (App. Div. 2005).

Michigan Supreme Court: Pollution Exclusion Excludes Sewage Claims

The Supreme Court of Michigan, applying Michigan law, has held that the pollution exclusion bars coverage for damage to houses caused by sewage overflow from a creek. The Michigan high court held that: 1) sewage is a "pollutant" under the unambiguous language of the general liability policy's pollution exclusion; 2) the fact that the insurance pool had paid other "basement backup" claims did not establish that there was a "latent" ambiguity in the pollution exclusion; and 3) the insurance pool was not estopped from invoking the exclusion because of its payment of the other basement backup claims. Although the full panel of the court agreed with each of the above conclusions, the court was evenly split (3-3) on the legal

continued on page 11

Case Briefs

continued from page 10

reasons for the result. *City of Grosse Pointe Park v. Michigan Municipal Liability and Property Pool*, No. 125630, 2005 Mich. LEXIS 1133 (Mich. July 19, 2005).

The defendant insurance pool is a self-insured group pool created by local governments in Michigan. The group provided 1-year, occurrence-based liability policies to the Policyholder City from 1985 through 1998. The policy in effect from August 1994 to August 1995 contained a pollution exclusion precluding coverage for "Bodily Injury or Property Damage arising out of the actual, alleged or threatened discharge, dispersal, seepage, migration, release or escape of pollutants" from certain premises. The policy defined "pollutants" as "any solid, liquid, gaseous or thermal irritant or contaminant, including smoke, vapor, soot, fumes, acids, alkalis, chemicals and waste."

Both before and during the policy period at issue, the policyholder had a combined sewer system in which sewage and rainwater were transported to a water treatment plant in the same sewer line. If the sewer line became overused — after a large rain, for example — the city was permitted to discharge the overflow sewage/rainwater mix into a creek.

In September 1995, a class action suit was filed against the policyholder in state court by residents who lived near the creek. The complainants alleged that their homes were flooded by sewage overflow in July 1995. The city asked the insurance pool for defense and indemnity. In October 1995, the pool agreed to defend under a reservation of rights, citing the pollution exclusion and advising that "if there is any judgment against the City ... for eminent domain, a discharge of any pollutants, or an intentional act" then the pool reserved the right to deny coverage. Prior to and during the course of the underlying class action, the insurance pool covered other "basement backup" claims not related to the lawsuit. The city reached a settlement with the residents, agreeing to pay $1.9 million and to eliminate the problem of sewage overflow. At that time, the pool notified the policyholder that it would not indemnify the settlement because coverage was precluded by the pollution exclusion. The city then filed this declaratory judgment action.

Justice Michael F. Cavanaugh, writing for the first three-judge plurality of the Supreme Court of Michigan, began by stating that, under Michigan law, ambiguities in written contracts can be categorized in two types — "patent" (ambiguities "that clearly appear on the face of a document'") and "latent" (ambiguities that "arise from a collateral matter when the document's terms are applied or executed"). The plurality quickly concluded that there was no patent ambiguity with respect to whether sewage was a "pollutant" under the policy. It found that "'[w]aste' is commonly understood to include sewage," especially given the types of materials that were contained in documented overflow. The first plurality then rejected the city's assertion that the pool's practice of covering basement backup claims without invoking the pollution exclusion provided evidence of a latent ambiguity. The plurality concluded that "[t]he pool's practice of paying basement backup claims does not render the clause susceptible to two reasonable, yet mutually exclusive, interpretations." Finding the exclusion unambiguous and giving "'waste' the meaning intended by the parties, as well as its commonly understood meaning," the court had "little difficulty concluding that the city discharged 'pollutants'" into the creek and that the pollution exclusion therefore barred coverage.

The plurality also rejected the city's argument that the pool should be equitably estopped from applying the exclusion because it had relied on the pool's practice of paying basement backup claims before and during the underlying litigation to its detriment. It found that the city's reliance on the pool's payment of basement backup claims was not justified, given the clear, timely and "particularly damaging" reservation of rights letter sent to the city at the beginning of the litigation. According to the plurality, "[t]he city was clearly on notice that the pool might not provide coverage under the pollution exclusion clause."

The second plurality opinion, authored by Justice Robert P. Young, Jr., reached the same conclusion but with a somewhat different legal analysis. It found that there was no patent ambiguity in the definition of "pollutant" as "[i]t is difficult to imagine an insurance policy that is clearer or more explicit than the one found in the present case." The plurality concluded that "sewage" fell under the plain and ordinary meaning of the word "contaminant" in the exclusion, as the creek was "tainted" or "made impure" by the sewage that was released into it. The second plurality also found that "most, if not all" of the specific examples of contaminants in the exclusion were found in the sewage.

The second plurality departed from the first plurality's analysis of "latent" ambiguity, however, concluding that the policyholder needed to prove the existence of such ambiguity by "clear and convincing evidence," which the policyholder here failed to do. According to the second plurality, requiring the policyholder to meet a clear and convincing standard was consistent with the "common theme" in Michigan that "contracting parties are always entitled mutually to modify the underlying contract, but the party asserting that a modification has occurred must present clear and convincing evidence to that effect." The second opinion then concluded that there was no "latent ambiguity" requiring the use of extrinsic evidence to interpret "pollutant," observing that the policyholder was "attempting to bootstrap its estoppel argument ... to manufacture a latent ambiguity claim" in "violat[ion] [of] basic contract construction principles."

The second plurality also rejected the policyholder's assertion that the pool was estopped from invoking the

continued on page 12

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D&O

continued from page 9

the language contained in the policy's applicable severability provision. The court held that where the applicable policy narrowed the basis for rescission from what is statutorily provided for in Alabama solely to intentional misrepresentations made in the application itself, the insurance company was bound by the bargained for, more restrictive, requirement.

These decisions underscore the importance of considering each and every policy provision independently, in conjunction with an understanding of the applicable case law, in order to ensure the most expansive coverage.

Mechanisms for Protecting the Innocent Policyholders

Negotiate for the Proper Severability Provisions

The case law discussed above illustrates the importance of negotiating for the correct type of severability provision in both the D&O policy and the application for the policy. Insurance companies may argue that the fact that the policy sought contains a severability provision, as most standard policies do, may not be enough to avoid rescission against innocent corporate officials. The diligent policyholder will ensure that both the application for insurance and the policy contain an appropriately worded severability provision. As illustrated by the case law discussed above, the unfortunate policy-seeker who signs an application without a severability clause and who fails to procure a policy containing such a clause may one day find itself in court litigating against a rescission claim.

Narrowing the Application

Insurance companies determine policy limits and premiums based on factors that include the information provided in the application process. The larger the universe of documents contained in the application for an insurance policy, the more likely it is that a misstatement (innocent or purposeful) is contained therein. While some jurisdictions disallow insurance companies from rescinding for reasons not provided for by statute, courts have not prevented policyholders from contractually limiting the grounds upon which an insurance company may seek rescission. This was precisely the reason why the insurance company in *In re Healthsouth Corporation Insurance Litigation*, 308 F. Supp. 2d 1253 (N.D. Ala. 2004), was unable to rescind the policy issued despite the misrepresentations contained in the policyholder's financial statement. *See also Federal Insurance Company v. Oak Indus.*, 1986 U.S. Dist. Lexis 29699, Civil No. 85-985-G(M) (S.D. Cal. 1986) (holding that misstatements and omissions contained in the policyholder's public filings were not grounds for rescission because the only statements inquired into and relied upon by the insurance company in issuing the policy were those contained in the application itself). Potential policyholders should be aware of language that incorporates an expansive list of corporate documents as "relied upon" in issuing a policy, especially when the documents listed are not even requested.

Purchase Separate Policies for the Outside/Independent Directors and Officers

Another option to reduce the ability of a D&O insurance company to attempt to rescind a policy is to purchase separate executive liability insurance for independent directors, also referred to as non-rescindable "Side A" excess liability insurance. The purpose of such insurance would be to protect innocent independent directors from rescission claims and fraud-based exclusions, and to set aside limits, accessible only to the independent directors.

Conclusion

Combine the recent increase in prosecutions for corporate misconduct as well as the surge in securities class action claims with the increasingly aggressive tactics of D&O insurance companies, and the directors and officers of corporations have become some of the most financially vulnerable individuals. Not only has the number of claims against directors and officers increased, but also have the stakes. Recent sanctions against directors and officers have included fines, penalties, punitive damages, and even imprisonment. On the other hand, the increasing amounts of settlements and verdicts against corporate directors and officers have caused D&O insurance companies to press claims to rescind coverage more than ever before. In light of these events, D&O insurance has never played as vital of a role as it does today. Simply having a D&O insurance policy in place is no longer sufficient. In order to sustain the ability to attract intellectual capital of the highest caliber, corporations must exercise great caution and carefully analyze policy provisions as well as applications for D&O insurance. They must understand the legal ramifications of the applications they sign and the policies they purchase.

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Case Briefs

continued from page 11

pollution exclusion. It found that the estoppel claim was a non-starter because, under *Kirschner v. Process Design Associates*, 459 Mich. 587, 592 N.W.2d 707 (1999), it is "well-established" in Michigan that "'the doctrine [of estoppel] will not be applied to broaden the coverage of a policy to protect the insured against risks that were not included in the policy or that were expressly excluded from the policy." According to the plurality, the policyholder here was "essentially requesting this Court to ignore the policy's pollution exclusion clause ... [which] would ... alter fundamentally the nature of the bargain struck ... and ... protect the city 'against risks that were ... expressly excluded from the policy.'"

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