D&O Insurance: Do You Really Have It?

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The headlines are packed with references to high profile corporate scandals, including the recent Enron, Tyco, and Martha Stewart scandals. Couple this media frenzy with the enormous increase in securities class actions, and the directors and officers of corporations appear to have become some of the most financially vulnerable individuals around. Not only has the number of claims against them increased, but so have the stakes. Recent sanctions against directors and officers have included fines, penalties, punitive damages, and even imprisonment. Although much is written about the misconduct of corporate officers and directors, and the amount of money damages involved, rarely is there any mention of the source of the funds to pay for the litigation and damages.

This article addresses issues relevant to directors and officers ("D&O") liability insurance, a prime source of such funds. The article begins by summarizing how D&O policies have evolved; Section II discusses the rescission remedy, its effect on innocent insureds, and the effectiveness of severability provisions; last, in Section III, the article argues that courts should follow the decision of the New Jersey Supreme Court in *First American Title Insurance Company v. Lawson*, 177 N.J. 125 (2003), where the innocent insured maintained his coverage.

I. D&O Policies Today

D&O insurance was originally issued solely to protect individual directors and officers ("Side A" coverage). Policies were subsequently broadened to include "entity coverage" of the corporation and coverage for the corporation to indemnify directors and officers. By the end of the 1990's D&O coverage was more expansive and the cost cheaper than ever.

However, in the wake of recent events, all of this has changed, and the scope of D&O insurance is narrowing. The standard D&O insurance policy has returned to the basics, providing Side A coverage, entity coverage, and corporate indemnification. While coverage has narrowed, the cost has risen dramatically and policy limits have dwindled. Even the larger, more secure insurance providers are feeling the squeeze.

II. Rescission, The Innocent, And Severability

Insurers invariably require a prospective D&O policyholder to complete an application. In addition to requesting information typical of institutional insurance applications, D&O insurance applications often incorporate by reference a company's latest annual report, financial statements, and SEC filings. The insured (and usually an officer) must verify the truth of the information 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. Policies often define the term "application," and some include "any" publicly filed documents in the definition. Apparently, many documents that are not even submitted to insurers have become documents insurers supposedly rely upon. Whether an insurer can demonstrate actual reliance on such documents remains to be seen. Nevertheless, any mistake, even if innocent, in any one of several SEC filings could potentially serve as a basis for an attempt to rescind.

Rescission voids the insurance policy *ab initio*, and requires the refund of all premiums. Recently, increasing numbers of rescission claims have involved companies' financial restatements, the most notable of which has been Enron. Despite some cross-jurisdictional variation, the elements essential for rescission are a (1) misstatement of (2) a material fact (3) relied upon by the insurer in issuing the policy. In New Jersey and New York, insurers may argue that even an innocent misrepresentation is sufficient to justify rescission.

Despite minor differences in their analyses, courts generally view rescission as a fair and equitable remedy. However, the fair and equitable nature of such a harsh remedy is not so readily apparent where it harms innocent parties. Because rescission is an equitable remedy, policyholders are well advised to argue that absent intent to deceive, the remedy is inequitable. Also, until an insurer obtains a judgment of rescission, its contractual obligations – including its duty to defend and to advance defense costs – continues.[1]

Earlier holdings regarding the rescission of D&O policies suggested that, regardless of whether only one officer materially misrepresented requested information, the insurer could rescind as to all insureds. While courts provided different reasons for this result, all were equally unconvincing. Courts that have held for insurers primarily have simply balanced the equities in favor of insurers and against innocent insureds.

In response to the changing marketplace, insurers introduced severability clauses into D&O policies and applications. Standard severability language isolates innocent directors and officers from the misconduct or misrepresentations of their counterparts by not imputing the knowledge and/or acts of any one insured to another. The lack of precedent discussing rescission and severability makes it difficult to predict how courts will decide such cases in the future, but it also leaves the courts open to various innovative arguments, including arguments adopted by courts construing other types of insurance.

Despite the presence of severability clauses, some courts nevertheless rescind insurance policies as to innocent insureds. These courts reason that severability clauses applicable to conduct exclusions in the policy do not apply to misrepresentations made in policy applications. Such holdings underscore the importance of negotiating for the correct type of severability provision.

Notwithstanding decisions rescinding insurance policies even as to innocent insureds, at least one New York court, *Wedtech Corporation v. Federal Insurance Company*, 740 F. Supp. 214 (S.D.N.Y. 1990), refused to rescind a policy against innocent insureds because of a severability clause in the application itself. Although no New Jersey case addresses the same factual scenario, developing case law suggests that New Jersey courts would reach a similar conclusion.

III. The New Jersey Supreme Court Takes A Step In The Right Direction

A. *First American Title Insurance Company v. Lawson*

The New Jersey Supreme Court's recent decision in *First American Title Insurance Company v. Lawson*, 177 N.J. 125 (2003), suggests that New Jersey courts will protect innocent insureds even without a severability clause. The insureds in *Lawson* were three partners and a law firm. Despite receiving an audit notification from the Office of Attorney Ethics, the managing partner warranted in a professional liability policy that he was not aware of any claims. Neither the policy application nor insurance policy in *Lawson* contained a severability clause. The court acknowledged that rescission is an equitable remedy that "lies within the inherent discretion of the court." Instead of rescinding *ab initio* as to all insureds, the court analyzed each insured's circumstances and rescinded only against the culpable parties.

The court rescinded as to the managing partner because he materially misrepresented information, which he intended the insurer to rely upon, and the insurer detrimentally relied on such. The court rescinded as to a second partner because his conduct was so intertwined with that of the managing partner that he should have known of the falsity. The court also rescinded "entity coverage," because to allow the managing partner to engage in such egregious conduct and still allow coverage for the firm "would, in essence, condone the use of a partnership entity as a subterfuge for fraudulent conduct."

The court noted that the factors favoring rescission as to others also favored rescission as to the third "innocent" partner. Nevertheless, the court also found that rescission would be inconsistent with the expectations of the innocent insured, and that rescinding coverage as to the "innocent" partner would result in the lack of coverage for unrelated matters, thereby harming the public at large. The court held that "the equities do not warrant rescission" as to the third partner because such a "harsh and sweeping result would be contrary to the public interest." Rather than granting a windfall to insurance companies, the New Jersey Supreme Court relied upon principles of equity, inasmuch as rescission is an equitable remedy.

B. Expanding *Lawson* To D&O Rescission Actions

The fact scenario in *Lawson* is analogous to a D&O rescission action where the D&O policy has a severability clause, one officer misrepresents application materials, but the other officers and directors are unaware of the culpable conduct. It can hardly be argued that the innocent directors expected exposure for liability arising out of another insured's independent conduct. Just as organizing the firm as a limited liability partnership in *Lawson* provided the innocent partner with "every reason to expect that his exposure to liability would be circumscribed," so too does the severability clause of an insurance contract with respect to the innocent directors of the corporation. As in *Lawson*, where the contrary result would trickle down to the public by leaving the innocent partner's clients without adequate protection should unrelated malpractice claims arise, rescinding a D&O policy with respect to an innocent insured director would similarly harm the public. Lack of such coverage not only threatens innocent directors' personal wealth, it also affects the shareholders, the corporation itself, and other members of the public. In the words of the *Lawson* Court, "the equities do not warrant rescission" with respect to the innocent parties because such a "harsh and sweeping result would be contrary to the public interest."

Beyond the Court's reasoning, other policy reasons favor not faulting innocent insureds. Because of the current crisis in D&O coverage, including denial of claims, rising prices, lower policy limits, and the possibility of rescission, qualified directors and officers, facing potentially staggering uninsured liability, are refusing to serve. The negative effect of this exodus of intellectual capital is at least two-fold. First, this exodus of intellectual capital will result in less productivity and lack of ingenuity in major corporations. As American ingenuity suffers, corporations abroad will gain a competitive advantage. Second, less competent corporate governance may lead to even more claims. Not only will this financially strain corporations even further, but it will also lead to more D&O claims.

Courts can no longer continue to ignore principles of law and equity in making decisions concerning the rescission of insurance policies. The New Jersey Supreme Court has taken a positive step in ignoring the illogical reasoning of decisions in other jurisdictions, properly analyzing the insurance rescission issue with principles of law and equity in mind. Hopefully other jurisdictions will take heed of the reasoning employed by the New Jersey Supreme Court and expand what is currently a fairly disparate body of law into the "*Lawson* doctrine."

[1] See Federal Insurance Company v. Tyco International Ltd., *No. 600507/03 (N.Y. Sup. Ct. 2004);* Associated Electric & Gas Insurance Services, Ltd. v. John J. Rigas, *No. 02-7444 (E.D. Pa. 2004).*

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