D&O Liability Insurance

Coverage Risks for Innocent Directors and Officers

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RECENT COURT DECISIONS HIGHLIGHT THE IMPORTANCE OF "SEVERABILITY" IN DETERMINING WHETHER OR NOT INNOCENT DIRECTORS AND OFFICERS ARE COVERED

Summary

Innocent directors and officers are at risk of losing D&O insurance coverage because of the knowledge or acts of other insureds. While severability clauses may provide a level of comfort, the specific language of these provisions, as well as the language of any related provisions, should be carefully reviewed. The specific language of these provisions may determine whether or not coverage exists for innocent officers and directors in situations where the carrier has valid grounds to rescind coverage for one individual insured.

When Can Knowledge of Misstatements or Omissions in the Insurance Application Be Imputed to Innocent Insureds?

Insurance policies for directors and officers typically cover numerous individuals, including board members and non-board officers. Because numerous individuals share a single policy, a frequently asked question is "when can the conduct or knowledge of one individual be imputed to other individuals for purposes of excluding or revoking coverage?" Several recent court decisions have considered this critical issue of "severability." As these decisions demonstrate, the precise severability language in a D&O liability policy—both with regard to statements in the insurance application and individuals' conduct under the policy itself—can mean the difference between coverage or no coverage for innocent directors and officers. This article focuses on the first issue—severability with regard to statements in the application.[1]

A company applying for D&O insurance is typically required to submit a detailed application to the prospective insurance carrier. For public companies, the term "application" is often defined in the policy to include recent periodic SEC filings, such as quarterly and annual reports.

D&O policies typically provide that if the insurance application contains "material misstatements or omissions" or "statements that are not accurate and complete," the policy will be void as to any insured (1) who knew of the misstated or inaccurate facts at the inception of the policy, and (2) *to whom such knowledge may be imputed*.[2] D&O policies also typically contain "severability" provisions, which determine when knowledge of application misrepresentations possessed by one insured can be imputed to other directors and officers for purposes of rescission.

Depending on the specific severability language in a particular D&O policy, misrepresentations in the insurance application may allow the carrier to void coverage as to directors and officers who had no role in the application process, had no knowledge of the alleged misrepresentations, and who honestly believed that the application was accurate and complete.[3]

Recent Court Decisions Dealing with "Severability in the Application" and Related Provisions in D&O Insurance Policies

Several recent court decisions have addressed the effect of "severability in the application" clauses in D&O liability policies on the ability of insurers to rescind or exclude coverage. When a policy has a "full severability" provision, the knowledge of one insured should not be imputed to innocent directors and officers. For example, in *In re HealthSouth Corp. Securities Litigation*,[4] several insurers attempted to rescind D&O insurance coverage based on application misstatements after former HealthSouth officers entered guilty pleas and admitted that they engaged in a scheme to misrepresent the company's finances.

The HealthSouth D&O policy included a "Representations and Severability" clause, which stated in pertinent part:

> With respect to the declaration of statements contained in such written application(s) for coverage, *no statement in the application or knowledge possessed by any Insured Person shall be imputed to any other Insured Person* for the purpose of determining if coverage is available.[5]

The court ruled that this full severability provision "preclude[s] rescission as to all insureds regardless of their involvement in the alleged fraud."

In some circumstances, however, courts have found that a D&O policy includes only partial severability. Under "partial severability," misrepresentations or omissions by signers of the application or other designated individuals may be imputed to other insureds. In one such case, the insurance carrier rescinded the D&O policy based on alleged misrepresentations made by the CFO, who signed the renewal application. The policy included a "Severability of Application" provision, which stated in pertinent part:

> In the event that the Application . . . contains misrepresentations made with the actual intent to deceive, or contains misrepresentations which materially affect … the acceptance of the risk[,] . . . this Policy in its entirety shall be void and of no affect whatsoever; and provided, however, that no knowledge possessed by any Director or Officer shall be imputed to any other Director or Officer *except for material information known to the person or persons who signed the Application*.[6]

The trial court ruled that the provision was unambiguous and clearly provided that "a director's or officer's knowledge of a misrepresentation made with an intent to deceive is not imputed to other directors or officers unless the application's signer knew of the misrepresentation." The court found that the CFO knowingly submitted materials with the renewal application that included material misrepresentations. Consequently, the insurer was entitled to rescind coverage for otherwise innocent officers and directors. The Ninth Circuit upheld the trial court's ruling on appeal.

A similar outcome was reached in a recent Ninth Circuit case. In *Federal Insurance Co. v. Homestore, Inc*., the insureds appealed a decision granting rescission as to all insureds. The carrier contended that it was entitled to such rescission because of material misrepresentations made by the former CFO, who signed the insurance application.

The Homestore D&O policy included a "Representations" section, which stated:

> [I]n the event that the Application, including materials submitted herewith, contains misrepresentations[,] … no coverage shall be afforded … for any Director or Officer who did not sign the Application but who knew on the inception date of this Policy the facts that were so misrepresented, and this Policy in its entirety shall be void and of no effect whatsoever if such misrepresentations *were known to be untrue on the inception date of the Policy by one or more of the individuals who signed the Application*.[7]

The insureds argued that this language was not clear and should be construed in their favor. Instead, the Ninth Circuit found as a matter of law that the Representations section did not limit the carrier's ability to rescind the policy only to the particular insureds who had prior knowledge of the misrepresentations. Reading the Representations section as a whole, the court concluded that the parties clearly intended to permit rescission (1) as to *any* insured who had prior knowledge of a material misrepresentation in the insurance application, and (2) as to *all* insureds if such misrepresentation was known to any signer of the application. Accordingly, the appellate court found the clause unambiguous and ruled that it permitted the rescission of coverage for innocent directors and officers if material misrepresentations were known to any person who signed the application.[8]

Even where D&O policies contain a seemingly unambiguous "full severability" provision, carriers have attempted to rescind or exclude coverage. For example, in a recent California state court case, the policy specifically provided for full severability, stating that "no knowledge or information possessed by one insured [regarding statements in the application] shall be imputed to any other insured for purposes of determining the availability of coverage under this Policy."[9] The insureds conceded that the former CEO, who signed the application, had failed to disclose adverse material information therein. However, relying on the policy's full severability provision, the insureds argued that coverage should not be denied to innocent directors and officers based merely on the former CEO's misrepresentations.

The carrier rejected this argument and sought a declaration that it could deny coverage as to all insureds for any claims arising from facts and circumstances that should have been disclosed in the application. The carrier argued that the application itself contained unambiguous language excluding claims arising from facts or circumstances known at the time the application was signed:

> No person(s) or entity(ies) proposed for this insurance is cognizant of any fact, circumstance or situation which they have reason to suppose might afford grounds for any claim such as would fall within the scope of the proposed insurance . . . . [A]ny claim arising from any claims, facts, circumstances or situations required to be disclosed . . . is excluded from the proposed insurance.

The carrier further argued that the policy's full severability provision had no effect on this claim exclusion in the

application, because the latter did not depend upon imputed knowledge to exclude undisclosed claims.

The court agreed that when the application's claim exclusion was read in isolation, the mutual intent of the parties was to exclude coverage for innocent directors and officers based on a failure by one insured to disclose information. However, the court ruled that the application could not be read in isolation, but rather should be read in conjunction with the policy's full severability provision. In so ruling, the court stressed that the full severability provision had been added to the policy by amendment, indicating an intent by the insureds to secure coverage for innocent directors and officers.[10]

The court concluded that the existence of both the application's claim exclusion and the severability provision within the same policy created an ambiguity regarding the proper construction of the policy. Under California law, "ambiguous terms are resolved in the insureds' favor, consistent with the insureds' reasonable expectations." The court found that the insureds' objectively reasonable expectation was that the severability provision applied to the entire policy. Accordingly, the court ruled that the exclusionary language in the application did not preclude coverage for innocent insureds.

This case demonstrates the critical importance of looking past the severability clause. Even in situations where the policy includes full severability or the insureds specifically negotiate full severability in an endorsement, innocent directors and officers may not be covered. Instead, all relevant policy provisions, including language in the insurance application or in any "warranty" or "representation" letter requested by the carrier, should be closely analyzed to determine whether any language exists that arguably contradicts the severability provision.

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Endnotes

[1] D&O policies also typically contain a second severability provision, which defines when certain specified conduct by one individual insured, such as intentional fraud or criminal acts, can be imputed to other individual insureds (or the company) for purposes of invoking the policy's conduct exclusions.

[2] In addition, state insurance law generally imputes these conditions into the policy. More broadly, state law provides guidelines for interpreting insurance policies, including detailed statutory provisions in many jurisdictions. The intricacies of individual jurisdictions' approaches to insurance policy interpretation is beyond the scope of this article.

[3] This article focuses on when knowledge or conduct of one individual insured can be imputed *to other individual insureds*. An equally important issue beyond the scope of this article is whether and when knowledge or conduct of an individual insured can be imputed to the company for purposes of rescinding or excluding coverage as to the company.

[4] 308 F. Supp. 2d 1253 (N.D. Ala. 2004).

[5] *In re HealthSouth Corp. Ins. Litig.*, 308 F. Supp. 2d 1253, 1261 (N.D. Ala. 2004) (emphasis added).

[6] *Cutter & Buck, Inc. v. Genesis Ins. Co.*, 306 F. Supp. 2d 988, 1011 (W.D. Wash. 2004) (emphasis added), *aff'd*, No. 04-35218, 2005 WL 1799397 (9th Cir. Aug. 1, 2005).

[7] *Fed. Ins. Co. v. Homestore, Inc.*, No. 03-55995, 2005 WL 1926483, at *1 (9th Cir. Aug. 12, 2005) (emphasis added).

[8] In a parallel state court action, a California court reached the same conclusion. *See TIG Ins. Co. of Michigan v. Homestore, Inc.*, 40 Cal. Rptr. 3d 528 (Cal. Dist. Ct. App. 2006).

[9] *See Twin City Fire Ins. Co. v. HPL Techs., Inc.*, No. 1-03-CV-006505, slip op. at 6 (Cal. Super. Ct. Santa Clara Co. Jan. 12, 2005).

[10] *See also Shapiro v. Am. Home Assurance Co.*, 616 F. Supp. 900, 904 (D. Mass. 1985) (ruling that "the severability clause should be taken as the manifest intent of the parties since it appears in an addendum to the policy").