AmWINS Group, Inc.

CLIENT ADVISORY

How to Soften the Insured vs. Insured Exclusion in Your Client's D&O Policy

Directors' and Officers' Liability Insurance ("D&O") policies are, according to most carriers who underwrite the coverage, primarily intended to protect senior managers against claims brought by third parties (including investors) who allege that they've suffered harm because of the way the company is being run. Thus, carriers believe, it's perfectly logical–and even necessary–to have an "Insured vs. Insured" exclusion (also known as a "One vs. One" exclusion) built into the D&O policy in order to preserve the policy limits for their intended use: to protect against outside threats.

Historically, D&O policies didn't contain an Insured vs. Insured exclusion as a standard feature until the mid-1980s. This came about after a major U.S. bank purchased a smaller competitor and was dismayed to learn that the target bank was not as well-run as originally advertised. Somehow, this fact had slipped past the acquirer's due diligence team. When the truth came to light, the purchasing bank filed a lawsuit against the acquired bank's directors and officers–who were now employees of the acquirer. Thus, the purchaser was suing its own executives for negligence. The carriers and reinsurers involved in the acquiring bank's D&O program quickly realized the major flaw (from their perspective) in their product and, almost overnight, an Insured vs. Insured exclusion became standard in the D&O insurance industry.

There are, however, ways to restrict, or "soften," the Insured vs. Insured exclusion. When exploring these, it's important to keep in mind the exclusion's key objective. "Its primary purpose is to exclude collusion between insured parties," notes Will Fahey, a senior vice president of Zurich North America Commercial's Specialties Management Solutions Group, and a leading underwriter of D&O insurance worldwide.

In theory, without an Insured vs. Insured exclusion, a company could pursue a risky business strategy knowing that if the plan failed and caused losses, the company could recoup those funds by merely having one executive sue another, claiming that he disagreed with the risky strategy and demanding that the D&O carrier make the insured company whole for the negligent acts of management. If D&O coverage actually worked this way, no carrier would be in business for very long since losses would be overwhelming. However, there are ways to limit the Insured vs. Insured exclusion's applicability while preserving its main objective for the insurer. These creative "win/win" solutions enable you to broaden coverage for your client while allowing the carrier to preserve the underwriting integrity of its D&O coverage.

While every policy is different, a typical Insured vs. Insured exclusion in a public company D&O form may read like this:

> *The insurer shall not be liable to make any payment for loss which is based upon, or attributable to, any claim made against any director or officer by any director or officer or by the insured institution as defined in the policy, except for a shareholder derivative action brought by a shareholder of the insured institution which is instigated and continued totally independent of, and totally without the solicitation, assistance, active participation, or intervention of, any director or officer or the insured institution.*

The last part of this specimen exclusion underscores the carrier's concern about not getting caught up paying where one insured may be working in concert with another to create a collusive claim. There are other potential claim situations, however, for which you can negotiate broader coverage for your clients. But keep in mind that the Insured vs. Insured exclusion can come back to haunt you when you broaden it in certain ways. "Sometimes this broadening of coverage can have unintended consequences, because the Insured vs. Insured is one of the most heavily litigated provisions of a D&O policy. For example, adding employees to the definition of Insured as an extension of coverage can also cause the side affect of implicating the Insured vs. Insured exclusion," says Mr. Fahey. One way around this potential misstep is to amend the exclusion to carve-back coverage for employees suing as shareholders.

The following are some additional ways to carve-back the Insured vs. Insured exclusion to enhance the policy's coverage for your clients. Some of these features will already be built-in to certain policy forms, depending on the carrier and the specific class of D&O insured you're dealing with (e.g. generic public company, non-profit, financial institution, etc.) But even if your form already contains some restrictions to the exclusion, you may be able to enhance your client's coverage even further by negotiating additional exceptions.

Successors-in-Interest. In today's economic climate especially, it's important to clarify that the Insured vs. Insured exclusion will not apply to claims against directors and officers which are brought by liquidators, bankruptcy trustees, receivers, examiners, creditor committees or any other parties which may be deemed a successor-in-interest to the insured entity. Where the Insured vs. Insured exclusion is ambiguous about

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this, legal decisions go both ways as to whether it applies to knock out the claim, although the majority seem to agree that the successor-in-interest is not really representing the bankrupt entity but rather the creditors and, thus, no collusive claim among management exists so coverage is allowed. However, you don't want your client to have to litigate this issue, so the best course of action is to have an explicit exception in the insured vs. Insured exclusion to make it clear that coverage will apply for Insureds when a successor-in-interest files a claim against them.

Former Insureds. Carriers don't want to pay whenever company executives have a disagreement, but frequently they'll agree to provide coverage for claims brought by former insureds that have been out of their executive position with the company for a stated period, usually four years or more. They put in a time buffer so a former officer is less likely to be suing for a problem he or she created before leaving the company. Remember that the definition of insured persons includes past, present and future directors and officers. Since a past officer is still technically an insured, coverage for claims brought by the former officer would be excluded by an un-amended Insured vs. Insured exclusion. It is common for former officers to remain shareholders after leaving the company. If the former officer sues in his or her capacity as a shareholder, you don't want that claim excluded. Depending upon the specifics of who has left the company and under what circumstances, carriers may liberalize this exception (after a careful review) so that claims brought by former executives who have been gone for as little as one year may not be excluded by the Insured vs. Insured exclusion. It's important to note that some carriers try to restrict this exception to just former board members, while others will allow it to apply to all former insureds. Obviously, expanding it to all former insureds is more advantageous to your client.

Employment Practices Claims. Insurers will sometimes provide an Insured vs. Insured carve-back to create coverage under a D&O policy for employment practices claims brought by an employee (or former employee) of the insured company against another insured person. This carve-back will not provide coverage for the corporate entity. Thus, for example, if the general counsel files a suit against the CEO for some type of employment discrimination, it would be covered under such a carve-out. This exception to the Insured vs. Insured exclusion will be considered by the carrier in light of any separate Employment Practices Liability (EPL) Insurance which may be available to the insured company. Sometimes a carrier will specifically state that the coverage provided by the Insured vs. Insured EPL carve-out only applies in excess of a EPL policy that's already in place. If you are looking for employment practices coverage, it is recommended to purchase that coverage rather than dilute your directors and officers policy with employment claims. The carve-back makes some sense because the hiring and firing of employees is often an executive level decision. A lawsuit brought by a former director or officer could have elements that trigger both a D&O policy and EPL policy.

Foreign Jurisdictions. In certain foreign countries the laws require directors and officers to redress corporate wrongs by bringing suit against the company and/or their colleagues. In these jurisdiction Insured vs. Insured exclusions are generally not allowed by law. If your client has foreign operations, it's imperative that you understand how the law governing this situation works in each of those foreign jurisdictions. However, you may be able to get a blanket exception to the Insured vs. Insured exclusion on your client's policy for all claims arising from foreign operations. At the very least, the carrier should underwrite each of the foreign subsidiaries and agree to provide the necessary coverage in each jurisdiction.

Cross-Claims and Third-Party Claim. Many carriers routinely provide exceptions to the Insured vs. Insured exclusion for loss arising from cross-claims and third-party claims for contribution or indemnity – as long as they arise from a claim that is otherwise covered by the policy. This enhancement is directed at a very rare circumstance that most brokers go an entire career without encountering. A better description of this type of claim would be a “redirection claim.” It is possible for a plaintiff to file suit against one insured person for the actions of a different insured person. A plaintiff may not necessarily be able to connect every outcome with the person committing the wrongful act. For example, a shareholder sues the CEO alleging that the revenues shown in the company's financial statements were completely fabricated to artificially inflate the company's stock price. The CEO may not have participated in the financial fraud and he or she will file a cross claim against the CFO who was responsible for the financial impropriety. To the insurer, there is a claim brought by one insured (CEO) versus another insured (CFO) and the exclusion would kick in. With this carve-back, coverage is allowed to go forward since the original claim brought by the shareholder is merely being redirected towards the proper perpetrator.

Fund Directors Suing the Investment Advisor under an Investment Management Insurance ("IMI") Policy. This is another rare circumstance, but it has occurred and has been litigated over in the past. IMI policies are unique in that both the investment advisor and the funds that they advise are covered under one policy for their D&O exposure, even though they are each technically separate legal entities. Thus, the Insured vs. Insured exclusion would apply to directors of a fund suing the directors of the advisor. A carve-back to the Insured vs. Insured exclusion which some carriers will grant allows fund directors to sue the advisor and its directors if the fund directors have obtained an opinion from independent legal counsel stating that the fund directors will subject themselves and/or the funds to liability if they do not bring a suit against the advisor and/or its directors. Again, this is a rare circumstance in real life, but a potentially valuable carve-back to have with any IMI policy.

As with all aspects of professional lines insurance, the Insured vs. Insured exclusion is a unique feature which needs to be considered in light of specific wording, the insured's particular needs and other relevant factors. As Zurich's Mr. Fahey observes, "Brokers need to be especially skillful in structuring coverage for these non-collusive Insured vs. Insured situations."

If you are unable to modify your D&O policy's Insured vs. Insured exclusion to your satisfaction, one remedy chosen by some buyers is to purchase a Side A DIC policy. That type of D&O policy often does not have an insured versus insured exclusion and is able to drop down from an excess position and fill that coverage gap (see our Client Advisory “Excess Follow Form D&O Coverage: Does it Really Follow Form” for a brief description of this product).

By using the above information as a general guideline, you can broaden your client's coverage while allowing the carrier to preserve what it considers to be an essential safeguard for its underwriting practices. As always, for more specifically-tailored help with this or any other aspect of your professional lines insurance accounts, please contact your AmWINS broker who will be more than happy to assist you.

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