

## **Director & Officer Insurance**

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### **A. Examining D&O Product Coverage**

Director & Officer (“D&O”) Insurance generally affords coverage for a director’s or officer’s wrongful acts relating to claims for which the D&O could be held legally liable, and also covers amounts which the Company may be or has been required to indemnify the D&O. These two types of coverages may be expanded to include direct coverage for the Company for corporate liability in connection with the wrongful acts or omissions of D&Os. The scope and cost of D&O insurance coverage has varied considerably over the last 30 years. The extent of coverage and the cost of premiums have been impacted by the numerous claims that arose following the heightened merger and acquisition activity that began in the 1980s and another wave of claims following the Savings & Loan and bank failures in the late 1980s.

Despite the intentions behind Congress’ enactment of the Private Securities Litigation Reform Act of 1995, the number of securities and similar lawsuits has now nearly tripled and settlement costs have steadily increased, particularly in cases involving accounting issues. Thus, as premiums were decreasing and coverage was being enhanced, claims and litigation were on the rise in the late 1990’s. According to American International Group, a leading provider of D&O insurance, D&O insurers were already struggling by 2000, when some D&O insurers became insolvent or had their ratings downgraded, and reinsurance became increasingly hard to find. *See*, “Why Your D&O Insurance Must Change...Now,” American International Companies, August 2002.

The plummeting value of technology stocks and other sectors beginning in mid-2000 and the discoveries of reckless or criminal reporting of financial information and other wrongful acts by Enron, WorldCom and many other companies prompted Congress to enact the Corporate Auditing and Accountability Act of 2002 (Sarbanes-Oxley Act or “SOX”). Likewise, the Securities & Exchange Commission, the NYSE and the

NASDAQ proposed or issued stronger corporate governance policies and guidelines. The combination of the already-rising level of securities litigation, the slumping economy and the fall-out from the corporate disclosure and reporting issues in 2002, has had a substantial impact on the D&O insurance industry. The enhanced reporting and other responsibilities under the *Sarbanes-Oxley Act* have further heightened the focus on director's and officer's responsibilities, liability and accountability.

The increased exposure of D&Os has led to the development of special and more expensive coverages and riders for securities-related claims and other fiduciary-related risks. D&O insurance also often includes riders for other types of insurance, such as Employment Practices Liability.

While most D&O policies broadly define the term "wrongful act," what constitutes a wrongful act for which a D&O may be held personally liable is determined by the relevant federal or state laws. "Corporate officers and directors owe a fiduciary duty to their corporation and its shareholders. They do not, however, owe such a duty to persons or entities which contract with the corporation." Dutton & Vaughan, Inc. v. Spurney, 600 So.2d 693, 697 (La. App. 4 Cir. 1992), writs denied, 601 So.2d 663 (La. 1992). "The liability of corporate officers and directors to third parties is generally determined under the laws of agencies or mandate. Thus, if the officers and directors do not purport to bind themselves individually, they do not incur personal liability for the debts of the corporation." Id. at 697. "A statutory exception to this rule arises when an officer or a director, acting through the corporation, defrauds or deceives a third party." Id.

"Generally, Louisiana law does not provide third parties with a cause of action against corporate directors and officers for negligence, mismanagement, breach or fiduciary duty, or for deaths of the corporation. Officers, employees and agents owe no duties to third parties, and they cannot be found liable to third parties for their negligent acts and omissions in a commercial context." Cameron Equipment v. Stewart & Stevenson, 685 So.2d 696, 700 (La. App. 3 Cir. 1996). "Absent fraud, shareholders,

directors and officers are not personally liable for the debts of a corporation, especially when they deal with other corporations.” Id.

**B. Claims-Made Provisions**

D&O coverage is nearly always issued on a “claims made” basis, which means that coverage is triggered when a claim is made against the D&O for a wrongful act or omission. Anderson v. Ichinose, 98-2157 (La. 9/8/99), 760 So.2d 302, 306. The term “claim” is typically defined as the insured’s receipt of a demand for money or compensation, or the service of an administrative claim, complaint, lawsuit or other proceeding. Typically, once the insured becomes aware of a claim, the claim must also be reported to the D&O insurer during the policy period in order to trigger coverage, or within a short period after the policy period lapses. Coverage is generally afforded so long as the claim is first made against the insured and reported to the insurer during the policy period, as the claim does not necessarily have to relate to an event or occurrence that took place during the policy period. Most claims-made policies include a continuity date or a retroactive date from which coverage for claims for prior acts commences, *so long as* a claim has not previously been made for such acts. Claims made policies also typically allow the insured to extend the reporting period for a specific period for wrongful acts that occurred during a policy period and for which claims may be first made and reported after the policy period lapses, which is referred to as “tail” coverage.

Coverage is also generally afforded for acts, errors and omissions of which the insured becomes aware and reports to the insurer during the policy period. If a claim is later made that relates to such potential claims, coverage should be afforded even if the claim is made and reported after the policy period lapses. Likewise, subsequently made claims that arise out of or relate to claims that were originally made and timely reported during the policy period will also relate back and be covered in the same manner as the originally reported claim.

“Under claims made policies, the mere fact that an insured loss-causing event occurs during the policy period is not sufficient to trigger insurance coverage of the loss. Such policies also typically require the insured to give prompt notice to the insurer of any

claims asserted against the insured, as well as of any occurrences that have caused or will potentially cause an insured loss. The notice requirements in claims made policies allow the insurer to ‘close its books’ on a policy at its expiration and thus to attain a level of predictability unattainable under standard occurrence policies.” Newpark Resources, Inc. v. Marsh McLennan of Louisiana, Inc., 96-0935 (La. App. 1 Cir. 2/14/97), 691 So.2d 208, 213, writs denied, 97-0691 (La. 4/25/97), 692 So.2d 1094. Under a claims made policy, “the issue is discovery and notice of a loss that triggers coverage.” Id. “A claim could not be discovered twice.” Id. Once a potential loss is discovered during a policy period, it cannot then be discovered again during a successive policy period. Id.

While most states have refused to apply the notice-prejudice rule to claims-made policies, a limited number of states have done so and a few states that have laws that require minimum reporting periods. *Compare* Zuckerman v. National Union Fire Insurance Company, 495 A.2d 395 (N.J. 1985)(refusing to apply notice-prejudice rule); City of Harrisburg v. International Surplus Lines Insurance Company, 596 F.Supp. 954 (M.D. Pa. 1984)(same); Lexington Insurance Company v. Rugg & Knopp, Inc., 165 F.3d 1087 (7th Cir. 1999)(holding that the notice/prejudice rule applies to claims made policies under Wisconsin statutory law); and, Hedgepeth v. Guerin, 691 So.2d 1355, 1359 (La. App. 1 Cir. 1997), writs denied, 701 So.2d 983 (La. 1997)(interpreting La.R.S. 22:629(a)(3) to extend the reporting period to a minimum of one year from the date of the wrongful act); *But See* Burns v. CLD, Inc., 38,998 (La. App. 2 Cir. 10/27/04), 886 So.2d 607, writs denied, 02-2906 (La. 2/18/05), 896 So.2d 31 (declining to follow Hedgepeth). In these few states, reporting may be extended beyond the policy provisions to the extent that any policy provision provides for a shorter time than state law requires.

### **C. The Impact of Sarbanes-Oxley**

The new disclosure, reporting and other obligations under the Sarbanes-Oxley Act have created more potential for claims being made and lawsuits being filed against directors and officers as well as companies. Premiums for D&O coverages have at least doubled for most companies as D&O insurers try to take into account the past losses and

predict the effect that the new laws and regulations will have on insured risks. Coverage has become more restricted in many instances.

In particular, the effect of Section 307 of the Sarbanes-Oxley Act has further tightened the market for and availability of D&O insurance, not to mention professional malpractice and miscellaneous professional liability coverages. Section 307 requires any attorney who represents corporate entities regulated by the Securities & Exchange Commission to disclose evidence of material violations of the securities laws, material breaches of fiduciary duties or material violations of federal or state laws by *clients* - the officers, directors, employees or agents of the corporate issuer. A prudent and competent attorney has the duty to disclose “that it is reasonably likely that a material violation has occurred or is ongoing, or is about to occur.” *See*, 17 CFR 205.2(e). The SEC Rule became effective on August 5, 2003.

Section 307 requires attorneys to report evidence of material violations to the chief legal officer (“CLO”) or to a qualified legal compliance committee (“QLCC”) created by the Company. The attorney’s duties end upon reporting the violations to the QLCC. In contrast, the reporting attorney has the duty to make sure that his supervisory attorney discloses the report to the CLO, and if this is not done, to do so himself until the violation is reported the Board of Directors, Audit Committee or another independent committee. The reporting attorney has the duty to ensure that an appropriate response to his report is made within a reasonable time. Likewise, the CLO has the duty to initiate an inquiry, issue an appropriate response, and advise the reporting attorney.

Many commentators believe that Section 307 will eventually have an even broader application as Congress and the states impose additional duties on attorneys regarding the duty to disclose or report material violations of law. Certainly, Section 307 requires attorneys to create a paper trail that discloses and describes material violations of law, and this likewise triggers duties under most D&O policies.

Disclosures regarding material changes affecting the company must also be made on a real-time basis under the Sarbanes-Oxley Act. Section 409 is entitled “Real Time Issuer Disclosures” and states: “Each issuer reporting under section 13(a) or 15(d) shall

disclose to the public on a rapid and current basis such additional information concerning material changes in the financial conditions or operations of the issuer, in plain English, which may include trend and qualitative information and graphic presentation, as the Commission determines, by rule, is necessary or useful for the protection of investors and in the public interest.” Thus, evidence of material violations of law that may cause material changes in the financial conditions or operations of the issuer will have to be reported to the SEC “on a rapid and current basis.”

How have or will Sections 307 and 406 of SOX likely affect D&O insurance?

D&O policies are issued on a “claims made” basis. While the coverage, notice and reporting requirements vary from policy to policy, several general rules will be applicable to the reporting requirements under Section 307.

The duty to notify the insurer is triggered by the company’s receipt of a claim or a potential claim. The term “claim” is typically defined as a demand for money, or the filing of a lawsuit, or the commencement of an administrative or enforcement proceeding (such as by the EEOC or the SEC). Insureds are also obligated to give notice of potential claims of which the company becomes aware during the policy period, and the reporting of such potential claims will typically be the trigger for coverage even if a claim is not actually made and reported until after the policy period or notice period has elapsed. Potential claims are usually defined as including acts, errors, omissions or circumstances which the insured reasonably believes might later give rise to a claim against the company.

The duty to notify the D&O insurer timely and promptly is usually reinforced by exclusions that bar coverage for claims that were first made against the company during a prior policy period, or for potential claims that the company became aware of during a prior policy period, where such claims were not timely reported during that policy period. Such exclusions and the notice and reporting requirements are designed at narrowing and limiting the insured risks to claims or potential claims that arose during the policy period and which were timely reported to the insurer as required by the policy or any applicable law.

Compliance with Section 307 will no doubt create circumstances that may later give rise to claims. Thus, the most problematic issues will involve whether and when to report potential claims. Section 307's requirements regarding the reporting of evidence of material violations of laws will likely nearly always involve a wrongful act that may be potentially covered under a D&O policy. Thus, reports made under Section 307 should normally be disclosed as a matter of course to the D&O insurer in order to protect against the possibility that such potential claims may later mature into actual claims, when coverage no longer exists.

Two recent decisions by the United States Fifth Circuit Court of Appeals illustrate the care that should be taken when considering *when* to furnish notify of a potential claim to a D&O insurer.

In Federal Ins. Co., v. CompUSA, Inc., 319 F.3d 746 (5th Cir. 2003), the Fifth Circuit dismissed CompUSA's lawsuit seeking indemnity for a judgment from Federal, its D&O insurer. Federal denied coverage based on CompUSA's delayed notice of the potential claim despite its awareness of same. Federal issued a "claims made" Executive Protection policy to CompUSA for its officers from December 16, 1998 through December 16, 2000. Midway through that period, a claim was made against CompUSA and Halpin (an officer), who did not notify Federal based on the belief that the claim was frivolous and even though policy required notice "as soon as practicable." Id. at 749. After the notice period had expired, a multi-million dollar judgment was rendered and CompUSA belatedly sent notice of the claim to Federal. The Fifth Circuit affirmed the district court's summary judgment dismissing CompUSA's claims, because it failed to report the claim timely to Federal i.e. when the claim was first made, and adopted the district court's decision in its opinion. Id. at 749. The Fifth Circuit has previously enforced similar notice provisions in a case arising under Louisiana law. See FDIC v Barham, 995 F.2d 600, 603-605 (5th Cir. 1993).

Likewise, in National Union Fire Ins. Co. of Pittsburgh, Pa. v. Willis, 296 F.3d 336 (5th Cir. 2002), CyberServe plaintiffs filed suit against EqualNet, Netco Acquisition, L.L.C., Mark A. Willis and Willis Group, L.L.C. in state court in Harris County, Texas

on September 21, 1998. National Union issued three successive D&O policies to EqualNet with one year policy periods each from March 8, 1998 to March 8, 2001. National Union contended that notice should have been given under the 1998 policy when suit was filed, but Willis argued that the notice provided during the 2000 policy was sufficient because the claims for negligent misrepresentations were not made until that time and there was no reason to report any claims that would not be covered. *Id.* National Union argued that its policy excluded coverage for unreported claims that arose from “Wrongful Acts” occurring during policy periods of prior policies. The Fifth Circuit held that the National Union policies’ definition of “claim” as a “civil proceeding which is commenced by service of a complaint or similar pleading” precluded the argument that the filing of an amended complaint also commences a civil proceeding, because such an interpretation “would result in one lawsuit qualifying as two different civil proceedings.” *Willis*, 296 F.3d at 341-342.

CompUSA and Willis demonstrate that a company’s knowledge or receipt of facts or circumstances that may later give rise to a claim against a director or officer triggers the duty to report such matters promptly to the D&O insurer. This remains true where only the company is named in the lawsuit, but wrongful acts of a particular director or officer are described in the lawsuit. Another consequence of the events of the last few years, and the enactment of the Sarbanes-Oxley Act, will be more restrictive limitations and exclusions on coverage. Further, the certifications that SOX requires, and the typical reliance that D&O underwriters place on financial records and reporting, will likely generate further litigation regarding rescission of policies. The senior officers and board members who certify the reporting to the SEC will usually correspond to the person or persons who sign and submit the applications for coverage to D&O insurers.

The economic downturn and epidemic of adverse corporate financial disclosures have driven the D&O insurance industry to a return to more careful compliance with underwriting guidelines and heightened scrutiny of financial information furnished by a company seeking D&O coverage. The Sarbanes-Oxley Act should require corporations subject to Section 307 to monitor closely the reporting of evidence of material violations

of laws, and to coordinate the reporting of potential claims relating to such material violations through Risk Management or the Office of General Counsel.

**D. Bankruptcy of Insured Company**

Lawsuits filed against non-debtor defendants such as D&Os are generally not subject to the automatic stay provisions. Sav-A-Trip v. Belfort, 164 F.3d 1137 (8th Cir. 1999). Some courts have held that non-debtor partners or non-debtor entities that are closely related to the debtor may be subject to the stay where the assets or property of the debtor could be affected (such as guarantors of loans, or persons with absolute indemnity claims against the debtor, or non-debtor partners who might contribute to a debtor's reorganization, etc.). A.H. Robbins, Co., Inc. v. Piccinin, Inc., 788 F.2d 994 (4th Cir. 1986); In Re Marley Orchards Income Fund I, Ltd. Partnership, 120 B.R. 566 (Bkcty. E.D. Wash. 1990). Even so, one court has specifically held that securities claims against D&Os of a bankrupt corporation are not stayed. In Re Reliance Acceptance Group, 235 B.R. 548 (D. Del. 1999).

The discharge of the Company granted in the reorganization plan generally does not affect the liability of other non-debtors such as directors and officers for their individual breaches of duties. 11 U.S.C. §524(e); In Re Continental Airlines, Inc., 203 F.3d 203, 211-214 (3rd Cir. 2000)(summarizing cases on issue); In Re Lowenschuss, 67 F.3d 1394 (9th Cir. 1995), cert. denied, 116 S.Ct. 2497 (1996).

Claims against D&O insurers are generally not stayed by the corporate insured's bankruptcy filing. Matter of Vitek, Inc., 51 F.3d 530 (5th Cir. 1995). Some courts have held that claims a bankrupt corporation may bring against its directors or officers and their insurers are property of the bankruptcy estate. In Re Davis, 730 F.2d 176, 184-185 (5th Cir. 1984). "Whether a particular state cause of action belongs to the [bankruptcy] estate depends on whether under applicable law the debtor could have raised the claim as of the commencement of the case." Matter of Educators Group Health Trust, 25 F.3d 1281, 1284 (5th Cir. 1994). "If a cause of action alleges only indirect harm to a creditor (i.e., an injury which derives from harm to the debtor), and the debtor could have raised a claim for its direct injury under the applicable law, then the cause of action belongs to the

estate.” Id.; see also, In Re Mediators, Inc., 105 F.3d 822, 825 (2d Cir. 1997). Claims for negligent mismanagement, conspiracy to commit or allow any fraudulent transfer to take place, or conspiracy or allowed the company to become insolvent, or committing fraud against the company, or for breach of fiduciary duty, and unjust enrichment, are all derivative claims as a matter of law which only the trustee or debtor-in-possession may assert. Matter of Educators Group Health Trust, 25 F.3d at 1285-1286.

In Miller v. Dantin, 466 So.2d 798, 799 (La. App. 4 Cir. 1985), the Louisiana Fourth Circuit Court of Appeal recognized that the corporation was the proper party to “assert a cause of action against its former director for misuse of corporate funds and other mismanagement.” Rodrigue Co., Inc. v. Gilmore, 339 So.2d 527, 527-528 (La. App. 4 Cir. 1976) recognized that the bankruptcy trustee has the sole standing to assert claims for unauthorized distributions of corporate assets even though Louisiana law allows such claims to be brought by creditors. Likewise, Dennis v. Copelin, 669 So.2d 556, 560 (La. App. 4 Cir. 1996), writs denied, 675 So.2d 1079 (La. 1996), holds that claims for illegally disbursed funds can only be brought against a corporation by a shareholder’s derivative suit “wherein the shareholder is only a nominal plaintiff and the recovery is for the corporation.” “[A]ctions for mismanagement or fraud based on breach of fiduciary duties by corporate officers and directors belong to the corporation, not to individual shareholders, and may only be addressed in a shareholder’s derivative action.” Id. “Further, corporate officers, employees and agents do not owe duties to third parties and cannot be held liable to third persons for negligence, mismanagement and omissions in a commercial context.” Id. at 561; see also, Goodwin v. Agrilite of Louisiana, 643 So.2d 249, 253 (La. App. 2 Cir. 1994).

#### **E. Severability Issues**

Severability clauses may provide protections against an insurer’s rescission defenses. Severability may arise by reason of the separate classification of warranties or representations made by directors or officers involved in signing applications for coverage or renewals. That is, the application itself may provide that the warranties and representations are severable as to each director and officer who signs the application.

As such, the breach of warranty or material misstatement by one director or officer may not impact the coverage for other D&Os, and may limit any rescission defense to the single director or officer. Provisions in some D&O policies likewise contain similar provisions. These protections are designed to ensure that “innocent” D&Os will not find themselves stripped of coverage by reason of the bad acts, misstatements or omissions of other D&Os. Some companies have limited these broad protections by restricting severability clauses to those D&Os who actually sign the application. Under such circumstances, the wrongful omissions or false statements by the signing D&Os may be used to rescind the entire policy as to all insureds. *See Cutter & Buck, Inc. v. Genesis Ins. Co.*, 306 F.Supp. 988 (W.D. Wash. 2004).

Additionally, several D&O insurers are offering policies for independent or outside directors where the primary D&O coverage is rescinded. Heightened standards of good governance will be required as a condition of such policies (regular attendance at board meetings, company must have audit, compliance and other committees that regularly meet, compliance with corporate governance standards of the securities exchange on which the company is listed, etc.).

#### **F. Rescission**

La.R.S. 22:219, 22:619 and 22:641 set forth the basis for rescission of policies, as do Articles 1953 to 1958 of the Louisiana Civil Code. The Louisiana Supreme Court has held that the insurer must prove that the false statement was made with the intent to deceive **and** that the false statement materially affected the risk. *Coleman v. Occidental Life Insurance Company of North Carolina*, 418 So.2d 645, 646 (La. 1982). “The difficulty of proving intent to deceive is recognized by the court. Thus, the courts look to the surrounding circumstances indicating the insured’s knowledge of the falsity of the representation made in the application and his recognition of the materiality of his misrepresentations, or to circumstances which create a reasonable assumption that the insured recognized the materiality. *Perault v. Time Insurance Company*, 633 So.2d 263, 266 (La. App. 1 Cir. 1993), writs denied, 634 So.2d 833 & 834 (La. 1994). “Anti-technical statutes such as Revised Statute 22:619 have been enacted to preclude an

insurer from denying coverage by use of complex policy provisions concerning facts the untutored insured would find relevant to his coverage.” Id.

“Strict proof of fraud is not required to show the applicant’s intent to deceive, because of the inherent difficulties of proving one’s intent. The intent to deceive must be determined from the attending circumstances which indicate the insured’s knowledge of the falsity of the representations made in the application and his recognition of the materiality thereof, or from circumstances which create a reasonable assumption that the insured recognized the materiality of the misrepresentations.” Watson v. Life Insurance Company of Louisiana, 335 So.2d 518, 521 (La. App. 1 Cir. 1976). The test of materiality is whether knowledge of the facts would have influenced the insurer in determining whether to assume the risk or in fixing premiums. Green v. Pilot Life Insurance Company, 450 So.2d 406, 408 (La. App. 3 Cir. 1984).

The ‘known loss’ and “fortuity” doctrines relate to the rescission of contracts and may be applicable where a material fact is omitted regarding coverage, even where the insurance application makes no inquiry or request for the information.

Some Louisiana courts have imposed a necessity that the loss of the insured be “fortuitous” in nature. CXY Chemicals v. Gerling Global General Ins. Co., 991 F.Supp. 770, 778 (E.D.La. 1998). A fortuitous event is one that, at the time the contract was made, could not have been reasonably foreseen. La. Civ. Code art. 1875. The insured bears the burden of proving that a loss was fortuitous. CXY Chemicals v. Gerling Global General Ins. Co., 991 F.Supp. at 780. Similarly, some Louisiana federal courts have recognized the “Loss in Progress” principle, which provides that when a loss is already in progress at the time a policy is issued, the contract of insurance does not take effect. Summers v. Harris, 573 F.2d 869, 872 (5th Cir. 1978).

The principles underlying the “Fortuity” doctrine and the “Loss in Progress” principle can also be found in the “Known Risk” doctrine which provides that coverage is precluded in cases like the one at hand, where the insured had knowledge of circumstances which might result in a claim under the policy prior to its issuance. Generally, the “Known Risk” doctrine is applicable under Louisiana law if the insured

knew or reasonably should have known that there was a substantial probability of a loss before the policy period began. Korossy v. Sunrise Homes, Inc., 94-473 & 94-502 (La. App. 5 Cir. 3/15/95); 653 So.2d 1215, 1223. These principles have been applied in the Louisiana jurisprudence to preclude coverage in situations like the one at hand.

In Dietrich v. Travelers Ins. Co., 504 So.2d 970, 972-973 (La. App. 1 Cir. 1987), the Louisiana First Circuit Court of Appeal held that an employer's liability policy did not provide coverage for an employee's claim where the policy expressly indicated that coverage was only provided for claims that occurred prior to the effective date of the policy when such claims were unknown or unsuspected by the insured. The First Circuit Court of Appeal rejected the insured's argument that the policy provided coverage because the insured disclosed the claim to the insurer prior to the issuance of the policy and the policy was issued without a rider excluding the claim. Id.

In Professional Managers, Inc. v. Fawer, Brian, Hardy and Zatzkis, 799 F.2d 218 (5th Cir. 1986), the United States Fifth Circuit Court of Appeals upheld a decision granting a legal malpractice insurer's motion for summary judgment. Because members of a law firm knew of circumstances relating to a specific claim when they were issued a legal malpractice binder, the Fifth Circuit held that they were not entitled to coverage as to that claim. Id. at 219. The Court found that at the time the "claims made" legal malpractice binder was issued, the insured thought (and therefore had knowledge) that if he sued his client for his fee, his client intended to counterclaim for negligence. Id. at 223. The Court held that a lawsuit did not have to be filed nor a claim to be made prior to the issuance of the policy in order to defeat coverage; rather, it was enough that the insured knew that his client was angry about the quality of his representation and might counterclaim if sued for a fee. Id. at 224.

In Stream v. Aetna Cas. Insur. Co., 608 So.2d 260, 262 (La.App. 3 Cir. 1992), the Louisiana Third Circuit of Appeal applied an exclusion in a professional liability policy which excluded coverage for a suit pending before the policy went into effect, where the insured was aware that the suit filed might expose him to professional liability but failed to list the claim in his application. The Third Circuit found that the defendant-attorney,

though not named in his professional capacity in the lawsuit prior to the effective date of the policy, was aware at that time that the facts at issue might expose him or the firm to professional liability. The Court thus upheld the district court's grant of summary judgment dismissing the professional liability insurer. Id.

Where an insured knows of circumstances relating to specific claims prior to the issuance of an insurance policy, it is not entitled to coverage as to those claims. Professional Managers, 799 F.2d at 219. Courts applying Louisiana law have held that it is not necessary that suit have been filed against the insured prior to the issuance of the policy for coverage to be precluded, where the insured knew of circumstances which could trigger coverage. Professional Managers, 799 F.2d at 223-224; Stream, 608 So.2d at 262.

#### **G. Exclusions**

Like most insurance policies, D&O policies contain numerous exclusions from coverage, including exclusions for claims based on breaches of contract, dishonest, criminal or fraudulent acts or omissions, ERISA, insured versus insured actions, outside directorships, personal or bodily injury, property damage, personal profit or advantage, pollution, prior acts, prior notice, prior or pending litigation and securities. While the purpose of D&O coverage is to cover Loss arising from a D&O's wrongful acts and omissions, the definition of Loss when read with the usual exclusions limits coverage to the advancement of defense costs to the D&O insureds and the indemnification for economic damages claimed by the adverse party.

The exclusion for breach of contract is generally based on the recognition that D&Os are typically not liable for the Company's contractual obligations, as this is the point of creating a juridical entity in the first place. The exclusion for dishonest, criminal or fraudulent acts or omissions usually requires that there be an adjudication that the D&O insured intentionally engaged in such conduct. Exclusions for claims based on ERISA are standard provisions in most D&O policies, and recognize the distinct obligations imposed by federal law on Companies providing defined employee benefit plans. The insured versus insured exclusion is designed to preclude coverage where one

insured under the policy sues another insured, with the exception of cases where the involvement of a D&O or an insured as a plaintiff is independent of any solicitation by the other plaintiffs involved in the lawsuit. The outside directorship exclusion is based on the unsurprising premise that D&O coverage is limited to the conduct of the D&O while he or she is acting in that capacity for the Company in question. Exclusions for damages relating to personal or bodily injury and property damage are very typical in D&O policies and are upheld by courts. Exclusions for personal profit or undue advantage to which the D&O is not entitled arise from the statutory provisions imposing fiduciary duties on D&Os and the general prohibition against acting for self-gain.

Exclusions for “prior acts” must be considered with any continuity or retroactivity provisions. In the absence of a continuity or retroactivity clause that predates the wrongful act at issue, prior acts that predate the commencement of the D&O policy period are not covered. Continuity or retroactivity provisions generally allow prior acts to be covered where the D&O insured had no prior notice of the claim or potential claim during the term of a prior policy. In this regard, “prior notice” exclusions generally concern prior acts of which the D&O insured has received notice before the onset of the D&O policy period in question and for which coverage would have been afforded by a prior policy if the claim had been properly and timely reported. The same is true for prior or pending litigation of which the D&O insured was aware but failed to report timely to the prior D&O insurer. Many D&O policies contain specific exclusions or limitations for coverage for potential claims for which the insured has received prior notice during the term of a prior D&O policy.

#### **H. Defense Costs**

Most D&O policies do not clearly impose a duty to defend the insured for any claims, but instead allow the D&O insurer to consent to or be involved with the appointment of counsel, or permit the D&O insurer to associate counsel or to decide to advance defense costs. Many policies are worded in such a fashion that courts have imposed a duty to contemporaneously advance defense costs to the D&Os based on the purported ambiguity posed by allowing the insurer the right to decide if and when may

will fund defense costs. Such cases reason that a reasonable insured would assume that an insurer acting in good faith would decide to advance defense costs in the event that the claims asserted in the lawsuit were first made to the insured and reported to the insurer during the policy period and concern at least some claims that could be covered by the D&O policy.

Defense costs are typically included in the definition of “Loss” under D&O policies, and the expenditure of defense costs often erodes the policy limits. Consideration of defense costs usually coincides with the deductible or retention amounts for which the Company or Insureds are responsible.

Unless the Company purchases “entity” coverage, there is no duty to defend or to indemnify the corporation for claims relating to or concerning the Company’s separate liability for a D&O’s actions, errors or omissions.

The standards for establishing whether there is a duty to defend under an insurance contract are well-established under Louisiana law. “The insurer’s duty to defend suits brought against the insured is determined by the allegations of the plaintiff’s petition, with the insurer being obligated to furnish a defense unless the petition unambiguously excludes coverage.” Steptore v. Masco Construction Co., Inc., 643 So.2d 1213, 1218 (La. 1994). “An insurer’s duty to defend arises when the pleadings against the insured disclose even a possibility of liability under the policy.” Id. “Additionally, the allegations of the petition are liberally interpreted in determining whether they set forth grounds which bring the claims within the scope of the insurer’s duty to defend the suit brought against its insured.” American Home Assurance Company v. Czarniecki, 230 So.2d 253, 259 (La. 1969). “Put differently, once a complaint states one claim within the policy’s coverage, the insurer has the duty to accept the defense of the entire lawsuit, even though other claims in the complaint fall outside the policy’s coverage.” Yarbrough v. Federal Land Bank of Jackson, 731 So.2d 482, 488 (La. App. 2 Cir. 1999).

An insurer may not “deny its duty to defend simply because the plaintiff has previously asserted coverage and a duty to defend by another insurer.” Yarbrough, 731 So. 2d at 489. Where two insurers have “other insurance” clauses which concern the

duty to defend, the defense costs will be equally borne by the two insurers. *Id.* at 489-490. The duty to defend only extends to a defense of the merits of the claim against the insured. Insurance contracts do “not impose a duty on the insurer to pay attorney’s fees in connection with the insured’s pursuit of the coverage issues.” Steptore, 643 So. 2d at 1218.

Two Courts have adopted the *Cumis* rule and concluded that an insurer’s denial of coverage may allow the insured the right to select independent counsel to represent the insured at the insurer’s expense. Belanger v. Gabriel Chemical, Inc., 00-747 (La. App. 1 Cir. 5/23/01), 787 So.2d 559, 663, writs denied, 2001-C-2289 (La. 2002), 802 So.2d 612; Smith v. Reliance Ins. Co. of Illinois, 01-387 (La. 1/15/2002), 807 So.2d 1010, 1022.

Louisiana cases have not definitively identified when an insurer’s obligation to defend terminates where there is a valid coverage defense, but commentators have stated that the “obligation should terminate upon the first judicial determination of the coverage issue.” McKenzie & Johnson, Louisiana Civil Law Treatise: Insurance Law & Practice (2nd Ed.), § 213, p. 447 (West 1996). One Court has held that the duty to defend ceased when deposition testimony unequivocally established that there was no coverage under the policy. Allstate Insurance Company v. Roy, 653 So.2d 1327, 1333 (La. App. 1 Cir. 1995), writs denied, 655 So.2d 339 (La. 1995)(An insurer is not “required to provide a defense where the undisputed facts obviously exclude coverage in a suit simply because the allegations of the petition omit crucial, undisputed facts.”). Where the petition alleges claims and facts which, if true, are excluded from coverage, there is no duty to defend or cover the claim against the insured. Jackson v. Lajaunie, 270 So.2d 859, 864 (La. 1973).

#### **I. Priority of Payment**

Because the limits of liability under most D&O policies are eroded by defense costs, the D&O insurer should keep the D&O insured apprised of the depletion of policy limits on an ongoing basis. This provides the D&O insured with adequate information to assess whether to continue to defend a claim and erode the limits or attempt to settle the claims before the limits are eroded to a point where the D&O insured may be faced with contributing monies out of his or her own pocket. This is particularly the case where

multiple D&Os are made defendants, and each appoints his or her own counsel due to actual, alleged or perceived conflicts of interests between the D&Os. Since the use of multiple counsel for multiple parties may substantially increase defense costs, D&O insurers may couple offers to advance defense costs with a condition that D&Os with common interests and no actual conflicts be represented by the same counsel. D&O insurers also make efforts to facilitate the joint defense and allocation of tasks where multiple D&Os are represented by separate counsel. Some policies include a requirement that D&O's waive objections in favor of a joint defense.

If the Company files for bankruptcy relief, numerous courts have addressed whether D&O insurance is property of the bankruptcy estate. Most courts have held that D&O coverage that is purely for the benefit of the D&O insured, as opposed to the Company, is not property of the bankruptcy estate and the limits may be used to fund the defense costs and any settlement or judgment involving individual D&Os. *See Louisiana World Exposition v. Federal Ins. Co.*, 832 F.2d 1391 (5<sup>th</sup> Cir. 1987). The more difficult questions arise when the Company has in fact indemnified the D&O insured, or where the D&O policy also includes entity coverage for which a single aggregate is available to the Company and to the D&O insureds. In such cases, the D&O policy proceeds *may* be property of the bankruptcy estate *if* there are creditors who have actual claims against the debtor Company which may be covered by the D&O insurance. *See Ochs v. Lipson*, 238 B.R. 9 (Bkcty. E.D.N.Y. 1999).