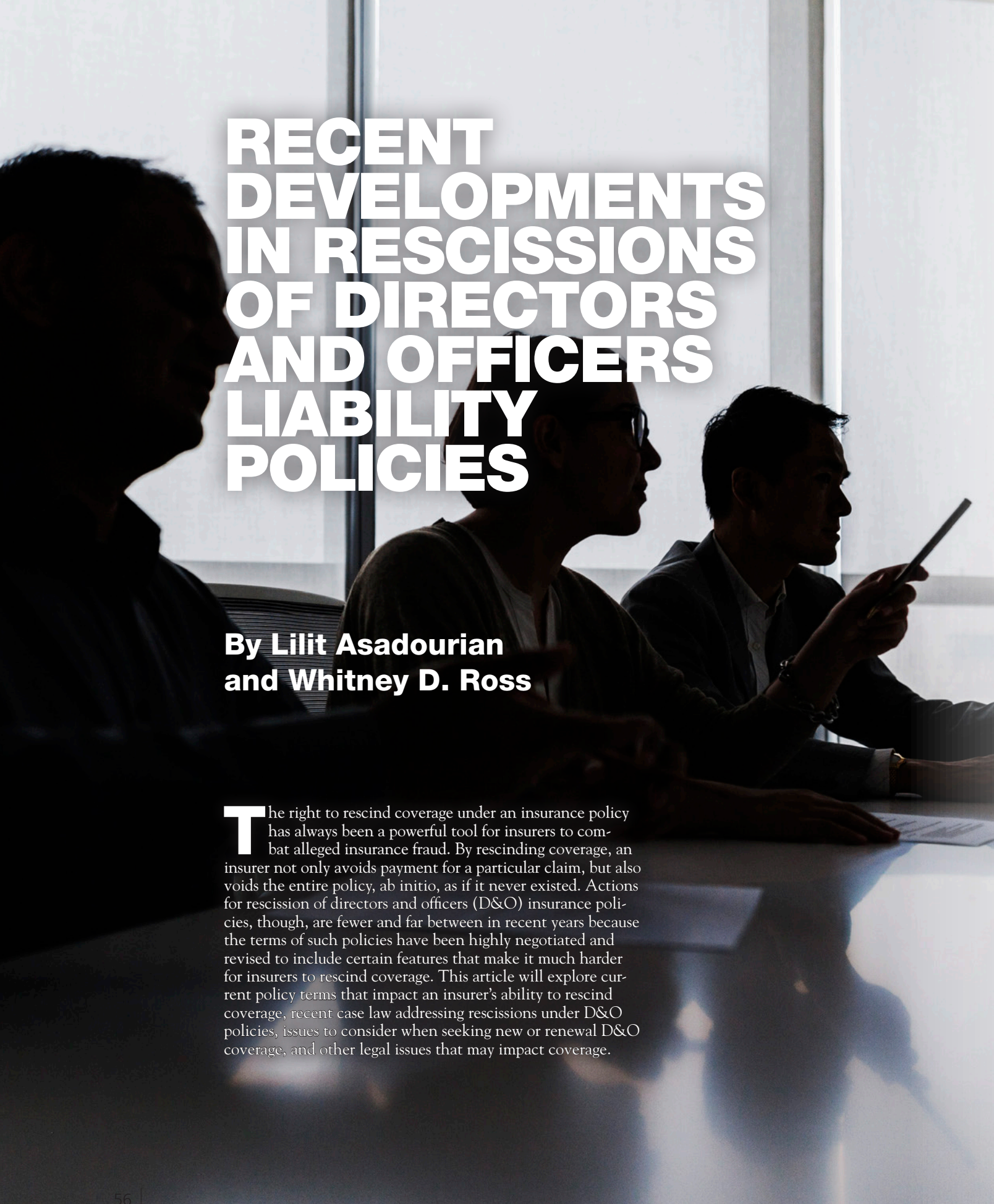

RECENT DEVELOPMENTS IN RESCISSIONS OF DIRECTORS AND OFFICERS LIABILITY POLICIES

By Lilit Asadourian and Whitney D. Ross

The right to rescind coverage under an insurance policy has always been a powerful tool for insurers to combat alleged insurance fraud. By rescinding coverage, an insurer not only avoids payment for a particular claim, but also voids the entire policy, ab initio, as if it never existed. Actions for rescission of directors and officers (D&O) insurance policies, though, are fewer and far between in recent years because the terms of such policies have been highly negotiated and revised to include certain features that make it much harder for insurers to rescind coverage. This article will explore current policy terms that impact an insurer's ability to rescind coverage, recent case law addressing rescissions under D&O policies, issues to consider when seeking new or renewal D&O coverage, and other legal issues that may impact coverage.

The Basics of D&O Coverage

D&O liability insurance was initially intended to protect the personal assets of directors and officers from claims alleging breach of their duties and claims arising out of their status as directors and officers. Additional coverages were later added to standard D&O programs, including entity coverage to protect against claims alleging harm attributable to the insured company itself. A typical D&O program for a publicly traded company today includes three types of standard coverage:

- The Side A insuring agreement provides material coverage for defense costs and losses due to settlements or judgments arising from claims or suits brought against directors and officers when the company cannot or will not provide indemnification. For example, directors and officers may not be entitled to or able to receive indemnification against derivative actions, certain suits brought under federal securities laws, or when the company is insolvent, bankrupt, or otherwise unable to fund an indemnification.
- The Side B insuring agreement provides for reimbursement to the company of defense costs and losses incurred in connection with settlements or judgments arising from claims or suits brought against directors and officers when the company is allowed or required to provide indemnification.
- The Side C insuring agreement provides coverage for defense costs and losses due to settlements or judgments arising from claims or suits brought directly against the entity. Public companies are typically covered only for securities claims under Side C, but private companies have access to broader coverage.

Unless a D&O policy contains terms limiting or preventing an insurer from rescinding coverage, all coverage parts may be voided if an insurer successfully rescinds coverage. However, directors and officers are naturally most concerned about any threat of rescission with respect to Side A coverage, which is the last resort for protection of unindemnified directors' and officers' personal assets from a claim or suit.

Legal Standards for Rescission of D&O Policies

In recent years, most of the significant court decisions addressing the legal standards for rescission focus on types of policies other than those providing D&O coverage. The lack of recent case law regarding rescission of D&O coverage is due to the evolution of policy terms discussed below. The legal standards for rescission of D&O policies, however, are often the same as those standards that apply to other types of insurance.

Under the law of all states, an insurer may rescind coverage under a D&O insurance policy where an officer or executive makes a false representation. Additional elements required to support a rescission vary by state. Many states require the false representation to be material and for the insurer to prove that it relied on the false representation during the underwriting process.[1] Other states do not require the insurer to prove reliance because it is not viewed as an element separate from materiality.[2] Finally, a minority of states require proof that the insured intended to deceive the insurer.[3] In addition to these general elements of rescission, there are other issues and differences in the laws of various states that may impact an insurer's right to rescind a D&O policy but which are not covered or discussed in this article.

Where an insurer seeks to rescind coverage under a D&O policy, the burden of proof rests on the insurer to prove all of the essential elements under the applicable jurisdiction's law.[4] The insurer truly bears a heavy burden to prevail in a rescission attempt, particularly in jurisdictions where the insurer is required to prove the insured made a representation that was false in material part, the insurer detrimentally relied on the specific misrepresentation in underwriting coverage, or the insured made the representation with intent to deceive.[5]

Evolution of D&O Policy Forms and Impact on Rescissions

D&O policy forms have changed dramatically over the past 15 years, with many of the major changes occurring in the wake of the Enron scandal, WorldCom bankruptcy, and subsequent enactment of the Sarbanes-Oxley Act of 2002 (SOX). Not only did D&O insurers take action to tighten the market in the wake of the Enron scandal and other instances of corporate accounting fraud, but insurers also increasingly looked for circumstances that would justify rescission of coverage based on fraud and misrepresentation.

Although D&O insurers have always been entitled to seek rescission of coverage based on misrepresentations in insurance policies, the enactment of SOX and subsequent litigation highlighting irregularities in corporate financial statements created a somewhat easier path for insurers to demand policy rescissions. Among the more stringent financial responsibility standards imposed by SOX is the requirement that certain corporate executives certify the accuracy of all financial disclosures. The CEO and CFO must certify that the report fairly presents the company's financial conditions and, based on their knowledge, the report does not contain any untrue statements or omit material facts. Following the enactment of SOX, D&O insurers began requesting copies of the applicant's financial reporting, which included the required certifications, during the application process. By reviewing the financial statements, D&O

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TIP
Carefully negotiate the terms, conditions, and exclusions of D&O policies to ensure appropriate coverage for protection against the risk of rescission by the insurer.

insurers could state they relied on the directors' and officers' certifications in underwriting coverage. If a financial statement was later found incorrect or restated, D&O insurers could assert that, like shareholders, they relied on the accuracy of the insured's financials in agreeing to provide insurance and threaten to bring rescission actions to void entire policies.

Unsurprisingly, coverage litigation over D&O policies increased substantially in the mid-2000s. Many cases involved insurers seeking to rescind coverage based on misrepresentations in policy applications. At the same time, insureds stepped up negotiations of new or renewal D&O coverage demanding more favorable terms to protect against the additional risks to their directors' and officers' personal assets created by the possibility of civil and criminal penalties being imposed for violations of SOX. Some of those more favorable terms and coverages granted by insurers in the wake of SOX have made it much more difficult to rescind coverage.

Nonrescindable terms. For many years, sophisticated insureds have negotiated with D&O insurers to include terms limiting or eliminating the risk of rescission in some policies; however, nearly all of the D&O policy forms coming to market today are highly negotiated and almost always contain a nonrescindable feature. Many policies today are fully nonrescindable, though it is also common for an insurer to offer nonrescindable terms only for Side A coverage.

Securing nonrescindable coverage for the nonindemnifiable portion of an entity's D&O policy is crucial for protecting those who serve on the board of directors. Imagine a scenario where you, as a member of a company's board of directors, are named as a defendant in a derivative action along with the company. You expect that your company's D&O policy will step up to pay for your defense costs, but learn that the D&O insurer rescinded the company's policy due to a misrepresentation of financial information in the policy's application. Nonrescindable coverage for Side A provides assurance to individual insureds that the policy will continue to exist and protect directors' and officers' personal assets, at least where the corporation cannot or will not indemnify the individuals.

The following is an example of a nonrescindable policy provision included in a current D&O form that applies to Side A only:

> *Insured Person Coverage Non-Rescindable*
> Under no circumstances shall the coverage provided by this Coverage Section for Loss under Insuring Agreement A. *Insured Person Coverage* be deemed void, whether by rescission or otherwise, once the premium has been paid.[6]

This provision very clearly applies only to the Side A coverage and is a stand-alone nonrescindable feature. As discussed below, sometimes insurers combine nonrescindable and severability terms.

Severability. In addition to nonrescindable terms, most D&O policy forms on the market today include severability terms, which also protect insureds against the possibility that a rescission will leave directors and officers without coverage. Severability terms limit an insurer's ability to impute one insured's knowledge or belief to all other insureds covered under a policy, essentially saving coverage for "innocent" directors and officers. A D&O policy may include either a full or limited severability clause. A full severability clause provides that a policy's application is a separate application for coverage by each of the insureds and that no statement in the application for coverage by one insured may be imputed to any other insured. A partial severability clause is narrower in that it provides that no knowledge of information possessed by an insured will be imputed to any other insured with the exception of material information that is known by specified directors or officers who sign the policy application.

Severability provisions should protect "innocent" directors and officers against rescission of coverage in the event the application contains any misrepresentations. The insurer should only seek to rescind coverage for the insured or insureds who knew of the misrepresentation

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in the application prior to the effective date of the policy. The following is an example of a full severability policy provision included in a current D&O form:

> *Severability Of The Application*
> The Application shall be construed as a separate application for coverage by each Insured Person. With respect to the Application, no knowledge possessed by any Organization or any Insured Person shall be imputed to any other Insured Person.
>
> If the statements, warranties and representations in the Application were not accurate and complete and materially affected either the acceptance of the risk or the hazard assumed by the Insurer under this Coverage Section, then the Insurer shall have the right to void coverage under this Coverage Section, *ab initio*, with respect to:
>
> (1) Loss under Insuring Agreement B. *Indemnification Of Insured Person Coverage* for the indemnification of any Insured Person who knew, as of the inception date of the Policy Period, the facts that were not accurately and completely disclosed; and
>
> (2) Loss under Insuring Agreement C. *Organization Coverage* if any Insured Person who is or was a chief executive officer or chief financial officer of the Named Entity knew, as of the inception date of the Policy Period, the facts that were not accurately and completely disclosed.
>
> The foregoing applies even if the Insured Person did not know that such incomplete or inaccurate disclosure had been provided to the Insurer or included within the Application.[7]

This severability provision does not address Side A coverage because that particular policy form provides for nonrescindable Side A coverage with no exceptions.

Often, insurers will combine severability and nonrescindable provisions in one section because they both act to limit the insurer's rights in the event of a misrepresentation in the application. The following is an example of a current D&O form in which the insurer combined a Side A only nonrescindable provision with a partial severability provision:

> If the Application contains intentional misrepresentations or misrepresentations that materially affect the acceptance of the risk by the Insurer:
> . . . .
>
> (2) [N]o coverage shall be afforded under this Policy for:
>
> (a) any Insured Persons, under Insuring Agreement (A), who knew as of the Inception Date of this Policy the facts that were so misrepresented in the Application, provided, however, that knowledge possessed by any Insured Person shall not be imputed to any other Insured Person. This shall be the Insurer's sole remedy under this Insuring Agreement (A). Under no circumstances shall the Insurer be entitled to rescind this Insuring Agreement (A).
>
> (b) an Insured Entity, under Insuring Agreement (B), to the extent it indemnifies any Insured Person referenced . . . above, and
>
> (c) an Insured Entity, under Insuring Agreements (C) and (D), if any chief executive officer, chief financial officer or any position equivalent to the foregoing of the Named Entity, or anyone signing the Application, knew as of the Inception Date of this Policy the facts that were so misrepresented in the Application.[8]

SEVERABILITY AND NONRESCINDABLE PROVISIONS ARE OFTEN COMBINED IN ONE SECTION BECAUSE BOTH LIMIT THE INSURER'S RIGHTS IN THE EVENT OF A MISREPRESENTATION IN THE APPLICATION.

Recent Case Law

Though litigation and significant court decisions addressing the rescission of D&O coverage have declined significantly over the past few years, several recently decided cases touch on issues that impact the rescission of D&O coverage.

Insured's honest belief credited unless clearly contradicted by factual knowledge where application responses are qualified. In *U.S. Liability Insurance Co. v. Kelley Ventures, LLC*, the court considered an insurer's motion for summary judgment seeking rescission of a D&O policy on the basis of an alleged misrepresentation by the insured on the policy application.[9] The insured, Kelley Ventures, is a limited liability company owned in equal shares by two other entities: Kelley Automotive Inc. (Kelley Auto) and Phoenix

Motors Inc. (Phoenix). The manager of Kelley Ventures, Kevin Kelley, is also a principal of Phoenix. In the fall of 2013, Kelley Auto sent multiple demand letters to Kelley Ventures and Mr. Kelley demanding that Kelley Ventures pay to Kelley Auto an equal share of a distribution that was planned to Phoenix.[10]

In December 2013, Mr. Kelley completed an application for D&O insurance to cover Kelley Ventures in which he was asked: "Is any entity or person proposed for this insurance aware of any fact, circumstance or situation which may result in a claim against the Applicant or any of its Directors, Officers or Employees?"[11] Mr. Kelley responded "no" to the question. The D&O insurer issued a policy covering Kelley Ventures, but not Phoenix, based on the application, which included language indicating that the responses were "full, true and complete to the best of [the applicant's] knowledge."[12]

After Kelley Auto filed suit against Kelley Ventures, the insurer brought an action seeking rescission of the policy and for a declaration that the insurer did not owe a duty to defend. With respect to the rescission claim, Florida law allows for the court to "credit" an applicant's belief to the extent it is not "clearly contradicted by factual knowledge on which it is based."[13] The insured argued that Mr. Kelley interpreted the demand letters as making demands against Phoenix, not against Kelly Ventures. The court found that the demand letters contained language that could reasonably have been construed as threatening a claim against Phoenix and that the substance of the letters did not clearly contradict that interpretation. Finding that a genuine dispute of material fact existed as to the applicant's knowledge or belief, the court denied the insurer's motion for summary judgment on the rescission issue.[14]

Though the court denied the insurer's motion to rescind the policy, the court ultimately held that the policy did not afford coverage for Kelly Ventures' claim based on several policy exclusions, including the pending or prior litigation exclusion. Unlike the responses provided by Mr. Kelley in the policy application, the pending or prior litigation exclusion was not qualified by the insured's knowledge or belief.[15]

WHEN REQUIRED, THE INSURED MUST DISCLOSE ALL DEMANDS, NO MATTER HOW "STATISTICALLY MINISCULE."

Insured not entitled to credit for reasonable belief where policy application does not contain such a qualification. In *Hale v. Travelers Casualty & Surety Co. of America*, the insurer did not make a claim for rescission of the policy at issue, but the court (and ultimately the Sixth Circuit in affirming the district court's decision) refused to apply a reasonableness standard to an insured's knowledge of a potential claim when the insured completed an application for D&O insurance.[16]

When applying for coverage under a D&O policy, the insured responded "no" when asked if, within the past five years, the insured knew of any "demands or lawsuits including shareholder, creditor, antitrust, fair trade law, copyright or patent litigation, against any Applicant, or any person proposed for this insurance, whether or not such claim or action would be covered" by the proposed policy.[17] At the time the insured applied for insurance, the insured was aware that at least 65 complaints were filed against it with the Better Business Bureau, seven complaints were filed with the Consumer Affairs Division of the Tennessee Department of Commerce and Insurance, a local news station was investigating consumer complaints, and a lawsuit for a refund was filed and dismissed.[18]

On October 8, 2012, the Tennessee attorney general filed an action against the insured and its directors alleging the insured's advertisements contained false and misleading statements and omissions of material information on the safety, efficacy, and side effects of its products. The insured, thereafter, sought coverage for the underlying lawsuit from its D&O insurer and ultimately filed a coverage action. The insurer filed for summary judgment in the coverage action on several bases, including that the insured made material misrepresentations on the policy application by not disclosing its knowledge of allegations in the consumer demands, complaints, and lawsuit that mirrored the underlying complaint allegations.[19]

In opposition to the insurer's motion for summary judgment, the insured admitted receiving customer demands for refunds prior to completing the policy application but argued that it was not aware of "looming lawsuits" or "on notice that the [attorney general] might file a lawsuit a year later."[20] The insured also argued that the court should employ an objectively reasonable standard to determine if the insured misrepresented its awareness or knowledge during the application process: "[T]he ultimate inquiry . . . is whether or not a reasonable person would be placed on notice that litigation which would be covered by the policy is reasonably possible in the foreseeable future, based on the presently-known demand or circumstance."[21] The court refused the insurer's argument and explained that the policy's language was determinative. When a policy application asks if *any* demands have been made against the insured in the prior five years, the insured must disclose all demands no matter how "statistically miniscule" or if the

demands were fully resolved prior to application.[22]

Waiver and estoppel are not applicable to an insurer's coverage defense of rescission. In *SavaSeniorCare, LLC v. Beazley Insurance Co.*, the court was asked to decide whether an insurer was entitled to amend its answer in a coverage action to assert a claim for rescission.[23] The insured brought an action against its excess D&O insurer seeking coverage for costs incurred in defending its former directors and managers in an underlying litigation. The excess insurer issued a D&O policy to the insured based on an application completed by the insured for the primary D&O policy prior to the effective date of the policy, which provided claims-made coverage from December 31, 2009, to December 31, 2010. The insured stated in the policy application that it had "no knowledge of any facts or circumstances or any actual or alleged acts, errors, or omissions that might give rise to a future claim that would fall within the scope" of the primary D&O policy.[24]

A real estate investor filed an underlying action against the insured and directors of the insured on June 23, 2010. The insured provided a defense for the directors and sought coverage under its D&O policies. The excess insurer initially agreed to provide a defense to the insured, but not the directors, and received defense invoices in the course of litigation. After receiving the invoices purporting to show that the insured retained counsel with respect to circumstances indicating a dispute with the underlying plaintiffs prior to December 31, 2009, the excess insurer moved to amend its answer to include affirmative defenses and a counterclaim for rescission. The insured advanced several arguments in opposition to the excess insurer's motion including that allowing amendment to include a counterclaim would be futile because the excess insurer waived its right to claim rescission by failing to cite rescission as possible grounds for denial in its coverage letter.[25]

Under Georgia law, an insurer's defenses to coverage may be categorized as either "policy defenses" or "coverage defenses." A "policy defense" is one based on the insured's alleged failure to fulfill a condition precedent to coverage, whereas a "coverage defense" is based on the insurer's argument that the asserted injury does not fall within the policy's scope of coverage. The court held that, under applicable law, policy defenses may be waived but the doctrines of estoppel and waiver may not be asserted against an insurer's coverage defenses. The court explained that an insurer's right to rescission was "better understood" as a coverage defense. To bring a claim for rescission, an insurer must argue that "it would not have provided coverage . . . had it received all the information known" at the time of application.[26] Accordingly, the court refused to conclude that the insurer's claim for rescission was futile due to waiver or estoppel.

Building a case for rescission based on alleged misrepresentation. Suppose the insured is a regional bank that applied for D&O coverage with a national carrier. The insured's chief financial officer (CFO) completed the policy application, which included making representations regarding the insured organization. The application asked a number of questions regarding the insured's organization and financial position. One question to which the CFO responded "no" asked whether, in the next 12 months or the prior 12 months, the insured had "under consideration" any "acquisition, tender offer, merger, consolidation, or divestiture." The signature section of the application explained that the individual completing the application represents in pertinent part:

> After reasonable inquiry, that the statements and representations set forth herein are true and accurate. . . . Any policy that [the insurer] may issue to the applicant would be issued in reliance upon the truth of all such statements, representations and attachments and will be the basis of, and deemed attached to and incorporated into, any policy that may be issued.

During the policy period, a shareholder of the insured filed a class action alleging that certain directors of the insured breached their fiduciary duties with respect to a tender offer by a separate entity proposing to acquire a majority controlling interest in the insured. The class action complaint alleged the insured held two meetings just prior to the effective date of the policy to discuss the transaction. Based on the allegations in the complaint, the insurer sought additional information from the insured suggesting the insurer was testing possible bases for rescission of the D&O policy based on the CFO's response in the application regarding the consideration of acquisitions or tender offers.

At the time the policy application was completed, the CFO was not a member of the insured's board of directors and was not privy to any confidential communications with respect to asset, equity, or offering information. The CFO responded to the policy application questions to the best of his knowledge; however, the application's representation imposed a "reasonable inquiry" standard. The fact pattern of this case study raises important questions including: (1) whether the "reasonable inquiry" standard would have required the CFO to inquire with the board for information on confidential discussions regarding a subject matter raised in the application; (2) whether the board would be required to disclose such information despite the confidential nature of such discussions; and (3) whether the phrase "under consideration" in the policy application should be interpreted to

include exploration discussions but no concrete plans.

Rescission-Related Considerations for Insureds Negotiating D&O Coverage

The process of negotiating coverage under D&O policies continues to become more sophisticated with directors and officers, general counsel, and risk managers taking an active role to ensure that the D&O program meets all of the insureds' needs. The negotiability of terms in D&O coverage depends on many factors, including but not limited to the insurer, the size and scope of the risk to be insured, and the company's claim history. Smart negotiation of terms resulted in the current crop of D&O policies that severely limit or entirely preclude insurers from rescinding coverage.

To the extent not already included in an insured's D&O program, directors and officers should push for the following key features in future coverage to protect against rescission risk:

- **Fully nonrescindable coverage.** Insureds should negotiate for fully nonrescindable coverage that applies to Sides A, B, C, and any additional coverages that are part of the program.
- **Full severability.** Insureds should negotiate for severability of the application and exclusions. The policy should construe the application separately for each insured and not allow imputation of knowledge from one insured to another. With respect to exclusions, the wrongful acts of one insured should not be imputed to any other insured.
- **Broad Side A coverage.** Where possible, an insured should purchase a standalone Side A "difference in conditions" policy that provides broader coverage, including where the primary D&O insurer refuses to provide coverage, where exclusions in the primary D&O policy bar coverage, or where the primary D&O policy cannot respond due to exhaustion or rescission.

Although insurers are not making rescission demands with as much frequency as in the past, insureds should still be mindful of the considerations discussed here to help prevent rescission issues from arising under future D&O policies. ■

Notes

1. *See* Home Ins. Co. of Ill. (N.H.) v. Spectrum Info. Techs., Inc., 930 F. Supp. 825, 835 (E.D.N.Y. 1996) (holding under New York law that insurers were not entitled to rescind D&O coverage where insurers failed to establish insured's misrepresentation was material to their underwriting decisions). *But see* Kiss Constr. N.Y., Inc. v. Rutgers Cas. Ins. Co., 877 N.Y.S.2d 253, 255 (App. Div. 2009) (holding under New York law that to sustain its burden of showing it is entitled to void or rescind policy, insurer is required to prove that insured made material misrepresentation with an intent to defraud).

2. *See* Shapiro v. Am. Home Assurance Co., 584 F. Supp. 1245, 1250 (D. Mass. 1984) ("Massachusetts common and statutory law is such that any statement that is shown to be material is one so central to the risk being insured that the insurer would be expected to take it into consideration in making the underwriting decision.").

3. *See* Cutter & Buck, Inc. v. Genesis Ins. Co., 306 F. Supp. 2d 988 (W.D. Wash. 2004) (holding under Washington law that a false statement knowingly made by insured is presumed to have been made with intent to deceive in absence of insured presenting credible evidence otherwise); Mt. Airy Ins. Co. v. Millstein, 928 F. Supp. 171 (D. Conn. 1996) (holding under Connecticut law that insurer may not rescind coverage if insured's misrepresentation was innocent).

4. *See, e.g.*, Douglas v. Fid. Nat'l Ins. Co., 177 Cal. Rptr. 3d 271, 283–84 (Ct. App. 2014) (explaining that insurer bears burden of proving material misrepresentation or concealment as grounds for rescission of policy). *But see Cutter & Buck*, 306 F. Supp. 2d at 1004 (shifting burden to insured to prove false representation made without intent to deceive where state law allows for presumption of intent where statement made knowingly).

5. *See, e.g.*, Cal. Ins. Code § 359 (requiring representation to be false in material point); Fla. Stat. § 627.409(1) (requiring insurer to prove false representation is fraudulent or material to acceptance of risk, or prove that insurer would not have issued policy if true facts had been known).

6. *See* Am. Int'l Grp., Inc. (AIG), Exec. Edge Pub. Co. Dirs. & Officers Liab., Form 115485, ¶ 11.C. (2013).

7. *See id.* ¶ 11.D.

8. *See* Hartford, Private Choice Ovation Policy Common Terms & Conditions, Form PP 00 H003 01 0314, ¶ XVI.(B)(2).

9. 137 F. Supp. 3d 1312 (S.D. Fla. 2015).

10. *Id.* at 1314–15.

11. *Id.* at 1315.

12. *Id.* at 1315–17.

13. *Id.* at 1317.

14. *Id.* at 1318.

15. *See id.* at 1318–19.

16. No. 3-14-1987, 2015 WL 6737904 (M.D. Tenn. Nov. 4, 2015), *aff'd*, 661 F. App'x 345 (6th Cir. 2016).

17. Hale v. Travelers Cas. & Sur. Co. of Am., 661 F. App'x 345, 346–47 (6th Cir. 2016).

18. *Hale*, 2015 WL 6737904, at *3.

19. *Id.* at *1–4; *see also Hale*, 661 F. App'x at 347.

20. *Hale*, 2015 WL 6737904, at *4.

21. *Id.* at *4 n.5.

22. *Id.* at *4.

23. 309 F.R.D. 692 (N.D. Ga. 2015).

24. *Id.* at 696.

25. *Id.* at 694–96.

26. *Id.* at 698.