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The Fine Print of Directors' and Officers' Liability Insurance Policies

By Kenneth J. Ashman and Michael F. Arvia

The individual financial protection of director and officer (D&O) liability insurance was once thought to be completely unnecessary, but today the majority of Fortune 500 companies carry such insurance. It is particularly useful in defraying the massive costs from securities fraud litigation launched by disgruntled investors. But the extent of D&O insurance coverage is highly specific to the particular policy in question and similar cases often have different outcomes. Everything turns on how certain terms are defined, and, naturally, the insurer and the insured do not always agree.

What constitutes a "claim" is perhaps the most often litigated question for D&O

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insurance. In *AT&T Corp. v. Faraday Capital Ltd.*, 918 A.2d 1104 (Del. 2007), for example, AT&T sought reimbursement under several D&O policies for defense and settlement costs from two lawsuits against the company in 2002. The policies in question were "claims-made," which only provided protection for claims made during the policy period; coverage was triggered when the insurer receives notice, not automatically from the underlying occurrence. The policies also contained exclusions for wrongful acts and prior litigation. The insurers successfully argued at the trial level that the two lawsuits were related and comprised only a single claim, and that the wrongful acts alleged in those suits had been litigated in two previous lawsuits, thereby excluding AT&T's claim from coverage. But the Delaware Supreme Court disagreed. The policies defined a claim as a "written or oral demand for damages or other relief." *Id.* at 1107. The court determined that every cause of action alleged in a lawsuit that was based on a distinct group of underlying facts was considered an independent claim, and remanded the case for determination of the number of claims before determining the existence of coverage. *Id.* at 1108–09.

The other primary question about claims is when a claim arises. In *National Stock Exchange v. Federal Insurance Co.*, 2007 WL 1030293 (N.D. Ill., 2007), for example, the plaintiff argued that an SEC investigation constituted a claim and should have triggered coverage for defense costs, while the defendant maintained that there was no claim until there was a specific allegation of wrongful conduct. The court looked to the policy itself and found unambiguous language that provided a decisive answer. The policy defined a claim as "a formal administrative or regulatory proceeding commenced by the filing of a notice of charges, *formal investigative order*, or similar document." *Id.* at *3 (emphasis added). The court determined that an order to commence an SEC investigation constitutes a proceeding, and is therefore a claim, especially since courts must err on the side of giving meaning to every term in a contract; otherwise, the term "formal investigative order" would be superfluous. The policy also stated that a wrongful act includes an allegedly committed or attempted action, so the SEC's investigation into wrongdoing that may have been committed was enough to give rise to a claim. The court ruled in the plaintiff's favor, ordering Federal Insurance Co. to pay the expenses National Stock Exchange incurred on behalf of its officers and directors to defend against the SEC's investigation from the time National Stock Exchange received notice from the SEC of such investigation. *Id.* at *5–6.

What constitutes "loss" that is covered by D&O insurance is also the subject of much dispute between insurers and policy holders. In *CNL Hotel & Resorts, Inc.*

v. Houston Casualty Co., 505 F. Supp.2d 1317 (M.D. Fla., 2007), for example, the plaintiff sued for reimbursement of a settlement amount paid in a cause of action under Section 11 of the Securities Act of 1933. The policy defined losses as funds the company or its directors or officers were legally liable to pay from a claim insured under the policy, including claims expenses, settlement amounts, compensatory damages, and legal fees and costs pursuant to judgments. *Id.* at 1322. But the settlement the plaintiff paid was actually a disgorgement from unjust enrichment, and the defendant refused to reimburse, arguing that the restitution for ill-gotten gains was not a loss. The court agreed. While individual directors and officers are not necessarily precluded from recovering on a Section 11 claim, a settlement that is essentially the return of misappropriated money is not a loss and is not insurable. *Id.* at 1326.

Practitioners should examine carefully the language of D&O policies—both for their clients and for those companies on which the practitioner sits on the corporate board—and examine the language in light of the business in which the client operates. Does the client have a history of claimed violations under the securities laws, whether private claims by investors or governmental inquiries? In renewing a policy, has there been prior litigation that is likely to arise again in the future? Has the client paid "damages" that, in reality, amount only to a return of ill-gotten gains? It is these types of questions, and others particular to the client, that one must examine in determining the best carrier—in light of policy premiums—for coverage for the directors and officers of the practitioner's clients. It is the fine print of these policies that will determine whether coverage exists or is denied.

Kenneth J. Ashman is a principal of Ashman Law Offices, LLC (ALO), a business law and litigation boutique with offices in Chicago, Lincolnshire (Illinois), and New York. He attended both Boston University School of Law and New York University School of Law, and prior to founding his own firm in 1997, served as an associate with New York's Weil, Gotshal & Manges, LLP and LeBoeuf, Lamb, Greene & MacRae, LLP (now Dewey & LeBoeuf, LLP). He served as a judicial law clerk to the Honorable Frederic Block, United States District Judge for the Eastern District of New York, who he now proudly calls a client. Mr. Ashman is a frequent publisher and speaker on a variety of areas of business law, and is not only active in the ABA, but also holds leadership positions in a number of state and local bar associations. Michael Arvia was formerly associated with ALO. Mr. Ashman's firm prides itself on competing with and providing the same quality representation as the largest law firms, but, through lean staffing, the latest in law office technology, and flexible

billing approaches, at greater efficiency and reduced cost. For reprints of other publications authored or co-authored by Mr. Ashman, please visit http://www.AshmanLawOffices.com or the firm's blog at http://www.Ashman-Law.com.

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