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 they've suffered harm as a result 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 to protect against outside threats.

BACKGROUND

D&O policies didn't historically contain an Insured vs. Insured exclusion as a standard feature. Then, in the mid-1980s, a major U.S. bank purchased a smaller competitor only to learn that the target bank was not as well-run as originally advertised. The purchasing bank filed a lawsuit against the acquired bank's directors and officers – who were now employees of the acquirer – thus suing their 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.

CONTACT

To learn more about how AmWINS can help you place coverage for your clients, reach out to your local AmWINS broker or marketing@amwins.com.

THE KEY OBJECTIVE OF THE EXCLUSION

According to 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, the primary purpose of the Insured vs. Insured exclusion is "to exclude collusion between insured parties." 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.

There are, however, 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 sample exclusion underscores the carrier's concern about not paying for collusive claims. Similarly, there are other potential claim situations for which you can negotiate broader coverage for your clients.

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," says Mr. Fahey. "For example, adding employees to the definition of Insured as an extension of coverage can also cause the side effect of implicating the Insured vs. Insured exclusion."

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One way around this potential misstep is to amend the exclusion to carve-back coverage for employees suing as shareholders as well as specific classes of D&O insured you're dealing with (e.g. generic public company, non-profit, financial institution, etc.). While some of these features may already be built into certain policy forms, you may be able to enhance your client's coverage even further by negotiating additional exceptions.

- **Successors-in-Interest**: 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. Experts seem to agree that the successor-in-interest represents the creditors rather than the bankrupt entity and, therefore, collusive claims among management do not exist and coverage is allowed. However, as you don't want your client to have to litigate this issue, **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 for disagreements between company executives, but will frequently agree to provide coverage for claims brought by former insureds that have not held an executive position with the company for a stated period of time – usually two years or more. This time buffer is in place so former officers are less likely to sue for problems 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. Also, keep in mind that it is common for former officers to remain shareholders after leaving a 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 the exception to include 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. For example, if the general counsel files a suit against the CEO for 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 Insurance (EPLI). However, a carrier may specifically state that the coverage provided by the Insured vs. Insured EPLI carve-out only applies in excess of an EPLI 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 EPLI policy.

- **Foreign Jurisdictions**: In certain foreign countries, laws require directors and officers to redress corporate wrongs by bringing suit against the company and/or their colleagues. In these jurisdictions, 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.**

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- **Cross-Claims and Third-Party Claims**: Many carriers routinely provide exceptions to the Insured vs. Insured exclusion for loss arising from "redirection claims" – 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. And, while this enhancement is directed at a very rare circumstance that most brokers will go their entire career without encountering, it is possible the plaintiff may not necessarily be able to connect every outcome to 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**: Another rare circumstance that has been litigated in the past involves IMI policies. They are unique in that both the investment advisor and the funds 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.**

SIDE A DIC POLICY

If you are unable to modify your D&O policy's Insured vs. Insured exclusion to your satisfaction, some buyers may want to consider purchasing a Side A DIC policy. This type of D&O policy often does not have an Insured vs. Insured exclusion and is able to drop down from an excess position to fill the coverage gap (see our client advisory "Excess Follow Form D&O Coverage: Does it Really Follow Form?" for a brief description of this product).

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. By using the above information as a general guideline, you may 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.

This article was prepared exclusively for AmWINS Group, Inc. by Larry Goanos, CEO of Andros Risk Services, an independent insurance consulting firm.