COVERAGE ISSUES MOST LIKELY TO ARISE FROM CREDIT CRISIS CLAIMS – INCLUDING THE APPLICATION (OR NOT) OF VARIOUS EXCLUSIONS AND LIMITATIONS TO COVERAGE

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I. SCOPE OF ARTICLE

Any number of types of policies could be argued to potentially apply to credit crisis claims. This article discusses the three most common: commercial general liability policies, director and officers liability policies, and professional errors and omissions policies. With respect to each, it discusses the applicable entry-level issues, including the applicable insuring clause and requirements and common exclusions.

II. OVERVIEW

As the credit crisis has been evolving, the numbers of dollars at issue have increased through the billions into the trillions, especially when you consider investment losses. There are any number of types of claims, from the purely fraudulent/Ponzi-scheme type (*see* the Bernie Madoff case and perhaps the Stanford Financial case) to regular negligence (such as claims against appraisers for negligent valuation) to simple contract claims for things such as defaults under a buy-back agreement. Just the explanation of the sub-prime crisis main features have lead to many explanations, serious and humorous, including one that has been widely circulated.[2]

Some of the types of cases that are appearing include:

- Borrower class action suits against mortgage lenders for fraud and against secondary investment banks for conspiracy to commit fraud. *See, e.g., In re First Alliance Mortg. Co.*, 471 F.3d 977 (9th Cir. 2006); *Parker v. Long Beach Mortgage Co.*, 534 F.Supp.2d 528 (E.D. Pa. 2008). *In re First Alliance Mortg. Co.*, 471 F.3d 977, 984 (9th Cir. 2006). Many of these suits assert causes of action under state consumer protection statutes and federal statutes such as the Truth in Lending Act ("TILA"), the Real Estate Settlement Procedures Act ("RESPA"), RICO, and even federal antitrust laws for conspiracies to inflate home values. Minority borrowers have also asserted violations of Fair Housing and Equal Credit Opportunity Acts.

- Shareholder actions for securities fraud against investment firms. *In re 2007 NovaStar Finan., Inc., Securities Litig.*, 2008 WL 2354367 (W.D. Mo. June 4, 2008).

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[1] The author wishes to thank Catherine L. Hanna of Hanna & Plaut, LLP, Austin, Texas who allowed her paper *Subprime Primer: Where's the Primary Exposure?* to be used as part of this paper, particularly the examples of current cases and discussions of the D&O policy. Any errors introduced in those sections are this author's errors, not Ms. Hanna's.

[2] *See* www.mymoneyblog.com/archives/2008/02/subprime-loan-crisis-explained-by-cartoon-stick-figures. Note that although the drawings are stick figures, so safe for work, the language is extremely coarse.

- Shareholder actions against ratings firms and officers like Standard & Poor's. *Reese v. Bahash*, 248 F.R.D. 58 (D.D.C. 2008).

- Investor suits against underwriters and auditors for stock issued by financial institutions issuing subprime loans. *Gold v. Morrice*, 2008 WL 467619 (C.D.Cal. Jan. 31, 2008).

- Investor suits against directors and officers of an investment bank under federal securities laws and theories of misrepresentation, fraud, and negligence for their participation or acquiescence in the securitization and marketing of subprime debt, which exposed the company to far greater financial risk than it disclosed. *See, e.g., Banker's Life v. Credit Suisse First Boston*, Cause No. 07-CV-00690 (M.D. Fla.).

- Investor suits against credit rating agencies. While purchasers of securities usually have no viable cause of action against rating agencies, some agencies are alleged to have helped bond issuers package loans to achieve certain ratings rather than acting as neutral third parties.

- Underwriter or investor suits against lenders that refuse to buy back defaulted loans.

- Employee class action suits against retirement plan administrators and trustees under ERISA. *See Alvidres v. Countrywide Finan. Corp.*, 2008 WL 2944866 (C.D.Cal. May 16, 2008).

- State and local government suits against lenders, banks, and developers for the increased costs associated with maintaining or demolishing abandoned and foreclosed properties or for consumer protection. Cleveland and Buffalo have alleged nuisance causes of action; Minneapolis sued a local developer for consumer fraud based on a scheme to illegally drive up housing prices; and Baltimore brought a federal suit against Wells Fargo for Fair Housing Act violations. The attorneys general in Ohio, New York and Massachusetts have all filed consumer protection based suits against lenders, title insurers, and others.

- SEC and state securities fraud investigations.

- Lender suits against title agents or attorneys for professional negligence in closing fraudulent loans.

- Suits against appraisers for issuing appraisals that were too high because they were either made as part of a conspiracy to defraud or negligently.

- Any of the foregoing can also contain claims based on the Sarbanes-Oxley Act. Sarbanes-Oxley was passed in 2002 to protect investors by improving the

> accuracy and reliability of corporate financial reporting. It creates an independent auditing-oversight board under the Securities Exchange Commission ("SEC"), imposes white-collar criminal penalty enhancements for criminal fraud offenses, provides for enhanced and more extensive corporate financial disclosures and reporting, and creates an enhanced recourse procedure and safeguards for those harmed by securities fraud. Elizabeth A. David, et al., *Recent Developments Affecting The Liability of Professionals, Officers, and Directors,* 38 Tort Trial & Ins. Prac. L.J. 585, 622 (2003).

Here in Texas, we saw many of these types of claims (such as straw-man loans, non-recourse loans, and conspiracies to inflate collateral prices) back in the 1980's through the savings and loan crisis after the oil bust. Now those same issues have returned, greatly expanded and complicated through the financial vehicles invented by Wall Street.

Both the potentially applicable types of coverage as well as the applicability of various exclusions will depend on the type of case and the defendant at issue. The most common insurance products that a credit crisis target may have are a commercial general liability policy ("CGL policy")(perhaps including excess/umbrella coverage), a director and officers liability policy ("D&O policy"), and a professional errors & omissions policy ("E&O policy"). There are other specialized products that may be potentially applicable. Therefore, any company involved in these types of cases, as well as any attorney seeking a recovery from the company, should make sure that all potential policies have been considered.

Once you know the universe of potential policies and the facts (including the facts as asserted under the "eight corners" rule discussed below), you can begin determining whether any of the policies potentially provide coverage.

III. INSURANCE CONTRACT INTERPRETATION, THE DUTY TO DEFEND, AND THE DUTY TO INDEMNIFY

Unlike many states, Texas has repeatedly declared that it will interpret insurance policies according to their language under standard contract interpretations rules and not under more insured-favorable rules, such as the "reasonable expectations" test. *See, e.g.*, *Forbau v. Aetna Life Ins. Co.*, 876 S.W.2d 132, 133 (Tex. 1994); *CU Lloyd's of Texas v. Hatfield*, 126 S.W.3d 679, 684 n.6 (Tex. App. – Houston [14th Dist.] 2004, pet. denied)(enforcement of "reasonable expectations" of parties other than through giving force to plain language of policy not supported by Texas law). Even when Texas coverage lawyers have criticized recent Texas Supreme Court opinions for their outcome or logic, the Court has been claiming to strictly follow the language of the policy. *See*, *e.g., Don's Building Supply, Inc. v. OneBeacon Ins. Co.,* 267 S.W.3d 20 (Tex. 2008)(applying "injury-in-fact" trigger to property damage based on policy language); *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1 (Tex. 2007)(determining that defect claim constitutes an "occurrence" and "property damage" under CGL policy language).

The primary concern in policy interpretations is to ascertain the parties' intent as expressed in the language of the policy, and in making that determination, the courts examine only the language of the policy to see what is actually stated, rather than other evidence of what

was allegedly meant. *See Esquivel v. Murray Guard, Inc.,* 992 S.W.2d 536, 544 (Tex. App.—Houston [14th Dist.] 1999, pet. denied). A court must consider all of the provisions with reference to the entire contract; no single provision will be controlling. *Coker v. Coker,* 650 S.W.2d 391, 393 (Tex. 1983). If a written contract is so worded that it can be given a definite or certain legal meaning, then it is unambiguous, and the court will not consider parol evidence as to the parties' intent.

An insurer's duty to defend (or indemnify for defense costs) is determined by the allegations in the pleadings and the language of the insurance policy. *GuideOne Elite Ins. Co. v. Fielder Road Baptist Church*, 197 S.W.3d 305, 310 (Tex. 2006); *Nat'l Union Fire Ins. Co. v. Merch. Fast Motor Lines, Inc.,* 939 S.W.2d 139, 141 (Tex. 1997). Because this involves the four corners of the relevant pleading and the four corners of the insurance policy, it is often referred to as the "eight corners" rule. When applying the "eight corners" rule, the courts give the allegations in the petition a liberal interpretation. *Merch. Fast Motor Lines, Inc.,* 939 S.W.2d at 141. The insurer is obligated to defend if *potentially* there is a case under the pleading within the coverage of the policy. *Id.* An insurer is obligated to defend an insured as long as the petition alleges at least one cause of action within the policy's coverage. *American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 848 (Tex. 1994). The burden is on the insured to show that the claim potentially falls within the scope of coverage under the policy. *Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 197 F.3d 720, 723 (5th Cir. 1999)(applying Texas law). However, if the insurer relies on a policy exclusion in denying its duty to defend or to indemnify, the burden shifts to the insurer. *Id.*

The duty to indemnify, however, is based on the actual facts developed in the underlying suit against the insured. *GuideOne*, 197 S.W.3d at 310. The duty to indemnify takes into consideration all the evidence developed in the suit and through trial in order to determine whether the policy actually provides coverage for the liability of the policyholder as adjudicated after trial or resolved through settlement. For this reason, it is sometimes said that the duty to defend is broader than the duty to indemnify. Because the duty to defend is broader than the duty to indemnify, however, "[t]he duty to indemnify is justiciable before the insured's liability is determined in the liability lawsuit when the insurer has no duty to defend *and the same reasons that negate the duty to defend likewise negate any possibility the insurer will ever have a duty to indemnify*." *Farmers Tex. County Mut. Ins. Co. v. Griffin*, 955 S.W.2d 81, 84 (Tex. 1997)(emphasis in original). In such a case, where there is no duty defend, there can be no duty to indemnify. *See GuideOne Elite Ins. Co. v. Fielder Rd. Baptist Church*, 197 S.W.3d 305, 310 (Tex. 2006); *State Farm Lloyds v. C.M.W.*, 53 S.W.3d 877, 889 (Tex. App.—Dallas 2001, pet. denied).

IV. THE COMMERCIAL GENERAL LIABILITY POLICY

The purpose of the CGL policy is to cover certain third-party claims against the insured. Most CGL policies are "occurrence" type policies, that is, they cover claims in which the occurrence giving rise to coverage arose during their period even if the claim or suit is brought years later.[3] If the policy is occurrence based, the insured typically must provide notice of the

[3] This is the reasons insurance policies issued decades ago are still responding to claims in long-tail claims involving asbestos and silica exposure, lead paint, and pollution contamination.

claim "as soon as practicable" or within some other similarly defined period. But under the Texas Supreme Court's recent holding in *PAJ. Inc. v. Hanover Ins. Co.*, 243 S.W.3d 630 (Tex. 2008), an insurer must show prejudice in order to rely on the insured's late notice as a defense to coverage.

A CGL policy usually has two coverage parts – Coverage A and Coverage B. Coverage A will cover "bodily injury" and "property damage" claims, including premises liability and operations. Coverage B is known as the "personal injury and advertising injury" form. It has undergone a number of modifications, but generally, under the 2001 ISO form, most of the claims that fall within personal injury or advertising injury include libel or slander; invasion of privacy; misappropriation of advertising ideas or style of doing business; and infringement of copyright, title, or slogan, all in the course of advertising the insured's goods or services. Usually, in order to trigger coverage for these types of claims, there must be a causal connection to advertising. The offense must occur in the process of advertising or, at least, the advertising must directly cause the damage. *See Sentry Ins. Co. v. R.J. Weber Co*, 2 F.3d 554 (5th Cir. 1993); *Everitt v. Transportation Ins. Co.*, 2000 Tex. App. LEXIS 1802 (Tex. App.—San Antonio, March 22, 2000, pet. denied)(injury must be caused by offense committed in the course of advertising the insured's goods, products or services). The need for an advertising nexus is frequently established through the use of websites.

Generally, a CGL policy excludes coverage for claims involving professional services, pollution, employment liability, and punitive or exemplary damages.[4] Under Coverage B, the exclusions include claims involving: knowledge of falsity,[5] first publication, willful violation of a penal statute, breach of contract, failure of goods to conform with advertised quality or price, copyright infringement of patent or trademark,[6] internet providers/web-site designers, and electronic chatroom and bulletin boards.

Because of the limited applicability of coverage B, this paper will primarily discuss Coverage A. Many of the discussions concerning Coverage A exclusions, however, will apply to analogous Coverage B exclusions.

A. Who is an Insured

In these types of cases, the identity of the general insured should be straight-forward – it will usually be named either as the named insured or in an additional insured endorsement. Others may be more problematic. For example, if there are multiple corporate entities related to each other, the definitions may be less than clear.

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[4] Some policies may cover punitive or exemplary damages, if the policy specifically provides for such insurance and the laws of the jurisdiction enforcing the policy does not have an overriding public interest to the contrary.

[5] Claims arising out of a publication or statement the insured knew was false when made constitute "knowing falsity" and are precluded from coverage.

[6] Coverage for copyright infringement is typically limited to use in advertisement.

Furthermore, many CGL policies insure more than just the corporation itself. They often include owners or partners or similar people, but usually limited to only conduct of the business. For example, the ISO 2000 CG 00 01 10 01 policy states that with respect to an organization other than a partnership, joint venture, or limited liability company (so, for example, a corporation):

> Your "executive officers" and directors are insureds, but only with respect to their duties as your officers and directors. Your stockholders are also insureds, but only with respect to their liability as stockholders.

Obviously a plethora of questions can arise as to whether people were acting within the scope of their duties when they wear multiple hats or have conflicting interests. A typical pleading, however, will often be sufficient to invoke the duty to defend for someone falling within one of the additional insured categories.

B. The Insuring Clause

In credit crisis claims, a major bar to coverage may be the insuring clause. As stated above, before there is coverage, there must me either "personal injury" or "property damage" (for Coverage A) or "personal injury and advertising injury" for Coverage B. Generally, a personal injury and advertising injury will not be claimed, although careful attention should be paid to artful pleadings of plaintiffs' attorneys. Even with such pleadings, however, the exclusions cited above will often provide there is no coverage under section B.

A more likely claim will be made under coverage A, although there also insureds and claimants will have their hurdles. A typical Coverage A insuring agreement states:

> We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies. We will have the right and duty to defend any "suit" seeking those damages.

It will continue:

> This insurance applies to "bodily injury" and "property damage" only if:
>
> (1) The "bodily injury" or "property damage" is caused by an "occurrence" that takes place in the "coverage territory;" and
>
> (2) The "bodily injury" or "property damage" occurs during the policy period.

In conjunction with these, the definition of "property damage" often is "physical injury to tangible property," and the policy will define an "occurrence" as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions."

This immediately sets out several conditions to coverage in a credit crisis claim. First, there must be "physical injury to tangible property" in order to create property damage.[7] Most claims, however, are going to concern a loss in value or loss of contractual rights. Such a claim would not usually be covered.

Second, many of the more egregious claims are going to be pleaded (or ultimately proven) as being based on intentional acts.[8] The definition of "occurrence," however, requires an "accident," which is generally understood to "a fortuitous, unexpected, and unintended event." *Lamar Homes, Inc. v. Mid-Continent Cas. Co.*, 242 S.W.3d 1, 8 (Tex. 2007). This type of language was at issue in *Trinity Universal Inc. Co. v. Cowan*, 945 S.W.2d 819 (Tex. 1997) in considering whether the acts of a photo shop clerk in showing a customer's "somewhat revealing" pictures to his friends (without the customer's permission) was an "accident" and therefore an "occurrence" under the clerk's parents' homeowner's liability insurance. The Texas Supreme Court ruled that the clerk's actions were an "intentional tort," and found that there was no "accident."

Intentional conduct pleadings, however, often plead that conduct was, in the alternative, grossly negligent or negligent. An insurer is obligated to defend an insured as long as the petition alleges at least one cause of action within the policy's coverage. *American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 848 (Tex. 1994). Therefore, even in the more egregious Bernie Madoff type cases, there will often be a pleading of occurrence sufficient to create a duty to defend.[9]

Moreover, whether an act and its consequences are an "occurrence" is determined from the standpoint of the insured claiming coverage, not the person who performed the act. *King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185, 191-192 (Tex. 2002). This means that when multiple insureds are named as defendants, there may be coverage for some even when the pleadings or facts show intentional conduct by others.

In *King v. Dallas Fire Ins. Co,* Dallas Fire's insured, King, was sued by a Jankowiak, who claimed that one of King's employees, Lopez, assaulted Jankowiak at a construction worksite. Jankowiak alleged that King was liable on the basis of *respondeat superior* and also that King was negligent in hiring and training Lopez.

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[7] Invariably, there will be some claims filed by enterprising attorneys who will assert that their clients suffered physical harm such as heart problems due to the stress caused by an insured's alleged bad acts. Unless very poorly drafted, such allegations will probably be sufficient to make a claim for "bodily injury" and will meet at least that element of coverage for a duty to defend. Proving such a claim is another matter.

[8] Intentional type acts are usually also subject to exclusions. For example, the typical Coverage A, exclusion a applies to "bodily injury" or "property damage" expected or intended from the viewpoint of the insured. Similarly, the typical Coverage B contains exclusions for "knowing violation of the rights of another," "material published with knowledge of falsity," and "criminal acts." But be wary of the *King v. Dallas Fire Ins. Co.* doctrine discussed herein.

[9] Whether there will ultimately be a duty to indemnify will depend on the facts as found at trial. Accordingly, any insurer assuming the defense in such a case should issue an appropriate reservation of rights letter.

Dallas Fire refused to defend King, stating there was no "occurrence" because the actions of Lopez were intentional. King contended he was covered because he did not intend to injure Jankowiak and his only potential contribution to Jankowiak's injury was perhaps negligently hiring, training, or supervising Lopez, and therefore, from his standpoint, Jankowiak's injuries were the result of an occurrence. The court ruled that the policy language (identical to the language in the 1998 and 2001 ISO forms) and the history behind the commercial general liability policy supported the conclusion that in determining whether or not there has been an "occurrence," it is the insured's standpoint that controls. According to the court, the "better approach" is that the actor's intent is not imputed to the insured in determining whether there was an occurrence.

In reaching its decision, the court relied upon the separation of insureds provision, which it described as creating separate insurance policies as to King and Lopez, and upon the "expected or intended injury" exclusion, which it determined would have no purpose if all intended injuries were excluded at the outset because they would not be an "occurrence."[10] Its duty, it said, is to give effect to all contract provisions and render none meaningless. Thus, King had coverage.

This difference could result in coverage even for somewhat intentional acts in a number of ways. For example, suppose an underling purposely committed purposeful, fraudulent acts. The corporate president, claiming he was merely negligent in not monitoring the underling more carefully, could argue that he still has coverage even if the underlying is found to have acted intentionally and expecting or intending harm to the plaintiffs.[11] Accordingly, not only must the nature of the claims in the pleading or case be examined, but, they must be considered separately with respect to each potential insured.

C. Exclusions

As insurance companies have been confronted with more and different financial coverage claims, they have responding with any number of related exclusions, many added by individualized endorsement. It cannot be over emphasized that anyone involved in such a case must look at each policy and its endorsements carefully. Some of the more standard exclusions contained in ISO form policy jackets can be addressed, however.

1. Exclusion a – "Expected or Intended."

As discussed above, you must be cognizant of the various roles of different insureds with respect to this exclusion. Just because the harm occurred through intentional acts of one insured does not mean the exclusion applies to another insured.

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[10] *Id.* at 188-189. This argument seems odd since the same reasoning used in the case would mean that even with the "expected or intended" exclusion, the result would be the same. Jankowiak expected or intended the injury so is not covered, but under the separation of insured's clause, King did not.

[11] Any resemblance to defenses asserted by Ken Lay in the Enron debacle is purely intentional.

2. Exclusion b – "Contractual Liability."

This exclusion applies to covered damages that the insured is obligated to pay "by reason of the assumption of liability in a contract or agreement." The exclusion then excepts out of its effect liability that the insured would have "in the absence of the contract or agreement" and obligations from an "insured contract." The definition of an "insured contract" usually contains a number of categories, but for these purposes means a contract in which the insured assumes the "tort liability" for covered damages to a third party, *i.e.* a tort indemnity agreement. In short form, this means that for credit crisis claims, contractual reimbursement claims are not covered except when (1) there was liability even if there had been no such agreement or (2) there was a assertion of tort liability by the claimant for "property damage" or bodily injury," and the insured had entered into an agreement to assume such tort liability.[12] Ordinary contractual buy-back and insuring agreements should not be covered.

3. Exclusions j-n.

These are exclusions that apply to damage to "property," "your product," "your work," "damage to impaired property or property not physically damaged," and "recall of products, work, or impaired property." Ordinarily just from their names, you would assume they had no application to these types of claims. Remember, however, that barring a pleading for an individual's "bodily injury," a insured or claimant had to invoke a claim of "property damage" before there could be CGL coverage. If they have made or are trying to make such a claim, it might by its nature also create an issue about these exclusions.

4. Punitive Damages, Exemplary Damages and Fines.

There are any number of endorsements concerning these types of damages, and they are usually enforceable. **But even without such an exclusion**, those damages may not be covered if applicable state law disallows coverage for punitive damages as a matter of public policy. Texas appears to do so, at least potentially.

In *Fairfield Ins. Co. v. Stephens Martin Paving, Inc.*, 246 S.W.3d 653 (Tex. 2008), the Texas Supreme Court, while upholding the insurability of punitive damages in workers' compensation cases, discussed a number of factors that determine on a case-by-case situation whether it may be against state policy to allow punitive-damage coverage. *See also American Int'l Spec. Lines Ins. Co. v. Res-Care, Inc.*, 529 F.3d 649 (5th Cir. 2008)(coverage barred for punitive damages assessed against group-home operator in case involving resident's death due to exposure to bleach as against public policy). Much like the intentional conduct exclusion, however, the applicability of the policy may vary from insured to insured involved in the claim. For example, the *Fairfield* court stated:

> The considerations may weigh differently when the insured is a corporation or business that must pay exemplary damages for the conduct of one or more of its

[12] If the situation appears to potentially involve the latter exception, there are still any number of potential issues concerning the effectiveness and scope of the indemnity agreement that are beyond the scope of this paper.

> employees. Where other employees and management are not involved in or aware of an employee's wrongful act, the purpose of exemplary damages may be achieved by permitting coverage so as not to penalize many for the wrongful act of one. When a party seeks damages in these circumstances, courts should consider valid arguments that businesses be permitted to insure against them.

246 S.W.3d at 670.

5. Endorsement Exclusions.

There are any number of form and manuscripted exclusions that may apply to claims in credit crisis claims. For example, one policy from a recent case in which I am involved has an endorsement stating:

SECURITIES AND FINANCIAL INTEREST EXCLUSION

> This insurance does not apply to:
>
> **Securities and Financial Interest**
>
> "Bodily injury" or "property damage" or "personal and advertising injury" arising out of:
>
> **(1)** The purchase, sale, offer of sale, or solicitation of any security, debt, bank deposit or financial interest or instrument; or
>
> **(2)** Any representations made at any time in relation to the price or value of any security, debt, bank deposit or financial interest; or
>
> **(3)** Any depreciation or decline in price or value of any security, debt, bank deposit or financial interest or instrument.

A practitioner involved in these claims must review all the potentially applicable policies in determining the possibility of coverage.

V. THE DIRECTORS AND OFFICERS POLICY

D&O insurance covers a broad range of actions under the term "wrongful acts" as opposed to CGL policy coverage for "bodily injury" and "property damage." The term "wrongful acts" is usually defined to include actual or alleged errors, misleading statements, and neglect or breach of duty. Coverage is then narrowed by a list of limitations and exclusions. Although D&O policies are often characterized as "liability" policies, they are more correctly

"indemnity" policies as they require compensations for losses incurred, rather than a duty to defend.[13]

D&O polices are created to protect companies and their directors and officers from liabilities arising from actions taken by the directors and officers themselves in their corporate capacities. Elizabeth A. David, et al., *Recent Developments Affecting The Liability of Professionals, Officers, and Directors,* 39 Tort Trial & Ins. Prac. L.J. 671, 688 (2004). In other words, the policy attempts to protect the good guys from the bad guys within the same corporation.

A. Claims-Made v. Occurrence-Based Coverage and Notice

Unlike CGL policies, many, if not most D&O policies are provided on a "claims-made" basis, *i.e.* their coverage depends on when the claim was made against the insured regardless of when the underlying events occurred.[14] Many such policies require that both the claim against the insured and the notice of the claim to the carrier occur within the policy period. Because notice is an integral part of the insurance bargain for claims-made policies, most jurisdictions have held that the insurer is not required to demonstrate prejudice when asserting a late-notice defense under a claims-made policy.

Extended "discovery" periods, "prior acts" dates, or other types of tail coverage can affect the reporting and notice requirements under claims-made policies. Claims-made policies often contain "notice-of-circumstances" clauses, which enable policyholders to obtain coverage even for claims made after expiration of the policy if they give written notice of facts and circumstances that can reasonably be expected to lead to a claim. Because these clauses provide an exception to the general function of "claims-made" policies, they are strictly construed. *See, e.g., FDIC v. Barham*, 995 F.2d 600, 604-05 (5th Cir. 1993). Insureds must identify specific acts that could lead to claims outside the policy period, and general descriptions of exposure, worsening financial situation, or feared litigation are usually insufficient to satisfy the objective standard most courts apply. *See McCullough v. Fidelity & Deposit Co.*, 2 F.3d 110, 112 (5th Cir. 1993). In fact, some more recent versions of the clause require the insured to provide specific dates, names of potential plaintiffs and directors, officers, or employees involved, and nature and scope of the expected claim. *See id.* at 113. Insurers should expect to see more notification letters from insureds regarding their anticipated involvement in credit crisis litigation and will need to evaluate whether these letters are sufficiently specific to preserve coverage under these policies or whether they are mere "laundry list" attempts by insureds to improperly extend claims-made coverage.

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[13] The obligation to pay for defense costs is usually defined as part of a covered "loss." This means that the defense costs are paid out of policy limits, making the policy what is often called an "eroding" or "wasting" or "burning" policy. This is in contract to most CGL primary policies where the duty to defend is paid outside of policy limits (but note many excess or umbrella CGL policies include defense costs as part of the limits).

[14] You should note, however, that some policies contain a "retroactive date," and claims based on events before that date are not covered. Retroactive dates are often present when coverage is placed by an insured with a new carrier, in which case the date is usually the policy inception date. This may lead to a temporal coverage "gap" if no notice was provided to a previous D&O carrier about a claim arising before the inception of the new policy.

Many claims-made policies also include language that for coverage, not only must the claim be made and reported to the insurer within the policy period, it must be reported "as soon as practicable." On March 27, 2009, the Texas Supreme Court put this requirement on the same footing as the similar language in occurrence policies – violation of the language is a defense to coverage only when the insurer shows prejudice from the late notice. No. 06-0598, ___ S.W.3d ___, 2009 WL 795530, *Prodigy Communications Corp. v. Agricultural Excess & Surplus Ins. Co.* (Tex. March 27, 2009). *See also* No. 07-1059, ___ S.W.3d ___, 2009 WL 795529, *Financial Indus. Corp. v. XL Spec. Ins. Co.* (Tex. March 27. 2009).

B. Qualifying as an Insured

D&O policies often provide three basic categories of coverage:

- side A covers the cost of defending and indemnifying directors and officers for claims not indemnified by the corporation;
- side B reimburses the corporation for its indemnification of directors and officers; and
- side C is "entity coverage" for the corporation itself.

Not all D&O policies provide each type of coverage.

The potential insured's relationship to the insured entity and the nature of the claim can also affect coverage. D&O policies usually define coverage in terms of "wrongful acts," but limit coverage to wrongful acts performed within a specific capacity. For example, a director or officer might be covered against shareholder suits under a D&O policy for board actions, but might not be covered if the director's liability stems from legal or accounting services rendered. In that case, E&O coverage might be triggered instead. On the other hand, the activity for which a "professional" is sued may not fall within the policy's definition or a court's construction of "professional service." The policy might also expressly exclude certain activities, such as underwriting, from the definition of either wrongful acts or professional services. A review of the company's bylaws may be necessary to determine whether the executives and managers named in a suit are considered "officers" for purposes of the policy. Allegations of *ultra vires* acts may also disqualify a party that would otherwise fall within a definition of insured.

C. Are the Claim and Loss Covered?

After determining whether the actor qualifies as an insured and the claim falls within an applicable policy's coverage period, coverage counsel must confirm that the claims and loss alleged fall within the coverage provided by the insuring agreement and definitions. For example, a typical D&O policy insuring clause for Side A says:

> The Insurer shall pay on behalf of the Insured Persons Loss resulting from a Claim first made against the Insured Persons during the Policy Period for a

Wrongful Act except for Loss which the Company is permitted or required to pay on behalf of the Insured Persons as Indemnification.

"Claim" is usually defined broadly to include written demands and formal investigations, as well as suits. Many policies include governmental or regulatory investigations within the definition of "claim" and provide coverage for defense costs incurred in responding to these investigations, but these policies may or may not provide indemnity coverage for statutory penalties in addition to other settlement or judgments. If the regulatory request and investigation is informal and a settlement is made in compromise to avoid a formal investigation, coverage may be precluded entirely. *See National Stock Exch. V. Federal Ins. Co.*, 2007 WL 1030293 (N.D. Ill. March 30, 2007)(informal document request regarding subprime activities did not constitute "claim"). Similarly, costs of internal investigations or special litigation committees may not be covered unless the policy specifically includes them within a definition of litigation or defense costs.

"Loss" is usually defined to include damages, judgments, settlements, and attorney's fees and costs of defense. But generally the policies do not cover the insured's liability for equitable relief. Mortgage purchasers who are merely trying to get lenders to buy back their mortgages may be seeking only equitable relief or breach of contract damages that do not constitute a covered "loss." The line between legal and equitable damages is also blurred when questions of restitution and disgorgement of profits arise, especially if these are not addressed in the policy's definition of "loss."

As in CGL policies, the wording of a D&O policy may attempt to exclude intentional wrongdoing through the insuring clause as well as through exclusions. This means, for example, if a company is found liable for intentionally failing to disclose or intentionally and wrongfully obtaining monies, then its D&O policy may not cover such a claim. Elizabeth A. David, et al., *Recent Developments Affecting The Liability of Professionals, Officers, and Directors,* 39 Tort Trial & Ins. Prac. L.J. 671, 691-92 (2004).

D. Exclusions

The typical D&O policy will have a number of exclusions potentially applicable to a credit crisis claim, including the "dishonesty", personal profit or advantage," and "insured v. insured," exclusions. Punitive damages may be excluded either through the insuring clause or through a specific exclusion as discussed under CGL coverage. As earlier discussed, under appropriate facts, coverage for punitive damages may also be barred by state public policy. *Fairfield Ins. Co. v. Stephens Martin Paving, Inc.*, 246 S.W.3d 653 (Tex. 2008).

1. Dishonest/Fraudulent Acts Exclusion

Dishonesty exclusions can vary widely, some referring to "dishonest" acts and some more narrowly to "criminal" acts. [15] While these exclusions probably do not require the same

[15] For a more detailed description of issues concerning this exclusion, *see* A. Rutkin and R. Tugander, *Dishonesty and Personal Profit Exclusions as Bars for Coverage for Suits Arising from the Subprime Crisis*, 43-4/44-1 Tort Trial & Ins. Prac. L.J. 169 (2008).

degree of scienter or intent to harm as intentional injury exclusions under CGL policies, some dishonesty exclusions require that the excluded conduct be "deliberate" or even "deliberate and active." The degree to which courts are willing to enforce these exclusions is an open question; the justification for the exclusions is often that dishonest conduct should be not insurable as a matter of public policy. However, as the Texas Supreme Court stated in the *Fairfield* case regarding the insurability of punitive damages, public policy does not preclude the insurability of damages awarded for malicious conduct as a matter of course if the liability for those damages is vicarious or the insurance policy anticipates their coverage. *Fairfield Ins. Co.,* 246 S.W.3d 653 (Tex. 2008). Courts in other jurisdictions have limited the reach of these exclusions, particularly when the policy appears to have been written to cover a specific class of claims. *See, e.g., Alstrin v. St. Paul Mercury Ins. Co.*, 179 F.Supp.2d 376 (D. Del. 2002). Moreover, similar to the *King* case under CGL policies, courts may separate the conduct of the various insured parties so that the same claim that was caused by dishonest conduct of one insured and is not covered for him, is covered for another insured, who was merely alleged to be negligent in monitoring or reporting conduct. *See, e.g.*, *King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185, 191-192 (Tex. 2002).

Furthermore, most of these exclusions require either proof of the dishonesty "in fact" or an adjudication to take effect. Mere allegations of dishonesty will not prelude the duty to defend in this case, although a final adjudication of fraud or a criminal conviction may result in an enforceable right to reimbursement of defense costs – whatever that is worth. *See In re Enron Corp. Secs. Derivative & "ERISA" Litig.*, 391 F.Supp.2d 541, 575 (S.D. Tex. 2005).

2. Personal Profit Exclusion

As with dishonesty exclusions, this common exclusion of D&O and E&O policies is likely to be implicated in a wide range of credit crisis claims.[16] While the language of this exclusion also varies, it commonly precludes coverage for losses "arising out of the gaining in fact of any personal profit or advantage to which the insured is not legally entitled." In a sense, this exclusion simply confirms public policy and the legal principle that "losses" resulting from the disgorgement and restitution for ill-gotten gains are not covered – either because these losses are an aspect of an equitable remedy rather than legal "damages" suffered by the injured party or because proceeds from a crime are not insurable. Litigation involving this exclusion usually involves: (1) whether the insured was "legally entitled" to receive the profits in the first place; and (2) the type of quantum of evidence required to establish the insured's lack of entitlement. In addition, if the exclusion precludes coverage only for "the insured" who receives the profit, the insurer will be required to show that the insured for which coverage is challenged directly profited. *See TIG Specialty Ins. Co. v. Pinkmoney.com Inc.*, 375 F.3d 365, 371 (5th Cir. 2004)(exclusion barring coverage when "an insured" receives a profit bars coverage for all insureds regardless of which insured actually profits).

Although criminal conduct may provide the best evidence of forbidden profits, courts have often broadly construed the exclusion by focusing on terms such as "arising from" and "advantage." As with the dishonesty exclusions, the quantum of evidence required to

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[16] *See* A. Rutkin and R. Tugander, 43-4/44-1 Tort Trial & Ins. Prac. L.J. at 169.

demonstrate that the insured was not entitled "in fact" to the profit may require that the insurer reimburse for a defense unless there is a prior criminal conviction or adjudication.

3. Insured v. Insured Exclusion

This exclusion usually excepts claims by, on behalf of, or in the name of any Insured Person, except for certain exceptions such as independent derivative actions. It became common in the 1980's when financial institutions started suing their own officers and directors in order to recover for bad loans. In the vast majority of cases, its application or non-application should be clear.

VI. THE PROFESSIONAL ERRORS AND OMISSIONS POLICY

Claims arising out of professional services rendered are usually expressly excluded under a CGL policy. Accordingly, firms and individuals rendering professional services that are at risk of being charged with having committed a material error or omission by their clients cover their potential liabilities by purchasing an E&O policy. Exposures covered by E&O insurance include professional liability, malpractice, and breach of fiduciary duty. Most carriers will offer specialized programs for each profession (*i.e.*, lawyers, accountants, engineers, physicians, mutual fund complexes, securities firms, etc.).

Like D&O policies, E&O policies are often "claims-made" policies and their duty to defend or indemnify often is included as part of the limits of coverage, making them "eroding" policies. Moreover, it is not uncommon for an E&O policy to have a significant (at least for an individual insured) deductible, such that the insured must come "out of pocket" for his defense until the deductible has been met.

E&O policies will cover claims against the professional for "Wrongful Acts." A "Wrongful Act" is usually defined as:

> Any actual or alleged statement, misstatement, error or negligent act committed or allegedly committed by the Insured, or by any other person whose actions the Insured is legally responsible, in rendering or failing to render Professional Services.

"Professional Services" are defined as "only those services performed or required to be performed by the Insured for compensation for a customer or client of the Insureds, pursuant to an agreement between such customer and the Insureds."

Like D&O policies, E&O policies will commonly exclude claims for fraud/dishonesty, unearned profit or advantage, and punitive damages. They also commonly exclude claims for (1) liability arising from the liability of a party pursuant to a contract (similar to the CGL exclusion) and (2) reimbursement of fees, commissions, costs or other charges paid or payable to the professional or for allegations against the professional of excesses fees, commissions, costs and other charges. The latter can become particularly important in Texas where attorneys can be

found to have lost their right to all or part of their compensation if they violated their duties to a client. *See Burrow v. Arce,* 997 S.W.2d 229 (Tex. 1999).

VII. OTHER ISSUES

Although not discussed in this paper, any other insurance issue can be applicable to these types of claims. These include questions of trigger of coverage (for CGL policies), application of other insurance clauses, allocation of claims, and number of occurrences (especially when a policy has an aggregate limit higher than its per occurrence limit.

VIII. CONCLUSION

With trillions of dollars of losses in portfolio losses as well as claims against numerous entities, the types of claims and the parties against whom they will be filed are going to be limited only by the fertile imaginations of attorneys for people and corporations that feel aggrieved. Target individuals and corporations should review the totality of their coverage and be prepared to present a claim to each of their carriers under each policy that may be applicable.