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D&O INSURANCE APPLICATION SEVERABILITY

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The material in this outline is not intended to provide legal advise as to any of the subjects mentioned but is presented for general information only. Readers should consult knowledgeable legal counsel as to any legal questions they may have.

One of the most important provisions in a directors and officers liability insurance policy is the Application severability clause. Such a provision determines in large part the extent to which coverage for a director or officer may be jeopardized by false information in the Application.¹

Issues relating to Application severability are not new under a D&O insurance policy, but are now being given unprecedented attention for several reasons, including the following:

- During much of the 1990's soft insurance market, D&O insurance Applications frequently were not used, thereby reducing the instances when coverage defenses based on misrepresentations in the Application arose;
- Insureds are now more frequently submitting long-form Applications (which contain broad warranties and representations), because companies are more often buying more insurance from new insurers;
- In the aftermath of numerous recent corporate debacles and the resulting claims severity, Insurers have been forced to adopt more protective and prudent underwriting practices.
- The increased frequency of financial restatements and corporate fraud in recent years has led to an increased focus on rescission issues;
- In the post-Enron era, particularly outside directors are demanding greater assurance that their insurance coverage will be available regardless of the conduct of other Insureds.

This paper summarizes the types of Application severability provisions utilized by different insurers, the effects of these provisions, and the need to balance the legitimate interests of the Insureds and the Insurer in crafting an appropriate severability provision.

What is Application Severability?

Generally, courts have held that absent special policy language, a representation by one Insured in the D&O insurance Application can void the policy as to all Insureds, including Insureds who had no knowledge of the misrepresentation or the facts that were not properly disclosed. Because underwriters rely on the information in the Application when making underwriting decisions regarding the entire policy, this rule allows insurers to rescind the entire policy if that information is false. To avoid that result, most D&O insurance policies contain an Application severability provision which is intended to preserve coverage for so-called innocent Insureds even if other Insureds misrepresent material information to the Insurer in the Application.

¹ D&O insurance policies typically also contain an exclusion severability provision, which limits the imputation of acts and knowledge of one director or officer to other insured directors and officers for purposes of applying some or all of the exclusions in the policy.

There are several different types of Application severability provisions utilized by D&O insurers. A “full” severability provision either states that the Application is deemed to be a separate Application by each Insured or states that no knowledge of one Insured is imputed to another Insured for purposes of the Application. If the Policy includes entity coverage, this full severability provision usually states that only the knowledge of certain executive officers of the insured Company is imputed to the Company for purposes of determining coverage for the Company. A full severability provision is intended to preserve coverage for an Insured even if another Insured knew facts that should have been but were not truthfully disclosed to the Insurer during the underwriting process.

A “limited” severability provision states that the knowledge of one Insured is not imputed to another Insured for purposes of the Application, except that the knowledge of either the signer of the Application or alternatively the knowledge of certain designated Executive Officers is imputed to all Insureds. Under this limited severability provision, coverage for all Insureds could be rescinded by the Insurer if the signer of the Application or any of the designated Executive Officers knew of the false information which was not properly disclosed to the Insurer in the Application. If any Insured other than the signer or a designated Executive Officer knew such information, severability would apply, and the Insurer would be able to rescind coverage only for the Insured who knew of the misrepresented information.

Although historically most Insurers utilized a full severability provision, many Insurers today are moving toward some form of limited severability.

Why is Severability Important?

Absent a severability provision, if material information submitted to the Insurer during the underwriting process is false, the Insurer may be entitled to rescind coverage under the policy for all Insureds. If successful, such rescission voids the coverage ab initio (i.e., “from the beginning”) and thus the coverage is deemed to never have existed. The justification for this remedy is that the Insurer would not have agreed to issue the policy at the agreed upon terms if the true facts had been disclosed to the Insurer, and therefore the Insurer should not be required to provide the coverage which was obtained under false pretenses.

The type of facts which the Insurer must prove in order to rescind coverage varies from state to state. At a minimum, the Insurer must prove that the Insureds made representations to the Insurer in the underwriting process which were materially false and upon which the Insurer relied in underwriting the policy. Most states do not require the Insurer to prove that the Insureds intended to deceive the Insurer. An unknowing mistake by the Insureds can be sufficient to justify rescission if the Insurer relied to its detriment on the false information. However, other states require the Insurer to prove that the Insureds either intended to deceive the Insurer or had knowledge of the misrepresentation in order to rescind coverage.

As noted above, if an Insurer successfully rescinds coverage, that coverage is treated as never having existed. Thus, Insureds who believe they purchased important insurance protection can be surprised to learn several years later that they in fact have no such insurance protection due to a misrepresentation in the Application by someone else. Frequently, the issue of rescission does not arise until the Policy Period has expired, at which time it is virtually

impossible for the Insureds to replace the lost coverage with other retroactive claims-made coverage.

As a result, the existence and quality of an Application severability provision can be critically important to directors and officers. For claims which cannot be indemnified by the Company (e.g., settlements in shareholder derivative suits and situations where the Company is insolvent), the personal assets of the defendant director and officer may be at risk unless the D&O insurance coverage can be preserved through a severability provision.

Why is Severability a Difficult Issue?

Both Insureds and Insurers have very legitimate, but conflicting, concerns regarding misrepresentations in a D&O insurance Application. Directors and officers, particularly outside directors, who acquire a D&O policy in good faith understandably want the assurance that they have insurance protection even if another Insured misrepresented information to the Insurer in the underwriting process. On the other hand, Insurers who rely on false information when making underwriting decisions understandably want a remedy for such misrepresentation, particularly if the Insurer would not have issued the Policy at the agreed terms but for the misrepresentation. Simply denying coverage for the Insured who made the misrepresentation affords little, if any, relief to the Insurer since in most claims the Insurer would still be required to pay out large amounts for other Insureds under the improperly obtained Policy.

Unfortunately, one cannot fully reconcile these two legitimate yet conflicting perspectives. Both the “innocent” Insureds and the Insurer are victims of the misrepresentation, yet only one of those two victims can obtain their desired relief (i.e., the Insureds obtain coverage or the Insurer voids the coverage). Stated differently, either the Insurer will be forced to pay potentially large amounts under a Policy which the Insurer would have never issued if the Application contained truthful information; or the Insureds who innocently relied on the existence of D&O insurance coverage when agreeing to serve will lose their very important insurance protection.

Although a “limited” severability provision seeks a partial compromise between these two competing concerns, any type of Application severability provision can create an inequitable result for the Insurer, particularly if the misrepresented information in the Application gives rise to loss which is covered under the policy because of the severability provision.

Does Severability Eliminate All Rescission Risks for Innocent D&Os?

Even if the D&O policy provides full severability, “innocent” directors and officers still have a risk that the Insurer may rescind their coverage under certain circumstances. A severability provision merely precludes imputing knowledge of one Insured to another Insured. As explained above, in most states an Insurer need not prove the Insureds knew of the misrepresentation or intended to deceive the Insurer in order to rescind coverage. Because knowledge or intent is irrelevant to a rescission analysis in most states, the existence of a severability provision may likewise be irrelevant. In other words, the Insurer may be able in certain circumstances to rescind the entire policy even if the policy contains a full severability provision. This risk depends in part on the type of alleged misrepresentation in the Application.

Most frequently, an Insurer may seek to rescind coverage under a D&O insurance policy in one of two situations. First, a long-form Application usually inquires whether any prospective Insured knows of any facts or circumstances which may give rise to a claim in the future. If an Insured knows of such facts or circumstances but fails to disclose that information in the Application, the Insurer may have grounds to rescind coverage. Because such a misrepresentation relates to the knowledge of an Insured, a severability provision should protect “innocent” Insureds from rescission even in states which do not require knowledge or an intent to deceive, if the rescission is based upon another Insured knowing about but not disclosing in the Application such a potential claim (i.e., knowledge of the potential claim will not be imputed to the “innocent” Insureds).

Second, rescission may be based upon the falsity of objective facts which are disclosed in Application answers. The submission to the Insurers of false financial statements (as evidenced by their subsequent restatement) is one of the more frequent circumstances which can give rise to this type of rescission. If under applicable state law the Insurer is not required to prove the Insureds intended to deceive the Insurer in order to rescind coverage, a severability provision may afford little if any protection to the “innocent” Insureds in this type of rescission. Because knowledge or intent is irrelevant, a severability provision which simply states that the knowledge of one Insured shall not be imputed to another Insured may be similarly irrelevant. Thus, depending upon what state law applies, even a full severability provision may afford no protection to Insureds against rescission if the Application contains false financial statements or other objectively false information.

What is the Preferred Solution to these Issues?

One reasonable severability solution which is gaining some popularity today recognizes that the preferred type of severability provision varies depending on the type of coverage being afforded. Because Side-A coverage (either under Insuring Clause A of a standard D&O policy or in a “Side-A Only” type of D&O policy) protects the personal assets of directors and officers against non-indemnifiable losses, the Insureds have the greatest need for full severability protection under that coverage, and Insurers are most willing to grant that protection for Side-A coverage. In fact, some Insurers in certain situations have gone so far as to expressly waive in the policy their right to rescind Side-A coverage.

In contrast, the more frequently invoked coverage for the Company (i.e., coverage under either the corporate reimbursement Insuring Clause B or the entity securities Insuring Clause C) merely protects the corporation. If the Executive Officer who acted on behalf of the corporation in obtaining the D&O policy knew of the Application misrepresentation, the Insurer should be entitled to rescind coverage for the corporation (i.e., limited severability should apply to Insuring Clauses B and C). This approach does not harm, and to some extent helps, the insured directors and officers since more of the policy’s limit of liability is preserved for Side-A losses which the directors and officers might otherwise have to pay personally.

Like many other aspects of a D&O insurance policy, Application severability creates difficult and challenging issues for both Insureds and the Insurer. There are no simple or easy solutions. Instead, both parties need to understand and appreciate the legitimate concerns of the

other and be willing to engage in a good faith dialogue regarding how to best address these competing concerns.