

This article originally appeared in riskVue, the free, monthly Webzine that analyzes and reports on the latest issues facing today's risk professional. Each issue is packed with important, useful information, including a feature story, risk news bites, an industry watch, writing tips, useful Web tools, and a look at the lighter side of things. Read the current issue and sign up for your free subscription at www.riskvue.com.

FEATURE STORIES

D&O Insurance: The "Profit or Advantage" Exclusion: How Bad Is It?

By R. Mark Keenan and Craig M. Hirsch

Today's headlines all too often detail class action lawsuits alleging "greed" and "avarice" by corporate directors who "ransack the corporate till" and "line their personal coffers as their companies flounder."

In many cases, such allegations prove to be entirely untrue.

But the road to vindication can be costly. Will your D&O insurance cover the defense costs incurred in your victory?

The "profit or advantage" exclusion under D&O liability policies is often used by insurance companies to deny coverage regardless of the veracity of the allegations. These provisions exclude the insurance company's obligation to pay out proceeds when directors and officers make, *in fact*, any profit or advantage they were not legally entitled to. As one court portended, *the "profit or advantage" exclusion is evolving into a "black hole" threatening to swallow up almost every legitimate claim of loss* tendered by a corporation seeking to rely on the insurance policy and the premiums it has already paid.

What Constitutes "Profit" or "Advantage" Under the Exclusion

A standard provision reads that the insurance company will not be liable for losses in connection with a claim "arising out of, based upon or attributable to the gaining in fact of any profit or advantage to which an Insured was not legally entitled."

The courts addressing this exclusionary language have made a distinction between the actions of two groups of directors: (1) the individual director who makes an illegal or illicit financial profit, whether it be through a sham stock transaction, personal transaction with the company or other forms of self-dealing and (2) the individual director whose only indiscretion is negligent oversight or failure to implement monitoring procedures to prevent others from gaining illegal profits. The "profit or advantage" exclusion was ostensibly made to apply to the former group, but should *never* be extended to include the latter group who gained no financial profit, advantage or opportunity through their unwitting ignorance or shameful neglect of their executive responsibilities. In either case, the exclusion only applies if the wrongful conduct is found "in fact" to have occurred.

Group One: Illegal Pecuniary Gain by Directors and Officers

A cogent analysis of this issue came from the District Court of Colorado in *Nicholls v. Zurich American Insurance Group*, 244 F. Supp. 2d 1144 (2003). There, the corporation's directors set up putative private placement sales to third-party investors under the guise that the shares being transferred emanated from the company's treasury. While investors believed that the proceeds of these transactions went directly towards day-to-day operating capital, instead they were funneled into the directors' wallets.

When an insurance dispute arose under the “profit or advantage” policy exclusion, the Court surmised that the language of the provision was clear and the actions of the directors fell squarely within it. The Court noted the prevailing logic behind the exclusion was “to prevent the looting of corporate assets by directors and officers and then, after being forced to remit the funds, turning to an insurer seeking indemnification for their wrongful acts under a directors and officers policy.”

However, this exclusion becomes applicable *solely* when the claims of illegal personal profit against directors and officers are proven accurate through evidence. If the accusations turn out to be specious, with the underlying allegations untrue *in fact*, then the exclusion cannot be triggered and one hundred percent of the insurance coverage must remain viable.

Group Two: Silent Acquiescence or Unwitting Ignorance by Directors and Officers Merely Breaching their Duty of Care

The insurance company cannot rely on the exclusionary language when a claim of loss arises from the Board’s failure to institute oversight or monitoring mechanisms meant to stop the very transactions attributable to Group One. To ensure this result, a smart policyholder will bolster his coverage by requesting a severability clause that modifies the exclusion. Such a provision commonly states, “the Wrongful Act of an Insured shall not be imputed to any other Insured for the purpose of determining the applicability of the foregoing exclusions.” This will thwart the insurance company’s efforts to impute the actions of officers who illegally profit to other directors and managers only culpable for corporate losses through their neglect or managerial ineptitude.

Clearly, any argument advanced by the insurance company attempting to color the actions of Group Two as an illegal profit or advantage should be summarily rejected by the courts. These directors do not reap a financial profit, pecuniary gain, business advantage or any other measurable increase in personal wealth by the mere derogation of their duty of care. As one court aptly noted, the “profit or advantage” exclusion necessitating a determination to deny coverage “by its terms, requires a profit or gain that is illegal; not an illegal act that produces a profit or gain to the [policyholder] as a by-product.”

What constitutes an “in fact” profit or advantage is unclear. While the case law does not provide a bright-line rule for interpretation, one commentator imparts that the definition of “in fact” may “imply less of a threshold of proof than adjudication.” However, prevailing wisdom suggests that the exclusion will only operate if an “adverse determination” against the director or officer has been decreed by the courts. Therefore, naked allegations which have not run the evidentiary gauntlet should not invoke any dormant policy exclusions requiring an “in fact” illegal profit or advantage as a condition precedent.

Don’t let your insurance company muddle the plain meaning of the “profit or advantage” exclusion. Know your rights. 📌

ABOUT THE AUTHORS

R. Mark Keenan is a senior shareholder in the New York office of Anderson Kill & Olick and Co-Chair of Anderson Kill’s Financial Services Group. His practice focuses on Insurance Coverage Securities Law and Litigation. Mr. Keenan regularly represents policyholders in insurance coverage disputes. Mr. Keenan can be reached at mkeenan@andersonkill.com or 212-278-1888. **Craig M. Hirsch** is an attorney in the New York office of Anderson Kill & Olick, P.C. Mr. Hirsch can be reached at chirsch@andersonkill.com or by phone at 212-278-1470.

Reprinted with permission from the Autumn 2004 issue of *AKO Financial Services Alert*, a publication of Anderson Kill & Olick, P.C.