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Concretely Phrased, Narrow in Scope: Conduct Exclusions in D&O and E&O Policies

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Most D&O and E&O policies include what are often called "conduct" exclusions, which bar coverage for losses arising out of a determination that the policyholder acted criminally, fraudulently, dishonestly and/or maliciously. Unlike typical substantive D&O/E&O exclusions (bodily injury, insured vs. insured, etc.), conduct exclusions typically only take effect if and when the policyholder is judged liable for the specified type of conduct. This generally enables policyholders to retain their initial right to an insurance company-funded defense until there is a finding of wrongdoing.

The language of conduct exclusions varies significantly, leaving ample opportunity for insurance companies to interpret the language in self-serving ways. As is often the case in insurance policy interpretation, the devil is in the details.

"Criminal," "Fraudulent," "Dishonest," "Illegal," "Malicious"

In the hands of an insurance company adjuster, the words listed above can have very different meanings, and they are rarely defined terms in a policy. While "criminal" and "fraudulent" are terms of art with specific definitions in law, "dishonest" is an inherently subjective term not governed by any formal legal standard. "Illegal," though perhaps more concrete, could be problematic because in theory any judgment against a policyholder could suggest the policyholder did something "illegal." An exclusion for "malicious" conduct lies somewhere in between—malice has an explicit meaning in certain areas of law, but also lends itself to subjective interpretation.

Phrasing like "deliberate criminal acts," for example, is particularly advantageous for policyholders, for two reasons. First, "criminal" refers to a concrete category of legal violations pursued by state or federal prosecutors, decreasing the likelihood that an insurance company would attempt to construe the exclusion overly broadly. "Fraudulent" can also provide certainty, since some underlying claims allege fraud while others do not. Second, "deliberately" imposes the burden upon the insurance company to show that the crime in question includes a knowledge standard not present in every single crime.

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"Determination in Fact," "Adverse Admission," "Adjudication," "Final Adjudication," "Final Non-Appealable Adjudication"

The next question is what type of adverse legal finding triggers the exclusion. Many lawsuits end in settlement, and nearly all conduct exclusions are not triggered by settlement, incentivizing policyholders to settle before motion practice or trial. Assuming the case does not settle, however, the exclusion's trigger language, which can vastly differ, becomes of central importance.

The most advantageous conduct exclusions are triggered only by a final and non-appealable adjudication against the policyholder. Conversely, insurance companies may interpret references to "determinations in fact," "adverse admissions," or other potentially non-final determinations as giving them license to adopt an earlier trigger. Triggers like "written admission by the Insured" or "plea of nolo contendere or no contest regarding such conduct" make it more likely that the insurance company will apply the exclusion. An insurance company might attempt to latch onto a statement by the policyholder's representative at deposition or a preliminary finding of fact by the court. Even an exclusion that lacks only the "non-appealable" component could be fodder for an insurance company to argue against coverage, even if an incorrect result is overturned on appeal.

Final, non-appealable adjudication language ensures the policyholder gets its full "day" in court and pushes the coverage decision further into the future, increasing the likelihood of a settlement that avoids the conduct exclusion altogether.

Severability

In order to preserve the rights of individual insured persons not involved in the conduct at issue, policyholders should negotiate for severability language ensuring that the acts of one insured person are not imputed to another insured person. Without this key carveout, insurance companies could try to use the criminal, fraudulent, dishonest, illegal or malicious act of one individual to preclude coverage for all insureds.

Recoupment

The final key issue with any conduct exclusion is whether the exclusion (or another policy provision) requires the policyholder to retroactively reimburse the insurance company in the event of an adverse determination triggering the conduct exclusion. Recoupment provisions are of major importance to policyholders and insurance companies alike, as defending a claim can cost millions, regardless of whether the policyholder has any liability in the end.

Recoupment language is not always obvious. In many policies, recoupment is addressed in a separate section concerning the conditions of the insurance company's defense obligation. The provisions are often ambiguous and encompass situations other than just the conduct exclusion. Some policies have no recoupment provision at all, offering the policyholder significant peace of mind.

Conclusion

The foregoing discussion illustrates not just the centrality of conduct exclusions in D&O/E&O policies but the extent to which they can differ. The best exclusions are concretely phrased and narrow in scope. Policyholders should always beware that their insurance companies will seek to interpret any conduct exclusion, no matter its terms, broadly.

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