

D&O Insurance Policies May Protect Against Y2K Bug



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B&O Insurance policies may provide significant protection against Year 2000 Bug related claims. Policyholders may find, however, that many D&O

insurance companies will attempt to deny coverage for certain claims for no other reason than that the claims are related to the Year 2000 Bug. Indeed, a paper prepared for one insurance company concluded that corporate insurance policies that "are silent on the [Year 2000 Bug] issue will rarely (and poorly) serve the best interests of the Board of Directors." Below is a discussion on some key coverage issues which may arise when policyholders file Year 2000 Bug related claims under their D&O insurance policies.

Wrongful Acts

Directors and officers of companies may become the frequent targets of claimants alleging that they have suffered losses caused by Year 2000 Bug problems. The two main claims that directors and officers may face stem from allegations: (1) that the company's Year 2000 compliance program was mismanaged and thus failed to remedy the company's computer operations before the new millennium; and (2) that the company failed to properly disclose the magnitude of the company's Year 2000 problem. Directors, officers and their companies may have insurance coverage under their D&O liability insurance policies for claims such as those described above.

Under the insuring provisions of many D&O policies, insurance companies are obligated to provide insurance coverage to their policyholders by:

pay[ing] the Loss of each and every Director or Officer of the Company arising from a Claim first made against the Directors or Officers during the Policy Period . . . for any actual or alleged Wrongful Act in their respective capacities as Directors or Officers of the Company except when and to the extent that the Company has indemnified the Directors or Officers.

"Wrongful Act" is often defined as any breach of duty, neglect, error, misstatement, misleading statement, omission or act by the Directors or Officers. As such, many claims made against directors and officers arising out of their alleged failure to disclose the scope of the company's Year 2000 exposure or to properly manage the conversion efforts of the company's computer systems should be covered as "Wrongful Acts" under the company's D&O liability policy. Indeed, cases addressing the scope of the "Wrongful Act" insuring provision of a liability insurance policy have recognized the broad grant of insurance protection conferred.

For example, in *Reliance Group Holdings, Inc. v. National Union Fire Ins. Co.*, addressing insurance coverage under a directors' and officers' ("D&O") liability insurance policy, the New York Appellate Division, First Department, noted that "Wrongful Acts" was defined broadly in the D&O policy, and that "[i]t would be hard to think of any act or omission by a director or officer, acting as such, which would not be covered by this definition." Similarly, in *Independent School District No. 697 v. St. Paul*, the Minnesota Court of Appeals rejected an insurance company's arguments against insurance coverage

for a claim where the liability insurance policy provided for “broad ‘Wrongful Acts’ coverage.”

Defense Costs Payable As Incurred

One distinguishing feature under the vast majority of D&O policies — as compared to other types of liability insurance policies — is that D&O policies do not require the insurance company to provide a defense to a lawsuit against the officers and directors covered under the D&O policy. Instead, the insurance company must reimburse the policyholder for defense costs. Some insurance companies have argued adamantly that they are not required to pay defense costs as they are incurred by the policyholder, but instead may wait until a settlement is reached or a judgment is rendered in the action against the officers and directors. Policyholders should know that numerous courts have held otherwise, and have required insurance companies to pay their policyholders’ defense costs as they are incurred under D&O liability policies.

Insurance Company Allocation Attempts

One argument occasionally raised by insurance companies to reduce significantly D&O insurance coverage involves the issue of allocation. By way of background, under most D&O insurance policies, only the directors and officers are afforded insurance coverage for “Wrongful Acts.” Typically, the company itself is not covered under the D&O policy.

Some D&O insurance companies routinely argue that they are entitled to apportion their costs of defense and indemnification between insured and uninsured parties. As such, insurance companies may argue that they are entitled to a reduction in the amount that they must pay under the D&O policy for liability and loss attributable to the company. By allocating these costs between those covered under the D&O policy (e.g., the officer) and those who are not (e.g., the company), some insurance companies attempt to saddle the corporation with as much of the expense as possible in order to reduce greatly their payout under the D&O policy.

Allocation issues can occur at two points in time. First, there is the allocation of defense costs and expenses during the time the underlying claims against the officers are pending. Second is the allocation of indemnity payments at the time of any settlement or judgment. While the majority of D&O

policies make no reference to issues of allocation, some insurance companies regularly attempt to allocate costs of defense and indemnity on an arbitrary 50-50 basis. This is true even where little or no investigation of the surrounding facts has taken place.

Fortunately for D&O policyholders, several courts have refused to rule in favor of insurance company attempts to limit insurance through allocation. In *Harbor Ins. Co. v. Continental Bank Corp.*, Judge Richard A. Posner of the United States Court of Appeals for the Seventh Circuit held that, “To allow insurance companies an allocation between the director’s liability and the corporation’s derivative liability for the director’s acts would rob the [policyholder] of the insurance protection that it sought and bought.” Despite some of the recent cases ruling in favor of policyholders, few believe that many D&O insurance companies will abandon completely their attempts to impose allocation upon their policyholders. Consequently, when dealing with a sizeable Year 2000 claim, an insurance company may try to argue that the company, which is not covered under the D&O policy, is somehow significantly liable or potentially liable and therefore D&O insurance coverage is substantially reduced for the Year 2000 claim. Indeed, one insurance company underwriter has warned that insurance companies will attempt allocations as high as 95 percent under D&O policies for Year 2000 Bug related claims.

D&O Policy Exclusions

In addition to the potential for a reduction of D&O insurance coverage where an insurance company pushes the allocation argument, policyholders should also be aware that D&O policies, like professional malpractice policies, are weighed down with exclusions, which can further erode D&O insurance coverage. In fact, while the insuring provisions of the insurance policies may be just a few lines long, the policy’s exclusions typically will run on for a number of pages. Accordingly, some insurance companies will attempt to apply these numerous insurance policy exclusions broadly, and in a manner that undermines the protection of the insurance policy that the policyholder relies upon and expects.

Conclusion

D&O insurance policies may provide significant protection against Year 2000 Bug related

claims. Policyholders of almost every kind should be aware that there is a potential for severe interruptions in commerce and communication due to the Year 2000 Bug. Nevertheless, one thing which policyholders can do when liabilities or losses arise, is to immediately consider any possible avenue of insurance coverage to address their claims. Policyholders pay substantial amounts in premiums to have insurance protection. Accordingly, policyholders should make use of these assets when faced with losses or liabilities stemming from Year 2000 Bug claims. ■

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