EXECUTIVE PROTECTION

D&O INSURANCE

The Policy Application

This article examines issues surrounding the application for D&O insurance and the application process. Although this might appear to be a straightforward topic, there are actually several important issues surrounding the D&O insurance application.

THE POLICY DEFINITION OF "APPLICATION"

As with most insurance, D&O insurers usually require insurance applicants to complete an insurance application as part of the insurance acquisition process. The D&O insurance application is of course a physical document – but it is much more. The term "Application" is usually defined to comprise several categories of materials beyond just the physical document.

The term "Application" is often defined broadly to include all prior applications that the applicant previously submitted; all materials submitted with the application; and, in the case of public companies, all documents filed with the SEC or equivalent regulatory bodies. These policy definitions of the term "Application" are sometimes unnecessarily broad and need to be narrowed to avoid sweeping in an entire universe of information that has no reasonable relationship to the actual application process. Fortunately, carriers will favorably reduce the documents to those filed within the preceding twelve months.

THE APPLICATION FORM ITSELF

With respect to the physical application document itself, there is a further question of *which* application form is appropriate for an insured to be asked to complete and submit. Specifically, there is an important difference between the questions that may be asked when new coverage is being placed (or increased limits are being procured), compared to what may be asked when existing coverage is being renewed.

When new coverage or increased limits are being put in place, it is appropriate for the insurer to ask the so-called "warranty question"– that is, whether the applicant is aware of any fact, situation or circumstance that might reasonably be expected to give rise to a claim. (The actual wording of the representation required varies among insurers and applications.) Any matters disclosed pursuant to the warranty statement will be excluded from coverage.

Because the policyholder is entitled to expect complete continuity of coverage in successive policy years, the warranty question is emphatically not appropriate in connection with the renewal of existing coverage.

Unfortunately, some insurance brokers sometimes use applications including the warranty question even in connection with renewals of existing coverage. The problem with providing an answer to the warranty question on renewal is that it can potentially provide the carrier with a basis on which to try to disclaim coverage, when the question should not even have been asked or answered in the first place.

APPLICATION MISREPRESENTATIONS AND THE CONSEQUENCES

The question of the carrier seeking to rely on application responses to disclaim coverage leads to the larger question of policy rescission – that is, the question of when the carrier may, on the basis of alleged material misrepresentations in the policy application, seek to have the policy declared void *ab initio* – that is, as if it had never been put in place. There are several components of this question, each one raising important considerations in connection with the wording of key policy terms and conditions.

The first issue of course is what the application consists of, as noted above. The second question is whose alleged misrepresentations may be relied on by the carrier and against whom they may be used.

THE REPRESENTATIONS CLAUSE

Many policies will specify in a representations clause whose knowledge of the misrepresented facts will result in a vitiation of coverage. For example, the policy might specify that if certain top company executives are aware that application statements were untrue, then coverage will not apply to those executives or to the company. Because the operation of the representations clause could void coverage for the company, it is critical that the group of persons whose knowledge can be imputed to the company be restricted and as narrow as possible, preferably no more than the CEO, CFO and General Counsel.

NON-IMPUTATION AND SEVERABILITY

Two related issues pertain to questions of imputation and severability. The question is basically whether one individual's knowledge will be imputed to the company or to other individuals. As noted in the preceding paragraph, certain officials' knowledge will be imputed to the company. But ideally, the policy terms will be structured so that no individual's knowledge is imputed to another individual – or to put it another way, that each individual's knowledge is severable from that of other individuals.

The inclusion within the policy of a provision of so-called "full severability" (that is, the specification that no individual's knowledge will be imputed to another individual for purposes of determining the effect of an application misrepresentation) is critical in order to ensure that coverage for innocent insureds remains unimpaired.

POLICY RESCISSION AND CLAIM EXCLUSIONS

The final question that should be asked about policy provisions pertaining to application misrepresentations is what the consequences of an application misrepresentation will be. As noted above, absent policy provisions providing otherwise, the carrier may seek to rely on application misrepresentations as a basis on which to rescind the policy. From the policyholder's perspective, policy rescission is highly undesirable on many levels, especially since the voiding of the policy means not only that coverage will be unavailable for the specific matter at hand, but also for any and all future matters that might arise.

In light of this latter consideration, many carriers will agree to amend their policies so that in the event of an alleged application misrepresentation, policy coverage is unavailable only for persons aware of the misrepresentation and only with respect to claims pertaining to the allegedly misrepresented matter. This formulation allows for the possibility that coverage might be available for future matters that might arise, even if it is not available for certain persons in connection with the immediate matter at hand.

NON-RESCINDABLE POLICIES

In addition, in many instances, carriers are willing to incorporate provisions specifying that the policy is non-rescindable. In some cases, the policy may provide that it is non-rescindable only as to Side A coverage (that is, the coverage protecting the individuals in the event that corporate indemnification is unavailable due to insolvency or legal prohibition). In other cases, the policy may be fully non-rescindable.

COMPLETING THE APPLICATION AND POLLING THE BOARD

As noted above, there are times when it is undeniably appropriate for the carrier to ask the warranty question. The issue for the applicant company is how to answer the question in a way that will not lead to problems down the road. Obviously, the applicant wants to make sure that all known circumstances are disclosed, so that coverage is not impaired if it later turns out that there were known circumstances that were not disclosed.

In order to address this issue, the applicant company should poll its senior executives and board members, in a process that communicates the importance of the inquiry. The polling process and responses to the survey should also later serve to substantiate the fact that the applicant company took reasonable steps to determine whether or not any person was aware of any fact, circumstance or situation that could lead to a claim.

TWO DIFFERENT KINDS OF SEVERABILITY

As noted above, in an appropriately structured policy, no person's knowledge will be imputed to any other person for purposes of determining the scope and effect of any alleged misrepresentations. This non-imputation is sometimes referred to as "full severability." This type of *application severability* is separate and distinct from another type of severability that operates in many D&O policies.

That is, many D&O policies contain a provision, typically at the end of the exclusions section, in which it is provided that for purposes of determining the operation of the policy exclusions, no individual's conduct will be imputed to any other individual. This "*exclusion severability*" is analytically separate and distinct from "application severability," but the similarity of the names can sometimes be confusing. Both types of severability are critically important, but they are dealt with in separate parts of the policy and they must be addressed separately.

In order for D&O insurance buyers to be assured that they have the appropriate counsel, it is critically important that they select a knowledgeable and experienced broker to assist in their acquisition of the insurance. The best brokers also have skilled and experienced claims advocates available to protect their clients' interests in the event of a claim.

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