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A Newsletter from Chicago Underwriting Group, Inc.
Underwriters of D & O and Professional Liability Insurance

Issue 28 **August 2003**

In the current public company D&O insurance market, one of the more difficult issues is the existence and scope of severability of the representations and warranties by the Insureds in the Application for insurance. This edition of CUG.COMments looks at this important coverage provision.

What is Severability?

In the context of D&O liability insurance, severability refers to a provision in the policy which states that for purposes of determining coverage under the policy, the acts or knowledge of certain Insureds will not be imputed to other Insureds. This provision can be applicable in determining if an exclusion applies to a particular Insured (e.g., does the fraud exclusion apply to an outside director if only the CFO committed fraud?) or with respect to determining whether a misrepresentation to the Insurer during the Application process voids coverage for a particular Insured (e.g., is coverage for an outside director void because the CEO provided false information to the Insurer in the Application?). Courts have consistently ruled that the D&O insurance policy is a "unitary" contract, and therefore absent a severability provision, the entire policy is void with respect to all Insureds if any one Insured misrepresents information to the Insurer in the underwriting process.

Why is Severability Such a Difficult Issue?

Severability with respect to exclusions is rather common in D&O insurance policies. Because the "conduct" exclusions for which severability typically applies are infrequently triggered, the exclusion severability provision historically has not been too controversial.

However, Application severability recently has become an important issue, particularly since Insurers are requiring Applications more routinely, even for renewals, and because of the recent frequency of companies restating their financial statements (which are typically a part of the Application). Application severability presents difficult issues because both Insureds and Insurers have legitimate but conflicting concerns regarding the existence and terms of such a provision.

On one hand, Insureds do not want their coverage voided because another Insured knew information that was not truthfully disclosed to the Insurer in the underwriting process. On the other hand, Insurers who are induced to issue a D&O policy based upon false representations by the Insureds rightly do not want to pay millions of dollars under that policy since the Insurer is as much a victim of the misrepresentations as the plaintiff shareholders.

Severability in Today's D&O Insurance Market

D&O insurers' approach to severability is not uniform, and can range from providing "full," "partial" or no severability. "Full" severability, which affords the broadest coverage for all Insureds, does not impute the knowledge or conduct of one Insured to any other Insured. Thus, each Insured is covered based on the facts applicable to that Insured, and no

Insured loses coverage because of misrepresentations to the Insurer by other Insureds.

Although protective to Insureds, full severability provides little protection to the Insurer for Application misrepresentations. Unable to correctly evaluate the risk presented, the Insurer issues a policy based upon material misrepresentations in the Application. If a securities class action lawsuit follows, being able to deny coverage to the perpetrators is small consolation for the Insurer, which is still exposed to potentially large losses on behalf of "innocent" Insureds.

At the other extreme, no severability provision in the policy allows the Insurer to rescind or void the entire D&O policy for all Insureds based on a misrepresentation of material facts in the underwriting process. This approach protects the Insurer, but can expose the "innocent" Insureds to uninsured personal liability if other Insureds misrepresented material information to the Insurer.

Partial Severability

As a compromise between "full" severability and no severability, many Insurers are now providing a form of "partial" or "limited" severability. One approach is to restrict the extent of imputation so that only the knowledge or conduct of certain named key executives is imputed to all Insureds, but knowledge or conduct of everyone else will not be imputed to all Insureds.

While broader than granting no severability, this format could still leave the possibility of an "innocent" Insured being denied coverage, so another variation is to impute knowledge or conduct (1) to those Insureds who were aware of it, and (2) to all Companies. This essentially has the effect of paring down coverage to "Side A" for the "innocent" Insureds, and thereby providing them with the safety net they require.

Please call our D&O underwriters for further discussion on the question of severability. ❖

We would like to thank Mr. Dan Bailey of the firm of Bailey Cavalieri LLC for his help in preparing this issue.

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