Do You Want to Know a Secret?
How Counsel Can Help Protect the Company's Bottom Line Through Prudent Insurance Reporting Practices

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Every attorney has stories about family, friends and acquaintances who hit them up for legal advice on topics from employment to divorce law. After all, it is understandable to assume that smart and articulate people who graduated from law school, passed the bar exam and work in a law firm would have ready answers to questions about "the law." Reality, of course, is quite different. "The law" is a vast, amorphous patchwork of statutes, rules, ordinances, opinions, articles, treatises and customs that encompasses nearly every aspect of modern life.

While corporate or outside counsel cannot be a jack of ***all*** trades, insurance is perhaps the best example of an area of law that they ignore at their peril. Failure to navigate the terms of an insurance policy can jeopardize the client's ability to pay their legal bills, or fund a settlement or adverse monetary judgment. Attorneys who have a basic understanding of how insurance policies work, and some common pitfalls to avoid, provide their clients with a critical value-added advantage over their competitors.

Let us assume that the fictional Uptick Realty is a booming Dallas-based real estate development fund with 50 investors and $1 billion in assets under management. Its executive team is a virtual who's who of the local real estate elite. As the fund's profits have grown, so have the managing directors' expendable income. To capitalize on their expertise and excess cash, three members of Uptick's executive team form an LLC to buy and sell real estate on the side. The LLC then sells a piece of land to the fund. A few weeks later, a disgruntled minor Uptick investor who hears of the transaction sends the senior managing director an angry letter claiming the executives who approved this transaction breached their fiduciary duties by paying an exorbitant price for the real estate.

Uptick seeks the advice of its attorney in determining whether or how to respond to this allegation. Under Texas law, directors and officers of a company have three fiduciary duties: (1) the duty of loyalty, (2) the duty of care and (3) the duty of obedience. Under the duty of loyalty, the director or officer must act in good faith, not allowing his or her personal interest to prevail over that of the corporation. The duty of care obligates them to act with diligence and exercise honest and unbiased judgment in the pursuit of corporate interests. Under the duty of obedience, they must adhere to the rules governing their conduct, including the company's bylaws and government regulations. Failure to disclose material insider transactions and conflicts of interest may also be a violation of Rule 10b-5, promulgated under the federal Exchange Act.

The attorney regards the allegations as troubling in substance from a corporate law standpoint, but not particularly threatening in a practical sense, because the investor has a reputation for venting his frustrations but taking no legal action. The attorney sends a letter to the investor denying the allegations, and as expected, receives no further response. Given the investor's notorious lack of follow-through, and in the hopes of keeping insurance premiums low, the executives elect not to give notice to Uptick's insurance carriers or advise its broker of the matter. Unfortunately, this is not an unusual decision. Many executives and legal teams may not even realize there could be considerable insurance implications for not reporting should such allegations lead to a lawsuit in the future.

About a year later, several other Uptick investors find out about the transaction and sue the fund's executive team for breach of fiduciary duty. The complaint filed by the investors, which closely tracks the assertions in the original investor's letter, alleges that the executives breached their duty of loyalty to Uptick by engaging in self-interested transactions resulting in personal profits at the fund's expense, and committing securities fraud by failing to disclose material insider transactions and conflicts of interest to the fund's investors. The investors seek tens of million dollars in damages. Realizing the executives' considerable liability exposure, Uptick's attorney advises the company to give notice of the lawsuit to its carriers.

Uptick has purchased several lines of insurance, including directors & officers insurance (also known as D&O or management liability insurance). D&O policies insure directors, officers and entities against loss from claims against them concerning the management and operation of the business. These policies generally fall into the "claims made and reported" policy type. This means they are structured to cover only those claims both (1) made against the policyholder and (2) reported to the carrier during the ***same*** policy period. Courts generally hold that notice outside of the policy period (or some specified grace period thereafter) under such a policy excuses the insurance company from any coverage obligations regarding the claim. To cabin the amount of coverage for a matter to a single policy (and single policy limit), D&O policies often contain single claim provisions under which all factually related claims are deemed a single, aggregate claim made during the policy period in which the first of those claims was made.

While D&O policies differ in their precise language, generally they define "claim" as a "demand for monetary or non-monetary relief." Courts interpret "demand" in this context as requiring more than a mere statement of displeasure; there must be an express or implied claim to legal remedies if the recipient fails to take a specified action.

Even when a letter does not rise to the level of a "demand" or "claim," its allegations may still place the policyholder on notice of a matter that could lead to a future claim or lawsuit. Most D&O policies contain notice of circumstances provisions under which problem scenarios noticed to the insurance company during the policy period will set the date on which any related future claim is deemed made. On the flip side, to prevent multiple policies from covering the same matter, many D&O policies also contain prior knowledge exclusions applicable to claims arising out of circumstances that the insured (or some control group thereof) prior to the policy period reasonably believed could result in a claim.

Getting back to the hypothetical, Uptick's D&O carrier soon learns about the prior letter and takes full advantage of both the single claim provision and prior knowledge exclusions to deny coverage of the lawsuit under the fund's current and prior D&O policies. The insurance carrier takes the position that, if the initial letter was a claim, then both the letter and the lawsuit are deemed to have been made in the prior policy period – resulting in late notice under the current policy.

On the other hand, the insurer takes the alternative position that if the letter was not a "demand" (and therefore not a "claim"), Uptick was aware prior to the current policy period that a claim could have arisen from the allegations in the letter, thereby triggering the prior knowledge exclusion under the current policy. Moreover, Uptick failed to notice the letter as a circumstance during the prior policy period, thereby failing to fix the lawsuit as a claim made and reported under that policy. With these coverage denials in hand, Uptick now has to hire coverage counsel to fight the insurance company, all while facing what may now be uncovered liability presenting a threat to the company as an ongoing concern.

Denials based on late notice, prior knowledge exclusions and similar types of policy provisions are, unfortunately, all too common, resulting in the loss of anticipated coverage that otherwise would be available to the policyholder. The denial of coverage does not mean the policyholder is out of options – sophisticated coverage counsel often find pathways to coverage even in the face of such denials. However, coverage disputes can hinder the company's ability to focus on defending against the underlying lawsuit and getting back to the business of being in business.

In most cases, notice-related coverage disputes can be minimized or avoided through a well-designed risk management program in which the company's stakeholders and agents clearly understand their roles in safeguarding the availability of insurance and establish lines of communication from stakeholders to the risk manager and/or general counsel to the company's broker. Corporate counsel and other attorneys handling its matters may not appreciate how seemingly minor incidents, inquiries or investigations, if not promptly reported to the insurance company, can result in an unexpected loss of insurance down the road – sometimes in dire, bet-the-company circumstances. While corporate counsel cannot be jack-of-all-trades experts, understanding how their company's insurance programs work can go a long way toward adding exceptional value to their services.