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The History Of Conduct Exclusions

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The conduct exclusions in directors' and officers' (D&O) liability policies and errors and omissions (E&O) policies – which eliminate coverage if an insured committed some illegal or improper act – generally are drafted to apply only when there is a final adjudication in the underlying litigation that excluded conduct occurred. This means that trying securities fraud actions and other claims for economic damages predicated upon intentional conduct carries a risk of losing coverage in the event of an adverse judgment.

To circumvent this risk, insureds want their insurers to settle these cases, and carriers that sell a lot of D&O and E&O policies understand this expectation and describe them in marketing pitches as providing primarily settlement coverage.

But the conduct exclusions were not always so easily avoided. When D&O and E&O policies were introduced in the 1970s and ´80s, the conduct exclusions had no qualifying language, and mere allegations of excluded conduct triggered them. When the narrow scope of coverage created was questioned in the marketplace, frustrating underwriters' efforts to sell these policies, they amended the conduct exclusions to apply to a claim attributable to any dishonest, fraudulent or criminal act "in fact" committed by an insured.

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They believed this amendment would clarify that mere allegations of excluded conduct would not trigger the conduct exclusion, and that coverage would be eliminated only in the event that the insured actually committed some excluded act.

Claim adjusters interpreted the “in fact” language to mean that they could deny coverage if facts revealed in discovery, or in their own investigation of a claim, tended to show that excluded conduct had occurred. Because this left adjusters substantial discretion over whether the exclusion applied – which many of them abused – brokers and insureds pushed back and policy sales suffered.

Shifting Strategies

Underwriters responded by replacing the term “in fact” with “final adjudication,” believing they had removed the risk of an adjuster denying coverage based on his or her conclusion that the available facts showed excluded conduct. This amendment, they reasoned, would remove all discretion from application of the exclusion. Only if an actual final judgment established that excluded conduct had occurred would conduct exclusions apply.

In response, adjusters changed strategy. An adjuster would file a separate declaratory relief action, in parallel with the action in which the excluded conduct was alleged (and often in another jurisdiction), attempting to reach final adjudication triggering the conduct exclusions before such an adjudication occurred in the litigation from which the claim arose. Again, brokers and insureds pushed back and policy sales suffered.

Underwriters responded by adding the term “in the underlying action” to the “final adjudication” language for two reasons: to clarify that only a final adjudication of excluded conduct in the lawsuit from which the claim arises can trigger conduct exclusions and to prevent the outcome of any lawsuit other than the one from which the claim arises from triggering these exclusions. Adjusters can no longer deny that adjudication in any lawsuit other than the one in which the excluded conduct is alleged and proven can ever trigger them. Underwriters generally regard it as closing the door on efforts by overzealous claims adjusters to apply conduct exclusions broadly, outside the confines of the litigation in which excluded conduct is alleged.

The conduct exclusions’ storied history illustrates the tension that can exist between underwriters whose job is to sell policies, and who cannot do so if their companies are not seen paying claims, and adjusters who often are far less concerned about business generation, customer expectations, or the intent of the parties.