7 tips for maximizing coverage

Fighting Back Against the D&O Personal Profit Exclusion

Few provisions in Directors and Officers ("D&O") insurance policies have given rise to more litigation than the personal profit exclusion. For those unfamiliar, the provision generally excludes coverage for claims arising from or based upon the gaining of any personal profit, advantage or remuneration to which an insured was not legally entitled. Insurers typically allege that this exclusion applies broadly to D&O lawsuits that allege an act of wrongdoing leading, directly or incidentally, to the company receiving some profit or advantage. Compounding the issue, the personal profit exclusion, unlike other conduct-related exclusions (*e.g.*, the "fraud exclusion"), does not require culpability or ill-motive. According to insurers' thinking, the clause excludes coverage for virtually all D&O lawsuits. Indeed, the potential reach of the personal profit exclusion seems bound only by the imaginations of creative insurers seeking to deny coverage.

Judicial Application of the Exclusion

Not surprisingly, given the amorphous language of the personal profit exclusion and its potentially broad application, the provision has given rise to substantial litigation in recent years. Some courts have been quick to apply the clause to all sorts of claims involving nearly any type of benefit allegedly obtained by an insured. Other courts have recognized that this exclusion, if applied too broadly, could swallow up the very protections intended under D&O policies.

Alstrin v. Saint Paul Mercury Insurance Company, 179 F. Supp. 2d 376 (D. Del. 2002), is the seminal case espousing a constrained view of the personal profit exclusion. *Alstrin* involved coverage for an underlying securities class action lawsuit alleging fraud and misrepresentations in the issuance of company stock. The court recognized that nearly all securities fraud complaints

will allege "that the defendants did what they did in order to benefit themselves in some way." *Id.* at 400. If mere allegations of profit or benefit were sufficient to implicate the personal profit exclusion, D&O coverage for securities claims would be rendered valueless. *Id.* Therefore, according to the court, the personal profit exclusion applies only "[i]f an element of the [underlying] cause of action . . . requires that the insured gained a profit or advantage to which he was not legally entitled." *Id.* It does not apply to illegal acts that produce profit or gain to the insured as a by-product. In other words, the clause would apply to "cases of theft, such as insider trading," but not to securities lawsuits, where "the only illegalities alleged are false and misleading disclosures in violation of the federal securities law." *Id.* Any profit or gain in such case is simply incidental to the proscribed conduct-- the illegal misrepresentations -- and does not trigger the exclusion. *Id.*

Numerous courts have adopted the *Alstrin* approach to the personal profit exclusion. *See, e.g., In re McCook Metals, LLC*, 2007 WL 1687262 (N.D. Ill. 2007) (holding that personal profit exclusion was inapplicable to breach of fiduciary duty claims, since an illegal profit was not an element of the underlying cause of action); *Peerless Ins. Co. v. Pennsylvania Cyber Charter School*, 19 F. Supp. 3d. 635 (W.D. Pa. 2014) (recognizing that exclusion applies only where underlying complaint alleges that insureds gained an illegal profit or advantage).

In contrast to *Alstrin's* circumscribed approach, other courts have applied the personal profit exclusion more broadly. In *Jarvis Christian College v. National Union Fire Ins. Co.*, 197 F.3d 742 (5th Cir. 2000), for example, the court declared that "the term 'advantage' is broader than the term 'profit,'" and that "[t]he former does not mean a balance-sheet profit; rather, it encompasses any gain or benefit, such as an *opportunity* to make a profit." *Id.* at 748-49; *see also TIG Specialty Ins. Co. v. Pinkmonkey.com, Inc.*, 375 F.3d 365, 372 (5th Cir. 2004) (relying upon the personal profit exclusion to deny coverage to innocent officers and directors and holding that "coverage is excluded for all insureds, not merely the Insured who profited"). *Jarvis* and *Pinkmonkey* are often cited by insurers seeking to deny coverage.

Actionable Strategies

The uncertainty that currently exists regarding judicial interpretation of the personal profit exclusion is unlikely to be resolved any time soon. There are, however, certain measures that companies can take in the meantime to lessen the risk that the provision is invoked to preclude coverage for a claim. Companies can, and should, work with their insurance brokers and coverage counsel to negotiate favorable policy language during the underwriting process. The following policy enhancements should be vigorously pursued:

1 PRESERVE COVERAGE FOR "INNOCENT INSUREDS"

The policy should clearly limit the personal profit exclusion's potential applicability solely to those insureds who have actually received an illegal profit. Coverage for "innocent insureds" should be preserved through inclusion of a clear non-imputation clause. The policy should provide within the personal profit exclusion, for example, that "[n]o Wrongful Acts shall be imputed to any person for the purpose of determining the applicability of the [exclusion]."

2 PRECLUDE APPLICATION OF THE EXCLUSION TO THE COMPANY

The "personal profit" exclusion was never intended to be applied to corporations, as corporations do not earn "personal profits." Accordingly, the personal profit exclusion should expressly provide that the exclusion does not apply to the insured organization or company. Alternatively, if this cannot be achieved, the exclusion should provide that only the conduct of certain individuals, such as the company's CEO, COO or CFO, shall be imputed to the company.

3 REQUIRE A FINAL JUDGMENT ESTABLISHING AN INSURED'S WRONGDOING

Language should be inserted in the clause clarifying that the exclusion is triggered only if a final, non-appealable, adjudication adverse to the insured in the underlying action establishes such profit. This language prevents the insurer from denying coverage based upon the exclusion unless the insured's improper profit or remuneration is established through litigation. Thus, the exclusion is inapplicable if a company settles a claim or a lawsuit. Moreover, by requiring a final, non-appealable, adjudication, the insurer cannot deny coverage based solely on allegations in a lawsuit against the insureds, or even on an unfavorable jury verdict. Finally, by requiring that the adjudication take place in the underlying action, the insurer may not attempt to prove an insured's wrongdoing in an insurance coverage lawsuit after the fact.

4 PRESERVE DEFENSE COVERAGE

It should be very clear in the D&O policy that the insurer is obligated to pay all of the insured's defense costs incurred in connection with the claim or lawsuit until such time that there is a final, non-appealable adjudication against the insured. Such language guarantees that the directors' and officers' defense will be fully funded unless and until they are actually adjudged to have violated the law. It also prevents insurers from attempting to recoup any previously advanced attorneys' fees and costs where the personal profit exclusion is ultimately triggered -- a growing practice among D&O insurers.

5 LIMIT THE EXCLUSION TO ILLEGAL PROFIT OR REMUNERATION

Most D&O policies exclude coverage for claims arising out of any personal profit, remuneration or advantage to which the insured was not legally entitled. The notion of "advantage" should be deleted from the exclusion. The term is simply too amorphous. One need look no further than the court's decision in *Jarvis* to see how broadly courts may apply the exclusion based on this term. There must be practical bounds to the scope of the exclusion and deletion of the term "advantage" will help to establish a workable and fair limitation on potential insurer abuse of the exclusion.

6 LIMIT THE EXCLUSION'S PREFATORY LANGUAGE

The exclusion should apply only to claims "based upon or ***directly*** resulting from" the gaining of an illegal personal profit. Wording such as "relating to" or "in any way involving" should be avoided. Deleting such language may limit the temptation of insurers to apply the exclusion too broadly.

7 COORDINATE DEFENSE STRATEGY AND COVERAGE ADVICE

In the event a claim is filed against the company that may potentially trigger the exclusion, coverage counsel should be timely consulted. An early understanding of the potential scope and impact of the personal profit exclusion based on the allegations against the insured may impact defense strategy in the underlying litigation. Moreover, compromise or settlement of claims, such as securities lawsuits, should be crafted with the potential impact of the exclusion in mind. Often times, a careful understanding of the scope of the personal profit exclusion can preserve insurance coverage and transfer the risk of loss from a company and its officers and directors to the insurer, where it belongs.

Conclusion

The personal profit exclusion is too often relied upon by insurers seeking to deny coverage for D&O claims. Insurers contend that the reach of the personal profit exclusion extends to virtually all claims, ranging from standard securities lawsuits to breach of fiduciary duty claims. Carriers also contend that the exclusion impacts the availability of insurance coverage for both organizations and their individual officers and directors.

The best defense against the exclusion is a good offense. In particular, the potential scope of the provision can and should be limited up front during underwriting. Coverage counsel can assist in proposing appropriate language, and can work alongside brokers to negotiate favorable policy terms.

Even if policy changes are not made and an insurer raises the profit exclusion to deny coverage for a particular claim, this should not prove fatal to coverage. Favorable judicial decisions exist, and policyholders should not accept a denial of coverage based on the personal profit exclusion without a fight. Appropriate informal advocacy by coverage counsel may be sufficient to defeat an insurance carrier's position and obtain the insurance protection to which a policyholder is entitled. And, in the event that insurance coverage litigation proves necessary, given the favorable state of the law in this area, it is unlikely that an insurer will ultimately prevail.

Tab R. Turano MIller Friel PLLC
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For additional information about this article,
please email or call Tab Turano:

TuranoT@MillerFriel.com
202-760-3163