



**Lowenstein Sandler's Insurance Recovery Podcast:
Don't Take No For An Answer**

**Episode 69:
Wearing Multiple Hats: Making Sure You Are Covered
in All Capacities**

By [Lynda Bennett](#), [Eric Jesse](#)

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Lynda Bennett: Welcome to, Don't Take No for an Answer. I'm your host, Lynda Bennett, Chair of the Insurance Recovery practice here at Lowenstein Sandler. And today I'm pleased to be joined by my partner and co-host, Eric Jesse. Good to see you again, Eric.

Eric Jesse: Hi, Lynda, glad to be here.

Lynda Bennett: So today we're going to do an episode that's focused on a common issue that arises under directors and officers, policies where we have a director or an officer who is wearing more than one hat and a claim has been asserted. And we're going to talk about the idea of capacity and capacity exclusions. So Eric, why don't you set the table for us and give us a basic example of how this comes up.

Eric Jesse: Sure. So when we're talking about wearing multiple hats, right, we're talking about, at least in the D and O insurance world, we're talking about directors and officers that are, for example, you have someone, an individual who is a director of ABC corporation and they serve on ABC corporation's board. But that same individual also serves on the board of XYZ corporation. And so you have a shareholder who brings a claim, for example, against that director and they want to try and access coverage under the ABC corporation's policy. So that's the situation that's set up and you have XYZ that might be involved in that claim brought by that shareholder as well. And so you have a director that is potentially acting in more than one capacity is, as you mentioned, the term of art we use in the insurance policy.

Lynda Bennett: Right. So the classic example of when we see this is our client is a private equity fund and they're putting one of their representatives on the board of a portfolio company, right?

Eric Jesse: Yep.

Lynda Bennett: And so now the claim comes in. So how Eric is capacity typically addressed in the directors and officers policy? What are the first couple of places we need to look to sort this out?

Eric Jesse: So there's two main places. So the policy will have language and upfront in the insuring agreement that says we will cover a claim made against an insured person because of our rising out of a wrongful act. And so that's going to be a defined term, wrongful act. And so we have to look to the definitions of the policy where it will usually be defined to say wrongful act means an act omission by an insured person in their capacity as such. So that's the first place we look. The other place we also look is at the exclusions because in many cases, not always, but in many cases, a D and O policy will have a capacity exclusion as well.

Lynda Bennett: And what does the capacity exclusion say?

Eric Jesse: And so the capacity exclusion will try to bar coverage for any conduct that the insured person takes on behalf of another uninsured entity.

Lynda Bennett: So let me pause there. And of course, most people who don't geek out on reading insurance policies are scratching their heads right now. So let me get this straight. We have a coverage grant that says, I promise we will pay for wrongful acts when you are acting in your capacity as an insured. And in the same policy we also have an exclusion that says, we will not provide coverage for you when you are acting outside of your capacity. So my first question is, do we always see both?

Eric Jesse: No, not always. In some cases there will be policies that don't have a capacity exclusion. Now that won't stop insurance companies from trying to pretend there's one, but it's common or it can be the case that a policy only has the capacity reference in the wrongful act definition.

Lynda Bennett: So in other words, we have to invoke one of our bedrock principles here on Don't Take No for an Answer. The words matter. You have to read the policy, you have to know whether you have one the other or both.

Eric Jesse: Yeah, absolute.

Lynda Bennett: Okay. So let's get a little bit more granular. What is the intention behind a capacity provision?

Eric Jesse: At its core, it's really about, I can appreciate that an insurance company does not want to cover conduct by a person made in their capacity or made on behalf of an uninsured entity. And so that's really what this is all about, making sure that that slice of liability associated with an uninsured entity is not picked up by the D and O policy. And so from our perspective, we really look at it as an allocation provision where the director and officer, because they are insured in our example, under a ABC's D and O policy, they should have coverage for things that they do on behalf of ABC corporation. So that's really what we argue for.

Lynda Bennett: So in other words, we should apply common sense, right? It makes perfect sense that if, going back to our example, if the things that I've done wrong are when I'm wearing my X, Y, Z hat, of course I shouldn't get coverage under ABC's policy, right?

Eric Jesse: Right.

Lynda Bennett: But when we get these complaints, it's not always so clear. If I've been alleged to have done 10 things wrong, it's not always so clear, am I wearing my ABC hat? Am I wearing my X, Y, Z hat? But I think we can all agree, of course you shouldn't get coverage under ABC's policies if I was wearing my X, Y, Z hat while I was doing it, right?

Eric Jesse: Exactly.

Lynda Bennett: So you mentioned an allocation provision or an allocation philosophy. So we should be talking about how much coverage should be provided, not whether. Is there any place that we should be looking in the policy beyond the two provisions? You already talked about the definition of wrongful acts and a capacity exclusion. Where else might we look to start to figure out how to carve up that slice as you referred to it earlier?

Eric Jesse: Yeah, so I think there's a few other provisions or places in the policy to look. So one is to deal with the situation that you were talking about where maybe the complaint isn't as clear. How do you do that allocation? Well, from a defense cost perspective, one of the things you might want to try and get into your policy or check and make sure there is language that says if there is this type of mixed claim where there's uninsured and insured entities, right, a hundred percent of the defense costs are covered. That can be tough to get, but it's great if you can get it. So that's one place to start.

Lynda Bennett: And let's just touch on the intention of the capacity exclusion. And you talked a little bit about entities and persons. Does the capacity issue apply to all insurances?

Eric Jesse: Well, not necessarily. I mean the capacity exclusion, because it's the individual who's wearing multiple hats, we would argue that the capacity exclusion should only apply at most to an individual director and officer. But in no way should that exclusion apply to an entity that's also a defendant in a lawsuit. They should have coverage because they only have acted one way, on behalf of themselves.

Lynda Bennett: So I want to spend a minute, 'cause you talked about these two provisions. There's the definition of wrongful acts and then where we'll get that capacity concept embedded, and then we have a capacity exclusion. Touch on the difference in approach that courts are required to take in evaluating the wrongful act definition as compared to a capacity exclusion.

Eric Jesse: So this is just a bedrock principle of insurance law. The wrongful act definition, that term is going to be used in the insuring grant. So insurance policies, insuring agreements, and insurance policies under most states laws needs to be interpreted broadly and liberally in favor of coverage. So you're

interpreting capacity to be all encompassing or very broad. Exclusions, in contrast, are narrowly construed. Insurance companies have the burden of if they want to avoid coverage, they have the burden of showing that every single aspect of the underlying claim falls within that particular exclusion. And so that's how courts are going to approach the, or should be approaching the analysis on the ensuring agreement versus the exclusion.

Lynda Bennett: Okay. So that's good table setting there, Eric. Let's start to talk about how these capacity issues really arise in practice. So let's go through a couple of examples.

Eric Jesse: Sure. So you already mentioned one, right? Where you have an investor and they invest in a company, a portfolio company, and the investor puts a representative on the portfolio company's board. And so capacity can arise under the investors' D and O policy or under the portfolio company's policy. And the question that comes up is when that board member is voting on or taking any corporate actions, who are they really acting on behalf of? Are they acting on behalf of the company or are they doing something that the investor expects or told them to? So that's one area where capacity issues are front and center.

Lynda Bennett: Sounds pretty fact sensitive, Eric.

Eric Jesse: Yes. Yes.

Lynda Bennett: And so that's why I want to draw back to the very important point that you made and I want to amplify it, which is those fact intensive issues get worked out eventually, but you should be getting a defense for those claims the whole time until we can sort out whether it was one hat, the other hat or a mix of both. So indemnity can be decided later, but you better be getting that defense coverage, right?

Eric Jesse: Exactly. And this ties back to another one of our podcasts where we talked about the duty to defend or duty to reimburse. This is if you have a duty to defend policy, the insurance company again should be defending the entire action.

Lynda Bennett: What's another example? We've touched on some of these. Give me another example of where capacities cropped up.

Eric Jesse: So it's also the ABC corporation and XYZ corporation where you have a related or affiliated party transaction. So that's another one. We've also seen this come up in the trade secret and tortious interference claims where you have an employee of one company, that employee moves over to a new competitor and the employee and the competitor are sued. In many cases, the insurance company will say, hold on, the wrongful acts here happened in your capacity as a, or I should say the competitor's D and O insurer will say, hold on, the wrongful acts here happened in your capacity as an employee of the former company. So that's an area where we see it pop up as well.

Lynda Bennett: Yeah. Well, Eric, what can our listeners do to avoid buying the coverage action that we've kind of laid out? Because these are very fact intensive,

oftentimes very complicated fact patterns to unwind. What are some practical tips that policy holders can employ at the front end to avoid getting in the soup on this?

Eric Jesse: Yeah, a few things. I mean, we talked about that hundred percent of defense cost allocation provision, tough to get but ask, because it's great if you get it. Duty to defend coverage is a consideration. Also look to your other insurance provision because the other insurance provision says in substance, if there's other available insurance, the one policy doesn't have to provide coverage or it might sit excess, I should say. And so get language in there that says, all right, even if there's other available insurance out there, this policy has to provide a defense.

And then another area is just sometimes you can actually get outside capacity coverage. So when the investor is putting a representative on the portfolio company's board, their policy absolutely needs that outside capacity coverage as a backstop for those directors and officers.

Lynda Bennett: Let's ask them just to remove the capacity exclusion. They going to say no.

Eric Jesse: Right.

Lynda Bennett: But sometimes they don't. Sometimes they don't. And what do we say? Don't take no for an answer, might as well. So Eric, if the policy holder hasn't followed those very good risk management suggestions that you just made and a claim has been made, what are some of the things that policy holders can do to defeat a capacity exclusion defense?

Eric Jesse: Yeah, so one thing, and we talked about this already, but I want to just hammer it home, which is whether your policy is a duty to defend policy or a duty to reimburse policy, courts interpret that obligation broadly. It's a very policy holder friendly provision of a policy. And so even if it's unclear what the allocation should be, unclear where exactly the wrongful acts lie, or with which entity the insured is entitled to a defense, unless and until the insurer can show that there's, there's no possibility of coverage. So rely on that broad duty to defend provision.

The other thing is just also relying on the narrowness of exclusions, right? If the capacity exclusion is invoked, the insurance company has the burden there and it's an exclusion that should be narrowly interpreted. So it can't swallow up an entire claim because otherwise, what coverage, illusory coverage was obtained in our example by ABC corporation, if their directors and officers aren't insured when they do things in their ABC hat.

Lynda Bennett: Yeah, I mean look, these are very fact sensitive oftentimes difficult issues to navigate. I think you're exactly right. The focus on the front end of getting that benefit of the broad duty to defend is critically important. But I think the other thing that you need to be thinking about when you get that reservation of rights letter or denial letter from the carrier, as you are defending your claim going forward, be paying careful attention to are there ways that these slices can be formed or is it not? Are you in a joint and several liability situation? So I think keeping a careful eye on the development of the underlying factual

record is also important to lay against that capacity issue that can rise up during the course of the litigation.

Well, I think we've about covered it today, and I appreciate your insights as always, Eric. So thanks for joining me and we look forward to catching everybody on our next episode.

Kevin Iredell:

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