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Claims-Made and First-Party Policies

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I. [7.1] ERRORS AND OMISSIONS INSURANCE

Errors and omissions (E & O) insurance policies are a type of professional liability policy intended to insure against risks inherent in particular professions. 9A Lee R. Russ and Thomas F. Segalla, *COUCH ON INSURANCE* 3D §131:38 (2008). One of the most common types of E & O policies is “malpractice insurance,” carried by attorneys and doctors as required by law and the Rules of Professional Conduct. E & O policies are commonly also purchased by accountants, engineers, architects, insurance brokers, and anyone for whom providing a professional, information-based service is central to their occupation. *See, e.g., General Insurance Company of America v. Robert B. McManus, Inc.*, 272 Ill.App.3d 510, 650 N.E.2d 1080, 209 Ill.Dec. 107 (1st Dist. 1995); *Management Support Associates v. Union Indemnity Insurance Company of New York*, 129 Ill.App.3d 1089, 473 N.E.2d 405, 409, 85 Ill.Dec. 37 (1st Dist. 1984).

Unlike commercial general liability (CGL) insurance policies, there is no standard form for an E & O policy. However, the format of E & O policies tends to be relatively uniform, beginning with an insuring agreement providing coverage for a “wrongful act” occurring on or after the “retroactive date” if the claim is made and reported during the policy period.

E & O policies also commonly are subject to a self-insured retention endorsement or a deductible, which is usually listed on the declarations page of the policy.

The precise language of E & O policies varies, but the insuring agreements of most E & O policies provide something like the following:

We will pay on your behalf those amounts, in excess of retention, you are legally obligated to pay as damages resulting from a claim first made against you and reported to us during a policy period or Extended Reporting Period (if applicable) for your wrongful act in rendering or failing to render professional services for others, but only if such wrongful act first occurs on or after the retroactive date and prior to the end of the policy period.

A. Prerequisites for Coverage Under an E & O Policy

1. [7.2] Claims-Made vs. Occurrence-Based

Like other professional liability coverage, E & O coverage is normally provided on a “claims-made” basis, meaning that the claims must be made against the insured and also reported to the insurer during the policy period. Claims made after a policy has expired are not covered unless notice is given during the policy term of facts or circumstances that might give rise to a claim. As with all insurance policies, it is important to check the policy itself to determine the extent of coverage. Some E & O policies provide “prior acts” coverage, for claims occurring prior to the policy inception, or “tail acts” coverage, for claims occurring after the policy has expired, but such coverage extensions entail higher premiums.

A “claim” is generally defined in an E & O policy as “a demand for money or services including a suit arising from your wrongful act.” To the extent that a policy fails to define the

term “claim,” courts have interpreted it as a specific demand for relief. *Insurance Corporation of America v. Dillon, Hardamon & Cohen*, 725 F.Supp. 1461, 1468 (N.D.Ind. 1988); *Home Insurance Co. v. Law Offices of Jonathan DeYoung, P.C.*, 32 F.Supp.2d 219, 226 (E.D.Pa. 1998); *Phoenix Insurance Co. v. Sukut Construction Co.*, 136 Cal.App.3d 673, 186 Cal.Rptr. 513, 515 (1982). A “claim” is distinguished from an “occurrence” in that a claim is brought by a third-party against the insured. *General Insurance Company of America v. Robert B. McManus, Inc.*, 272 Ill.App.3d 510, 650 N.E.2d 1080, 1083, 209 Ill.Dec. 107 (1st Dist. 1995). Courts recognize that the purpose of a claims-made policy is for the insurer’s underwriter to be able to limit the risk to a particular time period; therefore, reporting the claim during the policy period is generally considered a condition precedent to coverage. *Continental Casualty Co. v. Cuda*, 306 Ill.App.3d 340, 715 N.E.2d 663, 669, 239 Ill.Dec. 909 (1st Dist. 1999); *Esmailzadeh v. Johnson & Speakman*, 869 F.2d 422, 424 – 425 (8th Cir. 1989) (applying Minnesota law); *EmCode Reimbursement Solutions, Inc. v. Nutmeg Insurance Co.*, 512 F.Supp.2d 603, 606 (N.D.Tex. 2007) (applying Texas law). *But cf. Lexington Insurance Co. v. Rugg & Knopp, Inc.*, 165 F.3d 1087 (7th Cir. 1999) (applying Wisconsin law, requiring insurer to show prejudice under claims-made-and-reported policy due to public policy of Wisconsin).

2. [7.3] Wrongful Acts Committed in the Performance of Professional Services

Under E & O policies, “wrongful act” is generally defined as “any actual or alleged negligent act, error or omission, misstatement or misleading statement committed solely in your performance of Professional Services.”

“Professional services” is generally defined by a description of activities contained on the declarations page of the policy. Generally, the professional services covered are those that distinguish a particular occupation from other occupations due to specialized training or experience different from the ordinary activities of other businesses. Whether a particular act is a professional service is different for each occupation. 9A Lee R. Russ and Thomas F. Segalla, COUCH ON INSURANCE 3D §131:38 (2008). Generally, whether a particular act is a professional service will depend on whether the act utilizes the specialized training or learning of the profession, as distinguished from other ordinary activities common to all businesses such as paying bills, hiring staff, collecting accounts receivable, or maintaining files. *Medical Records Associates, Inc. v. American Empire Surplus Lines Insurance Co.*, 142 F.3d 512, 514 – 515 (1st Cir. 1998) (applying Massachusetts law; setting fees for medical records was not professional service of medical records company); *Visiting Nurse Association of Greater Philadelphia v. St. Paul Fire & Marine Insurance Co.*, 65 F.3d 1097, 1101 – 1102 (3d Cir. 1995) (applying Pennsylvania law; discharge planners do not provide hospital with “professional services”); *Crum & Forster Managers Corp. v. Resolution Trust Corp.*, 156 Ill.2d 384, 620 N.E.2d 1073, 1079, 189 Ill.Dec. 756 (1993) (actions of setting up competing real estate business were not “professional services” of real estate professionals).

To qualify for coverage, the claims must be caused by the “wrongful act,” or, as the Illinois Supreme Court has stated, “the claims made against the insureds by the underlying plaintiff must arise *because of* an act, error, or omission in the insured’s performance of [professional services].” [Emphasis in original.] *Crum & Forster Managers, supra*. Also, the wrongful act must first occur on or after the retroactive date of the policy.

B. [7.4] E & O Policy Exclusions

E & O policies contain coverage exclusions both within the insuring language of the policy and within endorsements following the main body of the policy. As with CGL policies, courts construe exclusions on professional liability policies narrowly in favor of coverage. Some exclusions are profession-specific, but there are also standard exclusions that are common to almost all E & O policies. As with CGL policies, courts will apply exclusions to bar coverage under an E & O policy only when their application is “clear and free from doubt” (*General Insurance Company of America v. Robert B. McManus, Inc.*, 272 Ill.App.3d 510, 650 N.E.2d 1080, 1083, 209 Ill.Dec. 107 (1st Dist. 1995)), and ambiguities will be resolved in favor of coverage (*Smith v. Neumann*, 289 Ill.App.3d 1056, 682 N.E.2d 1245, 1251, 225 Ill.Dec. 168 (2d Dist. 1997)).

1. [7.5] Damages Typically Covered by Other Policies

E & O policies generally exclude coverage for claims or occurrences that are typically covered by CGL or other insurance policies. For example, E & O policies typically exclude coverage for bodily injury, personal injury, and advertising injury.

2. [7.6] Insured Versus Insured

E & O policies also exclude coverage for claims made by one insured against another. For example, legal professional liability policies ordinarily do not cover claims by one attorney in a law firm against another attorney in the same firm.

3. [7.7] Governmental Agency Action

E & O policies also usually exclude coverage for claims brought by a governmental agency against the insured.

4. [7.8] “Prior-Acts” Exclusion

E & O policies usually include “prior-acts” exclusions. Under such exclusions, there is no coverage if an insured knows or has reason to know of a potential claim prior to the inception of the policy period. Most jurisdictions, including Illinois, apply these exclusions based on what the insured should have known based on an objective standard, rather than a subjective standard. *Smith v. Neumann*, 289 Ill.App.3d 1056, 682 N.E.2d 1245, 1254 – 1255, 225 Ill.Dec. 168 (2d Dist. 1997) (applying objective standard, attorney had basis to believe his drafting errors might result in claim prior to policy period, so coverage was excluded under prior-acts exclusion). See also *Mt. Airy Insurance Co. v. Thomas*, 954 F.Supp. 1073, 1079 (W.D.Pa. 1997). In contrast, a minority of courts look to what facts were actually and subjectively known by the insured. *Westport Insurance Corp. v. Atchley, Russel, Waldrop & Hlavinka, L.L.P.*, 267 F.Supp.2d 601 (E.D.Tex. 2003). Ordinarily, in this context, knowledge of an employee may not be imputed to the employer, if the employee alone had actual knowledge of the wrongful act. 9A Lee R. Russ and Thomas F. Segalla, COUCH ON INSURANCE 3D §131:38 (2008), citing *American Financial Corp. v. Fireman’s Fund Insurance Co.*, 15 Ohio St.2d 171, 239 N.E.2d 33, 44 Ohio Op.2d 147 (1968).

5. [7.9] Prior-Policies Exclusion

Many E & O policies prevent “stacking” of insurance policies by excluding claims covered by a previous professional liability policy. *Smith v. Neumann*, 289 Ill.App.3d 1056, 682 N.E.2d 1245, 225 Ill.Dec. 168 (2d Dist. 1997) (found to be valid exclusion to coverage).

6. Exclusions Addressing Particular Types of Conduct

a. [7.10] Dishonesty/Fraud/Criminal or Malicious-Conduct Exclusion

Dishonesty/fraud/criminal or malicious conduct is excluded from coverage under E & O policies. 9A Lee R. Russ and Thomas F. Segalla, *COUCH ON INSURANCE* 3D §131:38 (2008). Depending on the jurisdiction and the language of the exclusion, a court may require the allegedly dishonest or fraudulent act to be intentional to come under the policy exclusion. *Compare Continental Casualty Co. v. Reed*, 306 F.Supp. 1072 (D.Minn. 1969) (for exclusion to apply, act must have been actually intentional), *with Northland Insurance Co. v. Stewart Title Guaranty Co.*, 327 F.3d 448 (6th Cir. 2003) (exclusion applied regardless of whether intentional or negligent conduct was alleged).

b. [7.11] Personal-Gain Exclusion

“Personal gain,” *i.e.*, the insured gaining a profit or advantage to which he or she was not legally entitled, is excluded from coverage. However, this exclusion may not apply to an insured corporation. *Commercial Union Insurance Co. v. Auto Europe, L.L.C.*, No. 01 C 6961, 2002 U.S.Dist. LEXIS 3319 at **10 – 11 (N.D.Ill. Feb. 26, 2002); *Brown & LaCounte, L.L.P. v. Westport Insurance Corp.*, 307 F.3d 660 (7th Cir. 2002).

c. [7.12] Business-Enterprise Exclusion

The business-enterprise exclusion excludes coverage for the insured’s ownership of or interest in ventures outside of the insured firm.

d. [7.13] Contract Exclusion

The contract exclusion excludes coverage for liability that arises solely because of a contract when the insured would not be liable absent the contract.

C. [7.14] Special Issues Under E & O Policies

When the claim is made and when the claim is reported are critical issues with respect to coverage under an E & O insurance policy. Unlike CGL policies, which generally provide coverage for events occurring during the policy period, E & O policies require that claims be made and reported during the policy period. Both requirements must be met. A claim first must be made against the insured during the policy period, and, in addition, reporting the claim during the policy period is a condition precedent to coverage. In addition, the “wrongful act” must first occur on or after the retroactive date of the policy.

Another unique issue in applying E & O policies (in contrast with standard CGL policies) involves the actor's state of mind that gives rise to the claim. Courts are split as to whether E & O policies cover errors or omissions that are not negligent. Compare *New Hampshire Insurance Co. v. Westlake Hardware, Inc.*, 11 F.Supp.2d 1298, 1301 (D.Kan. 1998) (coverage only for negligent acts), with *USM Corp. v. First State Insurance Co.*, 420 Mass. 865, 652 N.E.2d 613 (1995). Some courts find that whether a policy provides coverage for intentional acts, as well as negligent acts, depends on the language of the policy. *Continental Casualty Co. v. Cole*, 809 F.2d 891, 896 (D.C.Cir. 1987) (finding potential for coverage for both negligent and intentional acts because of policy language covering any "error, negligent omission or negligent act"); *Independent School District No. 697, Eveleth, Minnesota v. St. Paul Fire & Marine Insurance Co.*, 515 N.W.2d 576, 579 (Minn. 1994) (finding potential for coverage for intentional acts when policy language covered "an error or omission, negligence, breach of duty"); *Corporate Realty, Inc. v. Gulf Insurance Co.*, No. 04-2933 SECTION "L"(2), 2005 U.S. Dist. LEXIS 1394 at *18 (E.D.La. Jan. 28, 2005) (holding there was potential for coverage for intentional acts when policy language covered any "errors, omissions, or negligent acts").

However, Illinois courts thus far have found there is no potential for coverage for intentional acts under an E & O policy, regardless of the policy language. *Management Support Associates v. Union Indemnity Insurance Company of New York*, 129 Ill.App.3d 1089, 473 N.E.2d 405, 410, 85 Ill.Dec. 37 (1st Dist. 1984). Courts are also currently split as to whether E & O policies cover claims couched in terms of breach of contract, although it appears those claims may be covered in Illinois, at least when they arguably arise out of negligent conduct. *Management Support, supra*, 473 N.E.2d at 411 – 412.

II. [7.15] DIRECTORS AND OFFICERS INSURANCE

Directors and officers (D & O) insurance provides protection for the directors and officers of corporations when they are sued in connection with their duties to the company. Due to caselaw extensions of the scope of D & O coverage, D & O policies have evolved toward expressly providing coverage to the corporation in addition to and to the same extent that they provide coverage to the directors and officers, should such coverage be desired.

A. [7.16] Prerequisites for Coverage Under D & O Policies

D & O insurance provides coverage that is similar in some ways to E & O insurance. D & O policies cover "claims" for "wrongful acts" taking place during or prior to the policy period. More than almost any other type of policy, the language of D & O policies varies greatly from policy to policy. This is partially due to the relative newness of this type of coverage and is a reflection of the bargaining power of the corporations purchasing those policies. Because D & O coverage is relatively expensive, the companies purchasing D & O policies often negotiate language specific to their own needs.

Generally, D & O policies encompass the following alternative coverages:

Coverage A for liability for the directors and officers. Coverage A provides coverage for claims when the corporation is not legally bound or is otherwise unable or unwilling to indemnify its officers and directors, such as situations in which public policy or corporate bylaws prohibit indemnification, or the current board decides against permissive indemnification.

Coverage B for liability of the corporation itself, to the extent it must indemnify directors and officers. Coverage B provides coverage for the corporation to the extent it indemnifies its officers and directors for a covered claim. It generally covers both permissive and mandatory indemnification.

Coverage C for liability of the corporation to the extent it is liable for a violation of federal securities law. Coverage C provides coverage for the company to the extent it is held individually responsible.

1. [7.17] “Wrongful Act” Requirement

D & O policies provide coverage for “wrongful acts” resulting in “claims.” D & O policy language varies in its definition of “wrongful acts.” The most prevalent definition of “wrongful acts” contained in D & O policies and quoted in cases is “any negligent act, error, omission, misstatement or misleading statement.” *See, e.g., Golf Course Superintendents Association of America v. Underwriters of Lloyd’s, London*, 761 F.Supp. 1485, 1489 (D.Kan. 1991). *Accord Florists’ Mutual Insurance Co. v. Ludy Greenhouse Manufacturing Corp.*, 521 F.Supp.2d 661, 686 (S.D. Ohio 2007); *Waste Corporation of America, Inc. v. Genesis Insurance Co.*, 382 F.Supp.2d 1349, 1352 (S.D.Fla. 2005) (excluding coverage for intentional acts based on public policy and not policy language). Another typical definition of “wrongful acts” is “any actual or alleged error or misstatement or misleading statement or act or omission or neglect or breach of duty by the Directors or Officers while acting in their individual or collective capacities, or any matter, not excluded by the terms and conditions of the policy, claimed against them solely by reason of their being Directors or Officers of the Company.” *See Ratcliffe v. International Surplus Lines Insurance Co.*, 194 Ill.App.3d 18, 550 N.E.2d 1052, 1059 – 1060, 141 Ill.Dec. 6 (1st Dist. 1990) (language from D & O policy issued by International Surplus Lines Insurance Company). *See also Federal Insurance Co. v. Kozlowski*, 18 A.D.3d 33, 792 N.Y.S.2d 397, 399 (2005) (quoting similar language).

2. [7.18] Wrongful Act v. Business Decision

A “wrongful act” is potentially covered by a D & O policy, but a “business decision” is not. However, distinguishing between the two can be a challenge. *New Madrid County Reorganized School District No. 1, Enlarged v. Continental Casualty Co.*, 904 F.2d 1236 (8th Cir. 1990).

3. [7.19] Requirement of a “Claim”

In D & O policies, a “claim” is generally defined as a written demand, suit, or formal administrative or regulatory proceedings. Earlier D & O policies failed to define a “claim,” and

courts interpreted a “claim” to mean an assertion of a legal right, broader than a lawsuit but not including informal inquiries. *See National Union Fire Insurance Company of Pittsburgh, Pa. v. Continental Illinois Corp.*, 673 F.Supp. 300, 307 (N.D.Ill. 1987) (distinguishing “claim” from “loss”); *Olson v. Federal Insurance Co.*, 219 Cal.App.3d 252, 268 Cal.Rptr. 90 (1990); *Murray Industries, Inc. v. Federal Insurance Co. (In re Murray Industries, Inc.)*, 122 B.R. 135 (Bankr. M.D.Fla. 1990). Depending on the language of a policy, an administrative investigation (for example, a Securities and Exchange Commission investigation) may constitute a “claim.” *Minuteman International, Inc. v. Great American Insurance Co.*, No. 03 C 6067, 2004 U.S. Dist. LEXIS 4660 (N.D.Ill. Mar. 18, 2004) (noting, however, “losses” do not encompass equitable relief).

4. [7.20] Notice and Reporting

D & O policies generally require claims to be made within a particular policy period to be covered, and they also require notice “as soon as practicable” of potential claims. Most D & O policies also contain a so-called “claim substitute” clause. A claim substitute clause allows the insured to report “any circumstances which may subsequently give rise to a claim,” and if such an anticipatory report is made, coverage will be provided under the policy period during which the report was made, even though a formal claim arising from those circumstances might not be made until a subsequent policy period. *See, e.g., California Union Insurance Co. v. American Diversified Savings Bank*, 914 F.2d 1271 (9th Cir. 1990); *American Casualty Company of Reading, Pennsylvania v. Federal Deposit Insurance Corp.*, 944 F.2d 455 (8th Cir. 1991).

5. [7.21] Severability Clauses

D & O policies usually provide coverage for several separate insureds, including multiple officers and directors, all of whom may be named in a third-party lawsuit even if each did not have actual knowledge of the facts out of which the same claim could arise at the time of the policy application. To avoid the overly harsh result of allowing an insurer to rescind an entire D & O policy on the basis of one of several insureds’ knowledge, D & O policies typically also contain a “severability clause” in the application, stating that the knowledge of one of the insureds shall not be imputed to the other insureds. *See, e.g., the severability clause referenced in Travelers Indemnity Co. v. Bally Total Fitness Holding Corp.*, 448 F.Supp.2d 976, 983 (N.D.Ill. 2006). Therefore, a D & O policy may not provide coverage to a director or officer who knew of a potential claim but failed to disclose it, but coverage remains available to other directors and officers if they had no knowledge of the potential wrongful act. *In re HealthSouth Corporation Insurance Litigation*, 308 F.Supp.2d 1253 (N.D.Ala. 2004). However, it should be noted that coverage for the company itself may be rescinded due to a material misrepresentation on the policy by one of the directors or officers. *See, e.g., ClearOne Communications, Inc. v. National Union Fire Insurance Company of Pittsburgh, Pennsylvania*, 494 F.3d 1238 (10th Cir. 2007) (applying Pennsylvania law).

6. [7.22] Payment of “Loss”

D & O policies generally undertake to pay “loss” on behalf of the insured(s). *Mortenson v. National Union Fire Insurance Co.*, No. 99 C 2419, 1999 U.S. Dist. LEXIS 12275 at *2 (N.D.Ill.

