Allocation issues

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The issue of "allocation" has always existed when it comes to the insurance coverage afforded by a D&O policy. However, the problems caused by this issue never have had much of an impact in the U.S. until the last couple of years. Although the issue of "allocation" generally involves the question of how much coverage is provided when the underlying claim brought against directors and officers contains covered and noncovered claims, the fact scenario that has caused so much of an impact in the U.S. is when the underlying claim is brought against the corporation itself, in addition to certain or all of the corporation's directors and officers.

The explosion in shareholder securities lawsuits in the U.S. in the last several years has been responsible for bringing this issue to the fore. D&O insurers have always argued that the corporate

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"entity" is not covered under a D&O policy for direct liability. Therefore, said the insurers, when the shareholder lawsuit names the corporation along with directors and officers, any defense costs or indemnity costs incurred in connection with such a lawsuit must be "allocated" between the purportedly noncovered corporate "entity" and the covered directors and officers. Such an allocation, however, leaves the company with a substantial uninsured loss that, in the case of shareholder lawsuits in the U.S., can range into the tens of mi1lions of dollars.

Several years ago, several large U.S. corporate insureds, faced with their D&O carriers' insistence on "allocation" in cases where both the corporations and certain or all of their directors and officers had been named in a lawsuit, refused to allocate and sued their insurance carriers for full coverage. Several of those lawsuits resulted in landmark decisions that favor policyholders.

Based on these cases and others like them, the favorable rules of allocation under D&O policies can be stated as follows. With respect to defense costs, the "reasonably related" rule dictates that, in order to not be obligated to pay a particular defense cost, the D&O insurer must show that the cost does not in any way relate to the defense of a covered claim against a director or officer or against the corporation based on the acts of a director or officer. With respect to indemnity costs for settlements, the "derivative liability" and "concurrent liability" rules dictate that if the corporation's liability in connection with the settlement is based on the acts of a director or officer, then the D&O insurer must pay the entire settlement amount (assuming there are no other grounds for the insurer to allocate costs to noncovered claims). In addition, even if some of the corporation's liability in connection with the settlement is not based on the acts of a director or officer, then the "larger settlement" rule dictates that, in order for the D&O insurer not to be obligated to pay the entire settlement amount, the D&O insurer must show that such "independent" corporate liability made the settlement larger than it would have been in the absence of such liability.

Although the U.S. insurance industry was attempting to address the allocation issue before the 1995 landmark decisions discussed above were rendered, those decisions accelerated the pace of the changes in the D&O insurance market. Indeed, at about the time of those policyholder victories in 1995 the U.S. insurance industry was providing the D&O marketplace with an array of D&O insurance options intended to deal with "allocation" issues.

Perhaps the first U.S. insurer to provide an optional D&O product in response to the allocation issue is American International Group (AIG). Several years ago AIG began offering an option to its D&O policy by way of an endorsement that purported to provide "entity" coverage for "open market securities claims." However, in 1995 AIG abandoned the endorsement approach and released an entirely new D&O form into the market. The new AIG form D&O policy is problematic for any policyholder trying to choose between the new form and the old form (AIG continues to renew its current policyholders on the form of the insured's choice). Among other things, the policy form contains unfavorable allocation language for non-securities claims that most likely precludes the application of favorable allocation rules. In 1996 AIG released its "Securities Plus" endorsement that it will offer to some insureds on AIG's new D&O policy form. The endorsement removes some of the deficiencies in the form, but does not remove the unfavorable allocation language for non-securities claims. Fortunately for policyholders, a large part of the U.S. D&O insurance market began offering "entity" coverage for securities claims in 1996, and several of those companies' policies do not contain such unfavorable allocation language for non-securities claims or the language can be removed if requested.

As an alternative to the "entity" coverage approach, other insurers, have offered a "predetermined allocation" endorsement to attach to their D&O policies. These predetermined allocation endorsements purport to resolve "allocation" coverage disputes by setting a predetermined allocation for "securities claims"-whether it be 60%, 75%, 90% or 100%-depending upon how much premium the insured is willing to pay (the higher the predetermined allocation, the greater the premium). These endorsements appear to be a less satisfactory response to "allocation" issues than even D&O forms offering problematic "entity" coverage. Among other things, predetermined allocation endorsements do not insure the corporation for direct liability in the absence of concurrent liability against one or more of the corporation's directors or officers. Thus, before the predetermined allocation is applied to any defense or indemnity costs incurred in connection with an underlying claim, there must first be a determination of whether such costs relate to the defense of claims also made against one or more covered directors or officers. It goes without saying that "predetermined allocation" coverage does not protect the corporation when it alone is sued or a judgment against it alone is rendered.

As an alternative to both approaches listed above, other insurers are offering a modified predetermined allocation endorsement-one that provides a "floor allocation." Such a floor allocation endorsement purports to provide that, no matter what, the insured will be entitled to a minimum allocation percentage, but the insured is free to argue that the allocation in any particular case should be greater than the floor. ■