RECENT DEVELOPMENTS IN D&O INSURANCE LAW AND PRODUCTS IN THE UNITED STATES*

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The proliferation in the United States of shareholder lawsuits within the last several years has had an important impact on directors' and officers' liability and corporate reimbursement ("D&O") insurance law and products. That impact became increasingly visible in 1996. This article will identify the issues that have created this impact, discuss the cases that have addressed these issues and discuss how the insurance industry selling D&O insurance in the United States has been responding to the issues and the cases.

It is hoped that this article is interesting and useful to insurance lawyers practising in the United Kingdom and Europe. As one commentator observed almost three years ago, "Many, if not most, Europeans may still consider directors' and officers' liability to be an American problem. This is no longer true."1 More recently, some commentators have noted that more and more companies outside of the United States are buying D&O insurance for various reasons - some because they are raising capital in the United States securities markets and face United States shareholder liability exposure, others because they have just been newly privatised or just issued an initial public offering.2

THE ISSUE IS "ALLOCATION"

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 had much of an impact on the development of D&O insurance products sold in the United States until the last several years. Although the issue of "allocation" generally involves the question of how much coverage is provided by a D&O policy when the underlying claim brought against directors and officers contains covered and non-covered claims, the fact scenario that has caused so much of an impact in the United States is when the underlying claim is brought against the corporation itself, in addition to certain or all of the corporation's directors and officers.

D&O insurers always have argued that the corporate "entity" is not covered under a D&O policy for direct liability. Therefore, say the insurers, when the underlying claim names the corporation, any defence costs or indemnity costs incurred in connection with such a claim must be "allocated" between the purportedly non-covered corporate "entity" and the covered directors and officers. Many D&O insurers argued that one form or another of a so-called "relative legal exposure" rule should be applied to D&O allocation issues. Pursuant to that rule, a court must engage in a complicated analysis of weighing several factors to come up with a definite allocation of defence costs and indemnity costs to all party defendants involved in the lawsuit, including the corporation and all individuals named in the lawsuit. Among other factors to be considered, the court must guess how much potential liability each party defendant faced and what proportionate benefit each party defendant received, from the expenditure of defence and settlement costs. Such an allocation, however, usually will leave the corporate entity policyholder with a substantial uninsured loss that, in the case of shareholder lawsuits in the United States, can range into the tens of millions of dollars.

Over the past several years, several large United States corporate insureds, faced with their carriers' insistence on "allocation" in cases where both the corporation and certain or all of its directors and officers had been named in a lawsuit, refused to allocate and sued their insurance carriers for full coverage. Obviously, the insurance industry's position on the "entity" coverage allocation issue was, and still is, completely at odds with policyholders' positions on the issue. With such a disparity in views, some important developments were bound to happen. Indeed, two very important developments have happened in the United States: (1) the development of D&O allocation case law and (2) the development of new insurance products intended to address these allocation issues before they develop into insurance coverage disputes.

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THE DEVELOPING LAW ON THE ISSUE OF "ALLOCATION"

The first United States Circuit Court of Appeals to address the "entity" coverage allocation issue did so seven years ago in Harbor Insurance Co. v. Continental Bank Corp.,3 In Harbor,4 the Seventh Circuit Court of Appeals squarely rejected the insurers' "entity" allocation argument, stating that:

[C]orporations purchase liability insurance for their directors and officers to avoid just the kind of liability that is at issue here, and to deny coverage of liability that arises from acts of the insured directors and officers would be to deny the full value of the premiums paid by the corporation....To allow the insurance companies an allocation between the directors' liability and the corporation's derivative liability for the directors' acts would rob [the corporation] of the insurance protection that it sought and bought.

Although Harbor was significant, it did not have any apparent immediate impact on D&O insurance sold in the United States. Nor did Harbor cause many policyholders to focus on the issue of "entity" coverage for securities-related claims. It was not until 1995, when three additional decisions were rendered by United States Circuit Court of Appeals applying the rationale of Harbor and other federal trial court and state appellate court decisions favourable to policyholders, that the issue received much publicity. Starting in the middle of 1995, many risk managers began seriously looking into the issue of "entity" coverage for the D&O insurance their companies purchased.

First, in Nordstrom, Inc. v. Chubb & Son, Inc.,5 the Ninth Circuit Court of Appeals applied Washington law and agreed with the analysis in Harbor. The Ninth Circuit affirmed the trial court's decision that all defence costs and the entire amount of settlement incurred in connection with a lawsuit brought against the corporate insured and certain of its directors and officers was covered. The Ninth Circuit ruled that the insurer had failed to show what amount, if any, of the corporate liability at issue was based on acts, errors or omissions committed by someone other than insured directors and officers. In other words, all of the liability of the corporation was "vicarious" of or "concurrent" with the liability of the covered directors and officers who were named in the lawsuit.

Secondly, in Safeway Stores v. National Union Fire Ins. CO.,6 the Ninth Circuit Court of Appeals applied California law and ruled that even if the underlying claim involves independent corporate liability, the "larger settlement" rule applies to the issue of allocating indemnity costs and the "reasonably related" test applies to the issue of allocating defence costs. The court ruled that because National Union failed to make a showing that the settlement in the underlying claim was larger than it would have been in the absence of the independent corporate liability at issue, the entire settlement amount was covered. The court also ruled that, because National Union failed to show what amount of defence costs were not at all related to the defence of covered claims, all of the defence costs were covered because they "reasonably related" to defending covered claims.

Thirdly, in Caterpillar, Inc. v. Great American Ins. Co.,7 the Seventh Circuit Court of Appeals followed its earlier ruling in 1990 in Harbor. The court applied the "larger settlement" rule to a settlement of an underlying claim naming Caterpillar and certain of its directors and officers to determine what portion of a settlement the insurer was obligated to pay.

THE DIFFERENT D&O INSURANCE PRODUCTS INTENDED TO DEAL WITH THE ISSUE OF "ALLOCATION"

As the coverage disputes played out in the cases described above, risk managers, the insurance industry and commentators alike began discussing the issue of "allocation" more and more. Almost everyone involved believed a "solution" was needed. The result has been the creation of several different manuscripted forms and indorsements, all intended to offer the corporate insured that "solution" to the "allocation" problem. Indeed, insurers have taken so many different approaches that one commentator has noted that "the number of D&O coverage allocation options for policyholders with securities-related exposures has exploded since last spring [of 1995]."8

Perhaps the first insurer to provide an optional D&O product in the United States in response to the "entity" coverage allocation issue is National Union Fire Insurance Company of Pittsburgh, Pa., a member of American International Group (or AIG) ("AIG"). Several years ago AIG began offering an option to its D&O policy by way of an indorsement that purported to provide "entity" coverage for "open market securities claims" as defined in the indorsement. However, in 1995 AIG abandoned the indorsement approach and released an entirely new D&O form into the market that provided "entity" coverage for "securities claims" as defined in the form. The new AIG form offered, however, only a "mixed bag" of benefits and disadvantages. Perhaps in response to criticisms of its D&O form and/or market pressures, AIG began offering its "Securities Plus" indorsement, which it first introduced into the market in mid-1996. AIG's "Securities Plus" indorsement goes very far to cure many of the deficiencies in its D&O policy form, although there still are issues that policyholders should address when placing such coverage (those issues are discussed below).

Although AIG was perhaps the vanguard for offering "entity" coverage to for-profit corporations in 1995, 1996 witnessed a tremendous proliferation in the number of insurers selling "entity" coverage D&O insurance in the United States. For example, whereas Federal Insurance Company, a member of the Chubb Group of Insurance Companies ("Chubb") offered only "predetermined allocation" coverage for securities-related claims in 1995 (a type of coverage discussed below),

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3 922 F.2d 357 (7th Cir. 1990).
4 ibid. at 368.
5 54 F.3d 1424 (9th Cir. 1995).
6 64 F.3d 1282 (9th Cir. 1995).
7 62 F.3d 955 (7th Cir. 1995).
Chubb introduced its own form of "entity" coverage indorsement in 1996. Many other insurers began offering "entity" coverage for securities claims in 1996, including but not limited to Admiral Insurance Company, Genesis Insurance Company, AESIC, Great American Insurance Company, Gulf Insurance Company, Reliance National Insurance Company and certain Underwriters at Lloyd’s and certain London Market Insurance Companies. Because of the vast number of different insurers offering "entity" coverage on their own manuscripted forms, I recommend to any company looking to purchase such coverage that it review all forms offered by all D&O insurers selling policies in the United States before the corporation ultimately buys such coverage. As will be explained below, there are several issues that should be addressed when placing or renewing such coverage and the forms offered by insurers do not use the same language in their coverage grants, exclusions, definitions and conditions. Indeed, after reviewing many of the forms in the market, I would venture to say that no one form is best, but rather that an as yet non-existent form combining the best parts of all existing forms would be the one that a corporation should purchase.

As an alternative to "entity" coverage, some insurers also offer a "predetermined allocation" or "concurrent liability" indorsement to attach to their D&O policies. Although in 1995 some insurers offered only such indorsements, rather than both "entity" coverage and such indorsements, in 1996 almost all insurers who offer such indorsements also offer full "entity" coverage. "Predetermined allocation" and "concurrent liability" indorsements purport to resolve "allocation" coverage disputes by setting a predetermined allocation for "securities claims" - whether it be 60 per cent, 75 per cent, 90 per cent or 100 percent - depending upon how much premium the insured is willing to pay (the higher the predetermined allocation, the greater the premium). These indorsements appear to be a less satisfactory response to "allocation" issues than the "entity" coverage concept. As with the "entity" coverage forms, a question remains as to what, if any, shareholder liability exposure falls outside the scope of "securities claims" as defined in "predetermined allocation" and "concurrent liability" indorsements. In addition, such indorsements 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 defence or indemnity costs incurred in connection with an underlying claim, there must first be a determination of whether such costs relate to the defence of claims made against one or more covered directors or officers. For what it is worth, an insured can avoid this last problem by buying an "entity" coverage form with a co-insurance clause whereby the insured retains some substantial percentage of all losses (e.g. 40 per cent, 30 per cent, etc.). Buying a form in such manner (which AIG has sold in the past) functionally makes an "entity" coverage form an enhanced "predetermined allocation" or "concurrent liability" form.

IMPORTANT ISSUES TO CONSIDER FOR ANY INITIAL PLACEMENT OR RENEWAL OF "ENTITY" COVERAGE

Although there are myriad issues to consider when initially placing or renewing D&O insurance in general, there are several important issues to consider when initially placing or renewing "entity" coverage. The fact that "entity" coverage forms are "manuscripted" by D&O insurers and for the most part have not yet been "tested" by courts in the United States gives rise to two unique problems when initially placing or renewing "entity" coverage. First, virtually every "entity" coverage form offered by insurers in the United States is different - the insurers define securities-related claims differently, they define claim differently, they use different exclusions that apply to the corporation, etc. Secondly, it is difficult, if not impossible, to discern what impact, if any, such differences will have on coverage for securities-related claims and non-securities-related claims. About the only concrete observation that can be made is that corporate policyholders should examine D&O policy forms offering "entity" coverage very carefully when placing such coverage for the first time or renewing an "entity" coverage programme.

Set forth below is a brief discussion of several of the important issues to consider. The discussion is not intended to be a substitute for an independent analysis of the forms being offered in the market. Rather, it is intended to provide the reader with insights to assist the reader’s own analysis of the policy forms should the reader decide to conduct such an analysis.

HOW CAN ONE RECONCILE "ENTITY" COVERAGE WITH A BELIEF IN ALLOCATION RULES THAT FAVOUR POLICYHOLDERS?

What does "entity" coverage really do? If the insured is in a jurisdiction that does not have favourable allocation rules applicable to D&O policies, the coverage buys "good law" on allocation. More importantly, however, what happens if the corporation alone is sued, or if the directors and officers sued along with the corporation are not held liable but the corporation is, or if the directors and officers sued along with the corporation eventually are dismissed from the case? Has this happened? Unfortunately, yes, and the D&O insurers involved denied indemnity coverage for the judgment because their policies did not afford "entity" coverage. Accordingly, "entity" coverage secures coverage in those circumstances where a policy not providing "entity" coverage might not apply.

What if the insured buys "entity" coverage for "securities claims" but not "predetermined allocation" or "concurrent liability" coverage for non-"securities claims"? If any at all, does that affect allocation issues for non-"securities claims"? There does not appear to be any law on this issue, but because "entity" coverage has not been purchased on a regular basis (until, perhaps, in 1996). In the absence of policy provisions to the contrary, insurers likely will argue that, if the insured does not buy "predetermined allocation" or "concurrent liability" coverage for non-"securities claims" but does buy "entity"
coverage for "securities claims," then the insured should not be entitled to favourable allocation rules for non-"securities claims." In such circumstances, D&O insurers likely will argue that the "relative legal exposure" analysis or worse should apply to all allocation issues posed by any claims.

However, there is a very straightforward way to reconcile an insured's decision to purchase "entity" coverage for "securities claims" but not buy "predetermined allocation" or "concurrent liability" coverage for non-"securities claims" (if the policy is silent on allocation issues for non-"securities claims"). Even if the insured believes that the "reasonably related," "derivative liability," "concurrent liability" and "larger settlement" rules apply to allocation issues under its D&O policy, the "entity" coverage is being purchased to protect against a contingency with respect to which such allocation rules might not apply—where only the entity is sued or a judgment is rendered against only the corporation while the same judgment exonerates all directors and officers named in the lawsuit along with the corporation. Thus, it is not inconsistent to buy "entity" coverage for "securities claims" but not buy "predetermined allocation" or "concurrent liability" coverage for non-"securities claims." By doing so, an insured should not be precluded from applying favourable allocation rules to its D&O policy for non-"securities claims."

**WHAT IS THE BREADTH OF SECURITIES-RELATED CLAIMS FOR WHICH "ENTITY" COVERAGE IS AFFORDED?**

Not every "entity" coverage form defines securities-related claims in the same way. Chubb, for example, uses the phrase "securities transaction", while AIG uses the phrase "securities claim." The language used to define "securities transaction" in Chubb's indorsement differs from the language used to define "securities claim" in AIG's policy. Regardless of the phrase or definition used, the important issue to analyse is the breadth of securities-related claims coverage. The definitions used should be as broad and all encompassing as possible, because only those claims that fall within the scope of such definitions will be subject to the "entity" coverage afforded by the policies.

In other words, whatever claims fall outside the definition of "securities claims" or "securities transaction" or whatever other "label" the insurer uses, such claims will not be subject to the "entity" coverage afforded by the policy. That is not to say that such claims will automatically be subject to an allocation not favourable to policyholders. As mentioned above, there is a logical way to reconcile the purchase of "entity" coverage with a belief in favourable allocation rules so that the insured's purchase of "entity" coverage should not preclude it from applying favourable allocation rules to non-securities-related claims. Unless the policy provides otherwise (and some do, as explained below), the policyholder should be free to argue that the allocation rules adopted by the courts in the cases discussed above apply to its claim.

Nevertheless, from the standpoint of trying to avoid as many coverage disputes as possible by taking time to address issues during initial placements and renewals of insurance policies, it is advisable to deal with this issue upfront by using the broadest possible definition of what securities-related claims are going to be subject to the "entity" coverage afforded by the policy. In this way, hopefully the insurer's response to securities-related claims made against the corporate insured are within the insured's expectations.

**HOW DOES THE POLICY ADDRESS ALLOCATION REGARDING CLAIMS FALLING OUTSIDE THE DEFINITION OF "SECURITIES CLAIMS"?**

Some of the "entity" coverage forms and indorsements provide that the "relative legal exposure" analysis will apply to the allocation of claims that (1) fall outside the definition of "securities claims," and (2) are not covered by the policy. Chubb's and AIG's forms are examples of such policies. The "relative legal exposure" analysis is, typically, favourable to insurers and it has been rejected by several courts in favour of very favourable allocation rules for policyholders, all as discussed above. In contrast, some policies are using "predetermined allocation" or "concurrent liability" coverage provisions to address allocation issues (whether they relate to securities and non-securities claims or covered versus non-covered claims)? Admiral's and Lloyd's and the London Market's forms are examples of such policies.

What should a policyholder do with respect to these allocation issues for non-securities claims? It seems self-evident that an insured should insist on removing any and all "relative legal exposure" language from its D&O policy. The harder question is whether an insured should leave the policy silent or use "predetermined allocation" or "concurrent liability" provisions for all allocation issues that are not resolved by the "entity" coverage afforded by the policy. To answer this question, one must ask what "predetermined allocation" or "concurrent liability" coverage really does for the insured who buys "entity" coverage for "securities claims"? It essentially indorses onto the policy the favourable allocation rules discussed above—typically, the "reasonably related" test for defence costs and the "derivative liability" or "concurrent liability" test for settlements and judgments (it is not certain whether "predetermined allocation" or "concurrent liability" coverage provisions are intended to incorporate the "larger settlement" rule).

Given these considerations, how does one answer the question of whether an insured should purchase "predetermined allocation" or "concurrent liability" coverage if the insured purchases "entity" coverage for "securities claims"? If the policy is silent on allocation for non-"securities claims" and other allocation issues, and the insured knows that favourable allocation law will apply to the interpretation of its D&O policy, then it does not appear to be cost-effective to pay extra premium for a "predetermined allocation" or "concurrent liability" indorsement for non-"securities claims" and other allocation issues—it does not really add coverage. If, however, the insured knows that the law applicable to its D&O policy is not favourable on allocation issues, then it makes sense to pay the extra premium for a 100 per cent predetermined allocation indorsement (or something like 90/10 or perhaps even 80/20 if the law is extremely bad). With respect to what law will apply to an insured's D&O policy, note that arbitration provisions add a "wild card" element because arbitrators typically are not bound to follow any particular
state's law, even when the arbitration provision itself says a particular state's law will govern the interpretation of the policy.

DOES THE POLICY PROVIDE SEVERABILITY AS TO EXCLUSIONS?

One of the more easy to identify issues when placing D&O insurance before the advent of "entity" coverage for "securities claims" was the issue of severability as to exclusions. The issue of severability is that the policy should be treated as being separately issued to each director and officer, so that if one director or officer is excluded from coverage for a certain claim, coverage can still be afforded for all other directors and officers.

This issue of severability is very important when it comes to "entity" coverage. Some "entity" coverage forms read as if there is no severability between the corporate entity and insured persons (note that some D&O forms now define "insured persons" to include all past, present and future employees for "securities claims" coverage), so that if one insured person is excluded from coverage for a particular "securities claim," the corporate entity is also excluded from coverage. Other forms extend severability as between the corporation and all insured persons except for the conduct of a few key officers.

What should corporate policyholders do with respect to this severability issue? The corporate policyholder should insist on complete severability between the corporation and all of its directors and officers. The only exception, perhaps, would be intentionally injurious conduct by an officer or director that is authorised or ratified by the shareholders or board of directors of the corporation. The law in many states is clear that a corporation insured can be provided coverage for its vicarious liability based on intentionally injurious acts by its employee or agent, as long as the corporation's shareholders or board of directors do not authorise or ratify the conduct at issue. Accordingly, the corporation should be afforded full coverage for any particular claim otherwise covered by the policy, even if one of its directors or officers is barred from coverage for the same claim.

DOES THE POLICY PROVIDE SEVERABILITY AS TO THE APPLICATION FOR INSURANCE?

When responding to claims, D&O insurers often reserve the right to deny coverage and sometimes actually deny coverage, on the basis that one or more particulars or statements made in the application for insurance are false. However, many D&O policies provide that there is complete severability as between all directors and officers with respect to the application for insurance. For such policies, if a false particular or statement permits the insurer to avoid coverage as to the director or officer responsible for the false particular or statement, the insurer is not also permitted to avoid coverage as to all other directors and officers.

As one might imagine, this issue of severability is very important for "entity" coverage. The corporate policyholder does not want the insurer to be able to avoid the policy as to the corporate entity merely because of a false particular or statement made by an insured person in the application for insurance. Also, the corporate entity does not want the knowledge of all insured persons imputed to it in order for the D&O insurer to assess whether, from the corporate entity's standpoint, there are any false particulars or statements in the application for insurance.

As with exclusions, the corporation should have full severability as between it and all insured persons with respect to the application for insurance. As an alternative agreeable to some insurers who will not give full severability, only the knowledge of a few key officers is imputed to the corporation.

DOES THE POLICY CONTAIN ARBITRATION, CHOICE OF LAW AND CHOICE OF FORUM PROVISIONS?

Some D&O forms offering "entity" coverage contain provisions relating to how and where coverage disputes will be resolved and what law will be used to interpret the policy. Corporate policyholders are encouraged to analyse these provisions and fully understand their importance. The most favourable provision from the insured's standpoint gives the insured the right to force the insurer to arbitrate or litigate the coverage dispute at issue. Some insurers are willing to provide such a provision. For example, AIG's "Securities Plus" indorsement and Chubb's D&O form contain such provisions.

SHOULD THE COMPANY ADD COVERAGE FOR EMPLOYMENT PRACTICES LIABILITY?

Although a thorough discussion of the developments of standalone Employment Practices Liability Insurance ("EPLI") policies in the United States is beyond the scope of this article (and very well could be the subject of another article regarding developing insurance law and products in the United States), a word about insuring Employment Practices Liability with the D&O insurance product is in order. Several years ago many D&O insurers began offering an indorsement that provides coverage for "employment practices liability claims" as defined in the indorsement. Such claims generally encompass claims involving wrongful termination, harassment (sexual and otherwise) and discrimination.

Some corporate insureds, not willing to buy standalone EPLI policies, add the EPL indorsement to their D&O policies. At best, however, such a decision appears to be only a temporary solution. EPL coverage under D&O policies typically does not provide coverage to the entity, so that allocation issues almost always exist for EPL claims tendered to a D&O insurer. Also, I question the long-term benefits of subjecting a D&O programme to claims experience and cost erosion of EPL claims. In my opinion, it is better in the long run to purchase a standalone EPLI policy programme to address both of these issues. Indeed, in response to the many policyholders looking into the issue of initially placing a standalone EPLI policy programme, the EPLI market in the United States has been just as "explosive" in 1996 as the "entity" coverage D&O market.

However, there currently is much "talk" amongst risk management professionals in the United States that some insurers offering D&O insurance in the United States are bent on making the D&O insurance product evolve into an
"entity" coverage form for not only "securities claims" and "employment practices liability claims" but also other claims as well. Such insurers apparently want to eliminate the entire market for standalone EPLI insurance and several other standalone products. This issue may be just as important to follow as the issue of the evolution of "entity" coverage for "securities claims" under D&O insurance. In other words, is D&O insurance offered in the United States in the process of moving to a revolutionary new form where risks never before insured under such forms will be insured, or will D&O insurance sold in the United States maintain its uniqueness while newer products on a standalone basis, such as EPLI policies, continue to proliferate? Time may prove very interesting indeed.

CONCLUDING REMARKS

Perhaps the developments that have transpired in the area of D&O insurance law and products in the United States within the last couple of years foreshadow events that will occur in other markets around the world. Or perhaps each market will develop its own particularities based upon the unique characteristics of its laws of director and officer liability and insurance contracts. Either way, insurance lawyers in the United Kingdom and Europe may find it useful to fully know and understand D&O insurance law and products so that they can better serve their clients' needs with respect to those issues, not only locally but also globally.