A VALUABLE GUIDE

What Risk Managers Should Know About D&O Claims

BY MICHAEL A. ROSSI

With potentially high defense and settlement costs, and the personal involvement of outside directors and senior managers, directors' and officers' (D&O) lawsuits can represent one of the most challenging exposures risk managers must address. There are a number of issues that I believe every risk manager should know about handling these potentially volatile claims. Although there are several different ways to convey that information, I thought I would give you a road map, so to speak, of what to expect and what to look for when handling a D&O claim.

If an allegation of improper conduct has been made against a director or officer of your company, where do you begin? Defending a D&O suit successfully starts with sending the proper notice. Look at the provisions of your D&O policy. Is notice supposed to go to the broker, insurer or some other person? Follow the policy's instructions. If it says that you must give notice to the insurer, do not merely notify your broker - there are actual court decisions addressing coverage disputes arising out of the form of notice given. Such disputes can be avoided simply by following the instructions in the policy. Of course, if you want to keep your broker involved, which is advisable, send the broker a copy of the notice.

In addition, analyze the claim to determine whether any of your company's other insurance policies can respond. The most commonly overlooked overlapping coverage is provided by commercial general liability (CGL) policies. What kind of claims can be covered under both D&O and CGL policies? Sometimes a corporation and its officers are sued by a competitor alleging antitrust or trade secrets violations or unfair competition. The lesson here is that a risk manager should never assume that a claim can apply only to one policy. Whenever an officer or director is sued

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(whether or not the corporation is also sued), the claim should almost always be tendered to all potentially applicable policies.

Incurring Defense Costs

Most D&O policies have a condition that provides that the insured must obtain consent from the insurer before it incurs any costs in connection with the defense of an underlying claim. Under this provision, any defense costs incurred before such consent is obtained are not covered. In response, I recommend inserting some language into the notice letter saying that because the insured must immediately defend itself (to protect its and the D&O insurer's interests), it presumes that the carrier consents to the policyholder's choice of counsel and decision to defend itself. It's also helpful to add that unless the insured hears to the contrary within a specified time (typically 15 calendar days), it will deem that the insurer has consented to the policyholder's choice of defense counsel and the incurring of reasonable costs.

What do you do when the D&O insurer's coverage lawyer sends a 30page reservation of rights letter listing a host of reasons why the policy does not or may not provide any coverage? In the past, most attorneys thought the best way to respond to such a letter was to address every issue raised. The thinking on that strategy has changed over the years. Rather than wasting money to prepare a response to all of the issues, I simply send a brief letter stating that my client disagrees with every point made in the reservation of rights letter – either because the insurer is wrong as a matter of law or the issues being raised are too premature and speculative to warrant further attention.

Another issue raised in a typical reservation of rights letter is the assertion that the insured's defense counsel must follow litigation practices and procedures guidelines promulgated by the insurer – typically some 20-page document filled with conditions that a defense lawyer would be unlikely to follow if he or she were representing only the insured. I meet this assertion head on, explaining that there is absolutely no basis in the policy or law for the insurer to insist on such a requirement. I have not had a D&O insurer yet refuse to withdraw its demand after I've stated such an objection. My advice is to resist that sort of conduct and encourage the insurer to address the real issues presented by the underlying claim.

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Sharing Information

One potentially dangerous and often overlooked issue in D&O insurance is how to respond to the insurer's request for privileged information. Most states recognize that disclosure of privileged information by the policyholder to its liability insurer does not act as a waiver of the privilege and protection that attach to the information. The two most common forms of privilege that should be preserved are the attorney-client privilege and attorney work product doctrine. Courts recognize that the waiver of such protections would not make sense when the liability insurer's policy contains a "duty to defend" that obligates it to appoint counsel to protect and defend the interests of its policyholder.

However, whether disclosing information to a D&O insurer whose policy does not contain a duty to defend waives such privileges is a serious issue addressed by only a handful of courts. Policyholders are encouraged not to treat this issue lightly. The policyholder should research the law that applies to its claim and determine whether privilege is preserved or waived by such disclosure. Some courts have held that disclosure waives the protections and therefore, the insured is not required by the D&O policy's cooperation clause to disclose any protected information to the carrier. Other courts, however, disagree.

If the law in your jurisdiction provides that disclosure of privileged information is not protected and that the insured is not obligated to share that information, you should advise your insurer and not disclose the information. If the law in your jurisdiction is not clear, I would advise the insurer of the issue and ask how the carrier wants to address it. Insurers typically suggest entering into an agreement with plaintiffs in the underlying claim that they will not take the position that the insured's disclosure of information waives any privileges that attach to the information. I cannot overemphasize how important this issue is: It is imperative for insureds to address the issue immediately after the D&O insurer requests privileged information - otherwise the policyholder or its defense lawyer may divulge information that is sensitive to the underlying claim and discoverable by the plaintiffs.

Another issue that should be addressed at the outset of the claim is whether the D&O insurer must pay defense costs on behalf of the insureds as costs are incurred, reim-

burse policyholders for such costs or pay nothing until the underlying claim is resolved. The choice depends upon the particular terms of the D&O policy and the state law that applies to the interpretation of that policy. Many policies contain a provision that expressly states that the insurer has no obligation to pay any costs until the final resolution of the underlying claim. If your D&O policy contains such a provision, ask yourself what value, if any, is derived by using "pay on behalf of' language.

let's assume that your D&O policy does not contain this provision. With respect to such policies, some courts have held that the D&O insurer is obligated to pay defense costs as they are incurred. Those courts focus more on the language "legally obligated to pay" in the insuring agreements than the "pay on behalf of" language, reasoning that an insured becomes obligated to pay defense costs as soon as a lawyer is retained. It does, however, help from a cash-flow standpoint to have a "pay on behalf of" provision rather than "indemnify" language.

When the D&O insurer must pay defense costs as they are incurred, an additional question is raised. What if the claim is ultimately not covered? Is the D&O insurer entitled to reimbursement of such costs? Was the insurer merely "advancing" defense costs, or was it "paying" or "indemnifying" defense costs as they were incurred? Again, it depends upon which state's law applies to interpret the policy. Some courts have held that the D&O insurer is merely "advancing" defense costs and can seek reimbursement if the underlying claim ultimately is not covered. Others have held that the D&O insurer's payment or indemnification of defense costs as they are incurred in connection with potentially covered claims is final.

Allocation Improvements

Although a discussion of allocation issues under D&O policies today is a bit dated, some court decisions have changed some of the traditional assumptions, so a review may be helpful. Unless the policyholder has purchased "entity" coverage, insurers would seek to allocate costs in any claim that names the corporation along with any directors or officers. Insurers would take the position that the corporation is not considered an insured under the D&O policy, so if a claim were made against both the corporation and its directors and officers, any defense, settlement and judgment costs attributable to the corporation would not be covered.

This situation improved from the standpoint of corporate insureds after several important decisions were rendered by the U.S. Circuit Court of Appeals in 1995. The court applied a variety of allocation rules to standard form D&O policies, including those with the "best efforts" allocation language in them, that are very favorable to policyholders. In brief, those allocation rules can make it very easy for a corporation sued along with its directors or officers to argue successfully that all of the defense and settlement costs incurred in connection with the underlying lawsuit are covered by a D&O policy, even if the policy does not expressly provide coverage for the corporate entity.

With respect to defense costs, the "reasonably related" rule dictates that, in order not to 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 actions of a director or officer. This burden is very difficult if not impossible to meet in most D&O cases.

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 actions 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 non-covered claims). In addition, even if some of the corporation's liability in connection with the settlement is not based on the actions 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. That too is difficult to show in most D&O cases.

The Final Option

If a coverage dispute arises, it rarely (if ever) makes sense to sue the carrier as an initial step. However, let me suggest one tactic that I have used successfully several times on past D&O claims. On more than one occasion, my client and I have argued strenuously that the D&O insurer was obligated to provide full coverage for a proposed settlement. After months of negotiation, we reached a stalemate and were headed for court. But in each instance the underlying claim was pending in a federal district court, so we filed our lawsuit with a notice of "related action" and got both actions brought before the judge presiding over the underlying claim. We immediately requested a settlement conference, and every time, the judge has been able to persuade the D&O insurer that it was obligated to provide full coverage. Some D&O insurers are much more inclined to fund a settlement of an underlying claim when the insured's position is shared by the judge presiding over the underlying claim and coverage lawsuit.

The potential difficulties and coverage disputes associated with D&O claims have inspired some industry critics to question whether standard form D&O policies have any value at all. I believe they do, although some of my clients have had to strenuously negotiate, and sometimes litigate, with their D&O insurers to get claims paid. But that is often a standard procedure when presenting claims under many insurance policies. And risk managers who know how to successfully navigate a claim through the insurance adjustment process are the ones who serve their employers most effectively. RM