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The Handling of a D&O Claim: The Insurer's Perspective

by Anthony J. Falkowski

What happens when a corporation's directors are served with a suit? Knowledge of the claims handling process from the insurer's perspective can assist astute risk managers in performing an invaluable role for their organizations at this critical time. The following describes what one can expect in the event of a D&O suit.

The Insured's Responsibilities

As soon as a suit is served, the insured should report the claim to the broker and insurer, thereby initiating the claims handling process. The D&O policy includes instructions for reporting a claim, but it is a good idea also to rely upon the broker's advice, given the complexity of D&O liability. A copy of each of the complaints and any exhibits to the complaints accompany the report. A responsible insurer will send an initial acknowledgement of the claim report within two days. A more detailed response will follow when the insurer has had an opportunity to examine the claim in light of the policy.

Simultaneously with reporting the claim, the insured must quickly select its defense counsel--the first critical step in the successful outcome of the claim. Because the D&O policy is based on the insurer's "duty to indemnify" the corporation's defense costs for its directors and officers--not the "duty to defend," as in some other types of insurance--it is the insured's obligation to retain defense counsel. Risk managers who understand what is involved can provide important insights into the selection of counsel. They should focus on several considerations:

First, should single or multiple counsel be retained? That decision hinges partly upon what potential conflicts might arise. Conflicts might occur between inside and outside directors, and occasionally between directors and the corporation itself. The presence of actual or potential conflicts may require the use of multiple counsel. Multiple counsel also greatly simplifies allocation negotiations (a subject to be discussed later). However, the benefits of presenting a single, unified strategy and appearance in defending the suit may weigh heavily in favor of using single counsel. The use of single counsel also helps to control

legal costs, so that the maximum amount of the policy limit remains available for the ultimate settlement.

Secondly, should the organization retain its existing outside counsel or hire new counsel specifically to handle this suit? If it is not precluded by a conflict of interest, the existing counsel has the obvious advantage of an ongoing relationship and an understanding of the organization's business affairs. On the other hand, if regular counsel lacks litigation expertise or specific expertise in D&O liability, it may make more sense to look for a firm with this experience, particularly one with a track record for achieving dismissal of D&O charges. A new firm brings an objectivity that is often valuable in decision-making. Furthermore, if the existing firm was the transactional counsel--that is, attorneys who gave advice on the transaction or event that gave rise to the claim--two areas of potential conflict arise: these attorneys may become witnesses or defendants in the suit.

The potential conflict of transactional counsel raises the issue of insurance considerations in appointing defense counsel. The policy requires that the insured gain the insurer's consent to the defense counsel. While the insurer will be looking for experienced defense counsel, it might be difficult to secure an insurer's consent for retaining transactional counsel. At least one insurance company is presently preparing a panel from which its insureds must choose its defense counsel. In other cases, a company seeking effective D&O defense attorneys may want to consult with its insurer for recommendations. While insureds might expect insurance companies to recommend attorneys sympathetic to their own views, in reality, the insurer realizes that getting the suit satisfactorily resolved is in everyone's best interests and will want to recommend professionals with a record of achieving favorable results.

The risk manager may need to explain other practical insurance considerations, as well. For instance, according to the D&O policy, will payments for defense expenses be made contemporaneously or reimbursed? What is the size of the deductible that must be met before the policy is triggered? Risk managers should also be prepared to explain why defense costs must be allocated at some point in the claim process--that is, a decision will be made assigning the insurer and the insured each a percentage of the defense costs, based on what portion of the allegations, named parties and capacities in the complaint are covered or not covered under the policy.

Once decisions based on these considerations have been made and a short list of potential defense counsel developed, the final choice will depend upon evaluating such important factors as qualifications, resources, litigation strategy, the confidence the lawyers inspire, and reasonable costs--an item that includes not only rates, but also staffing levels, timing of payments and the forms of bills.

The Insurer's Responsibilities

The insurer's actions during this initial period parallel those of the insured. On the basis of the claim report and the D&O policy, the insurer must decide whether or not to retain monitoring counsel, attorneys who represent the insurance company. The decision will be based on three factors: the severity of the claim, the complexity of the legal and factual issues involved, and coverage issues. If monitoring counsel is retained, the lawyers will assist the insurer in reviewing policy exclusions, just as the defense counsel does for the insured. Often allegations in a suit are very broad. Insurers do not know which of the allegations and named parties are covered under the D&O policy until they apply the policy exclusions which define coverage--a process that insurers must undertake as quickly as possible in order to provide their insureds a more detailed response known as the "Reservation of Rights" letter.

Examination of exclusions cannot be limited to the narrowly-defined "Exclusions" section of the policy. Sometimes exclusions are found in the form of definitions, terms and conditions, or appear in preambles and endorsements. The insurer looks at three general types of exclusions. Conduct exclusions, which pertain to standards of corporate governance, derive from state indemnification provisions and limitations of liability provisions. D&O insurance may not cover behavior related either to personal profit-taking--as unlawful remuneration, 16B profits (insider trading), and breach of the duty of loyalty--nor may it cover dishonesty and fraud.

Secondly, other insurance may preclude coverage under the D&O policy. There may be a prior policy in place, or allegations involving bodily injury, property damage, pollution, or ERISA, that are covered under other types of insurance policies. Finally, D&O policies have certain claimant exclusions. They do not cover claims by one insured against another, claims by creditors, or by regulatory bodies. In addition to these exclusions, D&O policies generally state that they exclude coverage for pending and prior litigation.

Making some coverage decisions may require delving deeper into the discovery process to obtain information. Yet the insurance company is required to inform its insured of possible coverage exclusions soon after the onset of a claim. Therefore, the Reservation of Rights letter, advising the client that there may be potential exclusions from coverage, is a legal necessity--if a sometimes unpleasant one.

First impressions are important, and there is much that a service-oriented insurer, who is sensitive to the risk manager's position relative to the senior management and director recipients of the Reservations of Rights letter, can do to improve these first communications. By limiting the length and content of letters to issues specifically germane to the case and adopting a non-confrontational tone, the insurer can do much to pave the way for a mutually beneficial working partnership. In addition, an explanatory phone call to the risk manager and broker prior to sending the letter and an invitation to call with further questions seem natural courtesies that go a long way in opening the lines of communication for handling the entire claim. This assistance from the broker and insurer gives the risk manager an opportunity to advise management about what to expect and why.

Interactive Strategies

The typically long discovery process continues, with the insurer usually requesting further information and documents. Depositions are scheduled, damages analyzed, expert witnesses aligned, and defense strategy formulated. The defense may enter a motion to dismiss the complaint. Barring such a dismissal, at some point in the process, both sides begin to evaluate the claim and move toward settlement and resolution of coverage and allocation issues through negotiation. Arbitration is a rarely-used means of issues resolution which should become more common in the future, as a way of containing defense costs. Because of the enormous potential damages in securities cases, they are almost always settled.

Because coverages are clearly delineated in the policy, coverage disputes occur less frequently than allocation disputes. Occasionally, a coverage dispute will derive from a question of capacity: Was the director or officer acting in his or her official capacity or in another capacity when the allegations occurred? If an individual was an outside director, whose interests was he or she representing?

Allocation is generally resolved later, near the time of settlement. Since the insured must go through the policy deductible before indemnification of defense expenses applies, allocation is moot early in the process. However, the fact that the deductible has not yet been completely depleted by defense costs can tend to distract insureds from anticipating the issue of allocation and thus create a problem. As a general rule, it is appropriate to start talking about allocation when 50% to 75% of the deductible has been used in expenses.

Allocation is the source of the most complicated negotiations between insurer and insured and, understandably, a source of frustration for many risk managers. Yet getting past this step enables both parties to concentrate on negotiating a satisfactory settlement with the plaintiff. Allocation negotiations occur simultaneously with the plaintiffs, defense counsel and the insurance company or its monitoring counsel. While defense counsel generally handles allocation negotiations on behalf of the corporation, a risk manager should remain actively involved, providing defense counsel with a thorough knowledge of the allocation process.

The need for allocation arises because the D&O insurer is not obligated to pay for defending allegations, parties, or capacities not covered by the D&O policy, even though these often appear concurrently with covered allegations and claimants. For instance, while D&O policies typically cover loss incurred by directors and officers, they do not cover the corporate entity's liability to claimants for its own wrongful acts. A single complaint may include such uncovered allegations as fraud or insider trading, together with such covered allegations as negligence or breach of fiduciary duties. And an insurer may not be liable for the entire costs of defense or settlement amounts attributable to a covered individual who is being sued in both an insured and an uninsured capacity. Such an issue can arise, for example, where a member of a law firm that advises the board of directors sits on the board or where a director or officer is also a potential buyer of the corporation, a director of a subsidiary, or a majority shareholder.

Allocation carries a burden of proof, and court decisions have not given a definitive answer to the question of where the burden lies. Consistent with the general principal that an insured must prove its loss under an insurance policy, the majority of courts have placed the burden on the insured to prove the extent to which incurred expenses are attributable to the D&O coverage. Yet in at least one major case, a state court held that the D&O insurer must bear the burden of proving the sums which were attributable to non-covered parties

and thus excluded from coverage. In another, a federal court held the D&O carrier responsible for defense costs and settlement.

Various methods have evolved as the courts have attempted to arrive at a fair apportionment of defense costs and/or settlement amounts. The approach in each case reflects the type of allocation sought by the parties. The relative exposure method allocates according to the relative risks of exposure or culpability of the parties involved in a claim. The relative exposure is indicated by certain factors, such as the order in which the defendants are named in the underlying litigation, allegations and facts actually discovered, and the extent to which individual defendants are exempted by statute or charter. In addition, the court may consider the relative benefit that each party will derive from settlement, as well as the parties' intentions and motivations for settling. These factors could alter with changing circumstances, such as a new acquisition, during the claim process. The court may also consider the relative resources available for funding defense costs and settlement and the potential effect of the "deep pockets" factor on the liability of each beneficiary. Of course, specific facts peculiar to particular litigation may always affect the allocation balance.

Even where allocation is performed using the relative exposure method, some courts have found it appropriate to group parties according to their involvement in the underlying action. This pro-rata approach involves apportioning the loss among the respective parties by grouping them, primarily according to their degree of fault or likelihood of adverse judgment. For instance, third-party defendants, such as accountants, may be grouped as one entity if their collective actions contributed to a loss, and their liability would then be assessed in relation to that of other co-defendants, such as named directors and officers and the corporate entity.

A few courts have used a reasonable relationship standard in allocating defense costs. That is, the insurer must pay the costs reasonably related to the defense of covered claims, even if they are partially related to the defense of non-covered counts.

A comprehensive approach to a fair allocation should include practical considerations, as well as an evaluation of legal and factual issues. Coverage issues, such as covered claims, capacity and recisión, are examples of practical considerations that may cause a modification of an apportionment initially based on the relative exposure of different defendants. The deductible is another practical consideration.

It is critically important that, despite possible differences over defense cost allocation issues, insurer and insured remain focused on the true adversary, concentrating on a unified defense strategy and a successful settlement. Settlement involves a tri-party relationship between the plaintiff, the defense counsel and the insurance company or its monitoring counsel. The insurer and insured have the same economic incentive to work cooperatively to bring the claim in for the least amount possible. Defense counsel should be prepared to present a settlement strategy and to get the insurer's consent to settle, a step that many policies require. Because the insurer will be paying a percentage of any settlement, defense counsel needs its consent before negotiating any settlement allocation offer with the plaintiff. Usually, establishing first the settlement allocation with the insurer enables the insured to determine accurately the uninsured portion of any settlement and to concentrate on negotiating a satisfactory settlement with the plaintiff.

The fourth party in the settlement scenario, the judge, can make a difference in the outcome. Occasionally, a very strong judge will force a settlement; conversely, a weak judge may not steer the parties toward resolution. By bringing a swifter resolution, the former helps to contain legal costs, since attorneys have an economic incentive to draw out the process. The judge is also responsible for approving the plaintiff fees. Experience suggests that many times the settlement amount is determined by these plaintiff fees, rather than by an objective evaluation of the liabilities involved in the suit.

Conclusion

As the foregoing discussion indicates, the D&O claim handling process is quite complex. Since everyone involved has the same goal of reaching a successful outcome, keeping clear lines of communication open becomes an important part of a working partnership. The insurer needs to be sensitive to the fact that a D&O lawsuit represents a risk manager's opportunity to work directly with the corporation's directors and senior management. Assisted by information from the insurer and a knowledgeable broker, the risk manager can enhance his or her value to the organization by advising management on the key insurance issues at this critical time.

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