This article was originally published in Enforce *(Volume 11, Issue 1)*

Enforce

The Insurance Policy Enforcement Journal

Allocation Clauses: **Hidden Exclusions**

By David E. Wood and Caroline R. Hurtado Ford

As the ripple effects of the financial crisis continue, corporate directors and officers face what seems like limitless liability exposure in the exercise of their duties. As shareholder advocates, regulators and bankruptcy trustees hunt for evidence of corporate mismanagement, their claims against unprotected directors and officers, and the entities for which they are fiduciaries, can be far more than a distraction from the company's core business: they can be a threat to its balance sheet and, as a consequence, its share price.

Officers and directors and the companies they serve depend upon D&O policies to fend off these threats. Covered "wrongful acts" usually are defined very broadly to include misrepresentations, misstatements, breaches of duty, errors and omissions. Policyholders justifiably expect broad coverage, especially their costs of defending potentially-covered claims of breach of fiduciary duty, securities fraud, and other causes of action arising out of the business of running a company.

But often a complaint against officers, directors and the entity they serve seeks redress for a mixed bag of supposed harms, including losses that would not be covered were the claimant to win a final judgment, like common law and securities fraud. In this scenario, policyholders report to their insurance company that there is no merit to plaintiff's claims, covered or non-covered, and expect their defense to be fully funded once the self-insured retention is exhausted. The D&O insurer may decline to do so, pointing to the policy's allocation provision.

Allocation provisions began to appear in D&O policies about twenty years ago, in response to

---

David E. Wood is editor of *Enforce* magazine and is co-managing shareholder of Anderson Kill's Ventura, CA, office. With more than 28 years of experience in the insurance industry, Mr. Wood devotes his practice to liability and errors and omissions coverage, professional liability insurance, crime coverage, primary-excess disputes, and rights of additional insureds. He has written about insurance recovery matters for the *New York Times* and *National Law Journal*, among others, and has appeared on *MSNBC* and *Fox Business Journal* discussing insurance recovery issues.
805-288-1300 | dwood@andersonkill.com

Caroline R. Hurtado Ford is a shareholder in Anderson Kill's Ventura, CA, office. Ms. Ford has extensive experience in policy enforcement, errors and omissions and business litigation. Her background and experience in handling complex business transactions ensures maximum benefits for clients.
805-288-1300 | churtado@andersonkill.com

D&O insurers' refusal to pay 100% of defense costs incurred by or settlements of claims against their policyholders. They contend they have a right to deny coverage for any part of defense costs allocable to non-covered persons, entities and claims. Back then, most courts addressing this kind of denial held that because a D&O policy typically does not provide a duty to defend—meaning that a D&O insurer need not select, pay and control counsel appointed to defend the entire action alleging a single potentially-covered claim—the insurance company may deny coverage on an interim basis for the portion of defense costs attributable solely to non-covered persons, entities and claims.

Courts disagreed, however, on when and how an insurance company may refuse to pay the non-covered portion of defense costs. Some ruled that a partial allocation of defense costs to non-covered persons, entities and claims is appropriate only where that which is non-covered creates a distinct basis of liability that increases the insured's overall exposure to liability; this approach was labeled the "larger settlement rule." Others held that D&O insurers may create a ratio of covered versus non-covered persons, entities and claims based on relative exposure to liability, and fund only the part of defense costs attributable to that which is potentially-covered; this was called the "relative exposure test."

The result was chaos. Consumers of D&O insurance—companies that buy such coverage to protect their balance sheets and their senior managers and directors against personal liability—complained to underwriters that implied allocation based on unproven allegations was unfair and unpredictable. Many of these underwriters responded by adding express allocation provisions to their policies which required allocation based on the relative exposure test. In many cases, these clauses established a procedure for provisional allocation of defense costs at the outset of a claim. Despite the protests, allocation became a fact of the insurance contract that D&O insurers generally refused to waive.

Application of these allocation provisions to actual claims proved that policyholders' fears about losing big chunks of defense costs coverage in lawsuits alleging non-covered persons, entities and claims were justified. Insurance companies offered less than 100% defense costs coverage based on allegations of non-covered conduct not because these claims had any merit, but because the claims existed. Where the non-covered conduct was a claim for fraud, policyholders pointed out that this seemed to defeat the purpose of the conduct exclusions, which excluded fraud and improper personal benefit to an insured only if the allegations were proven "in fact" or by a final adjudication. Policyholders were denied 100% defense costs coverage based on insurance companies' predictions of their relative liability exposure, even where no discovery had been taken and no facts had been found.

Today, allocation provisions in D&O policies still can come as a nasty surprise to the entity and its directors and officers counting on full defense costs coverage. Even though Side A coverage (to protect directors and officers for claims that the company does not indemnify), Side B coverage (to reimburse the company for its indemnification of directors and officers), and Side C coverage (to protect the company when it is a named defendant) appear broad and all-encompassing, unproven claims can still dilute coverage for defense costs from the outset of litigation.

Allocation has also become a sore point in annual renewals of D&O programs. In an effort to narrow the effect of allocation provisions, brokers and risk managers propose structural changes like:

- Removing the relative exposure test from the allocation clause, giving the insureds the benefit of the larger settlement rule in jurisdictions that follow it.
- Submitting a disagreement over provisional allocation of defense costs to accelerated, binding arbitration.
- Full defense costs coverage if the insurance company and the entity cannot agree on a provisional allocation formula.

Revisions like these can ease the insureds' feeling that the allocation provision is really an exclusion in disguise, crafted to suppress directors', officers' and entities' expectations of coverage.

Allocation In Action

The U.S. government's recent whistleblower suit against Bank of America can be viewed as a case study for analysis of allocation under a D&O policy. The government alleges that Bank of America fraudulently sold loans to Fannie Mae and Freddie Mac that did not conform to the requisite underwriting standards or representations and warranties in the parties' contracts. Assuming for the sake of analysis that Bank of America has a typical D&O policy with a "relative exposure" allocation provision, we can use this case as a hypothetical for considering how allocation might be dealt with by D&O insurers under these circumstances.

In arguing for dismissal of the government's complaint, Bank of America asserted that there were no allegations of deception and that all claims arose out of an alleged breach of a contract—the underwriting standards governing the sale of loans. Under these circumstances, a D&O insurer might argue that none of the government's claims are covered because of the breach of contract exclusion. This exclusion typically would be subject to an exception reinstating coverage where the same damages are recoverable under a non-contract theory of liability. In response to an insurer argument that this exclusion justifies allocation of a portion of defense costs to a non-covered contract-based claim, the insureds would point out that the government's claims are based not just on breach of contract, but also upon an alleged failure to conduct adequate due diligence and quality control. These facts trigger the exception to the exclusion because they articulate a negligence claim—precisely what is insured by a D&O policy.

The insurance company might also assert that a conduct exclusion precluding coverage for dishonest, fraudulent or criminal acts might also apply, justifying allocation. In its challenge to the government's complaint, Bank of America argued that inadequate diligence is not fraud. It is well-settled that a fraud claim must be based on more than a breach of contract, subject to narrow exceptions. In the face of a fraud claim that is surrounded by facts that show negligent conduct, the policyholder must argue that all claims—covered and non-covered—are inextricably linked, and that the insurance company must fund the insured's defense until there is a final adjudication that actual fraud occurred. Ultimately, the way to protect against allocation based on a conduct exclusion is to demand that the exclusion state expressly that it will not apply to defense costs except to support a claim for reimbursement in the event of a final adjudication that excluded conduct occurred.

But suppose that the bank's D&O policy was issued in California where Insurance Code § 533 acts as an implied exclusion for "wilful acts." This statute is a conduct exclusion that can apply—and be considered in allocating covered from non-covered liability exposure—without a final adjudication of fraud. The policyholder must argue that the insurance company's reliance upon § 533 directly contravenes the purpose of the "final adjudication" language in the typical conduct exclusion: to preclude its effect unless and until an insured is determined by a court or jury, after appeals, to have committed excluded acts. Here, the bank might also contend that findings of massive, systemic failures in due diligence can never rise to the level of actionable fraud, and therefore cannot trigger § 533 before a final adjudication is made. In other words, the government's allegations of fraud against Bank of America should never be part of a conversation with the D&O insurers about allocation.

We cannot know the exact language of Bank of America's D&O program, and analysis of how allocation might be treated by the policyholder and its D&O insurers is illustrative only. Apportioning defense expenses under a relative exposure allocation clause should be provisional, and should be driven by the argument that the policyholder has no real exposure to liability for non-covered acts. It should be noted that where a D&O policy provision requires allocation, rules of law disallowing apportionment (for example, where defense costs are reasonably related to defense of both covered and non-covered persons, entities and claims, in some jurisdictions all defense costs are covered) may be trumped by the policy language mandating allocation between covered and non-covered matters. The insured's careful examination of the complaint and the factual basis for liability, and assertive presentation to the insurance companies of real and potentially-dispositive defenses to liability, are critical to moderating or overcoming the exclusionary effect of an allocation clause.

Higher Scrutiny?

Uncertain profits, increased regulations and the complexities of today's financial markets mean higher scrutiny of corporate decisions—and more complex and expensive liability exposure for directors, officers and entities. Corporate management, boards and their counsel should expect D&O insurers to evaluate recently-filed litigation and parse claims in a way that allocates away part of defense costs coverage, and have strategies in mind ahead of time to resist allocation as much as possible. Forewarned is forearmed. Anticipating an insurance company's game plan at the outset of a claim, and finding ways to win the best allocation of defense costs available—preferably, no allocation at all—is the way to get the most defense costs coverage out of D&O policies.