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D&O Policyholders Defeat Allocation and Exclusions

By William G. Passannante

D&O liability Insurance companies routinely argue that they are entitled to apportion the costs of defense, and settlement or judgment between insured and uninsured parties or claims in the underlying lawsuit. Their arguments regarding allocation often have little basis other than financial expediency. Cases regarding allocation and exclusions show how D&O insurance companies improperly attempt to evade their obligations.

Allocation Rejected As "Partial Exclusion"

The United States Court of Appeals for the Sixth Circuit affirmed that National Union was responsible pursuant to a Directors and Officers liability insurance policy to pay Owens Corning to indemnify its directors and officers in settling a shareholder class-action lawsuit. The case, *Owens Corning v. National Union Fire Ins. Co.*, held that National Union's D&O insurance policy was ambiguous regarding allocation and applied the so-called "larger settlement rule."

In *Owens Corning*, the insurance policy suggested that the insurance company and policyholder should use their best efforts to determine a "fair and proper allocation of the amounts as between the Company and the Insureds." The court noted that "although settlement allocation between covered and uncovered claims is clearly contemplated by the Policy, where appropriate, the nature of the method of allocation is ambiguous." The court thus held, that in "the absence of clearer language in the policy, we interpret Ohio law as favoring the larger settlement rule in this instance, and supporting coverage of the settlement except to the extent that uninsured claims have actually increased the insurer's liability." The Owens Corning case expressly noted that allocation arguments are exclusionary and should be so interpreted. "Allocation is in effect a partial exclusion of the insurer's liabilities…" The case is another example of D&O insurance companies seeking to minimize or eliminate their responsibility.

"A Truly Wacky Result"

In another case, the United States Court of Appeals for the Seventh Circuit rejected an insurance company's overreaching application of the "insured versus insured" exclusion in a D&O policy. In *Level 3 Communications, Inc. v. Federal Ins. Co.*, a former director of a subsidiary of the corporate policyholder joined a securities fraud action against the corporation six months after the suit had been filed, as one of eight plaintiffs. The former director owned 16 percent of the corporations' shares. Based on the "insured versus insured" exclusion, and based on broad definitions which included a former director of a subsidiary as an "insured," the lower court granted summary judgment for the insurance company as to the entire claim, not just the part of the claim brought by the former director.

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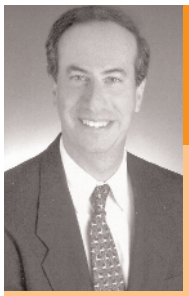

who's who

David M. Schlecker is a Member of the Executive Insurance Group, and co-chair of the AKO Financial Services Insurance Coverage Group. Mr. Schlecker has litigated in state and federal courts throughout the country on general commercial, insurance coverage, and product liability cases, including over 20 trials. The commercial cases have involved contracts, securities law, ERISA, and RICO claims. Mr. Schlecker also has represented corporations seeking insurance coverage for environmental, products liability, fidelity bond, directors liability, and other first and third party claims.

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The Seventh Circuit reversed, finding that the insurance company's argument "has no basis in the language of the contract" and "would produce the odd result that a claim fully covered when made could become fully uncovered when another plaintiff was permitted to join it." The Court suggested that even if this found support in the literal language of the policy, it was "a truly wacky result."

More Allocation Arguments

Insurance companies argue that "allocation" of two different types is appropriate. First, insurance companies argue for "allocation" of defense costs and expenses at the time the underlying claims against the officers are pending. Second, insurance companies argue for "allocation" of indemnity payments at the time of any settlement or judgment. When a D&O policy makes no reference to issues of allocation, insurance companies regularly attempt to allocate costs of defense and indemnity on an *arbitrary* 50-50 basis. This is true even where little or no investigation of the surrounding facts has taken place. Several courts have rejected insurance company attempts to limit insurance through "allocation" arguments.

Similarly, defense costs "reasonably related" to the defense of the covered claims should be covered by the policy, even if those services and expenses would also be of use in defending the non-covered claims. The "reasonably related" standard also has been applied to allocation between covered and non-covered parties.

New Zealand's highest appellate court (then the Privy Council in England) embraced the "reasonably related" approach, stating:

> On the ordinary meaning of the words which have been used it is reasonable to understand that the cover would extend to the whole costs incurred in the defense where the officer was the sole defendant. Why then should the meaning of the words change simply because there is another defendant who is not covered by the policy.

New Zealand Forest Prod. Ltd. v. New Zealand Ins. Co. Ltd., 1 WLR 1237 (Privy Council, 21 July 1997).

Whether by allocation or overbroad application of an exclusion, D&O policyholders need not accept the unreasonable claims positions of D&O insurance companies. ■

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