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Understanding D&O Policy Allocation

Law360, New York (November 15, 2011, 12:52 PM ET) -- Corporations buy directors and officers insurance to protect their senior managers and board members from operations-related liabilities.

Most D&O policies are reimbursement, or pay-on-behalf-of, policies under which the insurer does not have a duty to defend. A duty-to-defend carrier must appoint, hire and control defense counsel for its policyholder, and must pay 100 percent of defense expenses if even a sliver of a third-party claim is potentially covered.

By contrast, under most D&O policies, the policyholder retains the duty to defend itself, and is entitled to reimbursement from the insurance company to the extent the claimant's allegations are potentially covered and aimed at the insureds.

When they were introduced in the 1970s, D&O policies covered only the liabilities of individual officers and directors. They did not insure liabilities of the corporation. Over the years, these policies evolved to add entity coverage, giving the corporation the option of insuring its own liabilities as well as those of its managers and board members.

But where a corporate-insured passed on entity coverage and bought insurance only for its directors and officers, a lawsuit brought against the company and its individual managers and directors raised an issue for the insurance company: Must it cover the portion of "loss" — defined as defense costs, a settlement or a judgment — attributable to defense of or settlement for the noncovered corporation?

D&O policies normally contain allocation provisions to address this issue. An allocation provision allows the insurance company to deny coverage for whatever part of the cost of defending or settling a lawsuit is attributable to uninsured persons or entities, or to uninsured claims.

Early D&O policies contained allocation provisions under which the insurer and the insureds were to merely "use their best efforts to determine a fair and proper allocation." As such provisions lacked any clear basis for making such a determination, courts fashioned their own approaches.

A line of cases, starting with Pepsico Inc. v. Continental Casualty Co. (S.D.N.Y. 1986) 640 F.Supp. 656, articulated what became known as the “relative exposure” rule as a method of allocation. In Pepsico, a securities fraud case against an uninsured corporation and certain of its insured directors and officers, the district court determined that the D&O policy in question “requires the parties to allocate the settlement costs between those amounts attributable to the [insured] directors and officers and those attributable to [uninsured] PepsiCo and its accountants.” Pepsico, 640 F. Supp. at 662.

The relative exposure test for allocation became the applicable rule of law in jurisdictions following this Southern District of New York decision.

Other courts adopted a competing and vastly different method of allocation. Starting with the Seventh Circuit Court of Appeals in Harbor Ins. Co. v. Continental Bank Corp. (7th Cir. 1990) 922 F.2d 357, courts articulated what became known as the “larger settlement” rule.

Under this rule, unless the uninsured corporation had some basis for liability independent of that of its directors and officers, the carrier must pay 100 percent of the defense and 100 percent of a settlement involving covered directors and officers and their noncovered corporate principal. See Caterpillar Inc. v. Great American Ins. Co. (7th Cir. 1995) 62 F.3d 955; Safeway Stores Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa. (9th Cir. 1995) 64 F.3d 1282.

The rationale was simple. Where a covered and noncovered person or entity is named in the suit, but the insured’s liability was not increased by that of the noninsured, the carrier had to pay the whole freight.

This seemed a fair rule. Why should an otherwise covered loss be divvied up among insureds and noninsureds if the latter did not compound the loss? Put another way, why should directors and officers lose part of their coverage where the fact that an uninsured corporation was named as a defendant in the same suit did not increase the legal fees or the amount of the ultimate settlement by a single farthing? The larger settlement rule protected directors’ and officers’ rights to full coverage for defense expenses and settlements even where their uninsured principal was named a defendant as well.

D&O insurers were livid with the advent of the larger settlement rule. In the ensuing generation, insurers began to add relative exposure clauses to the allocation provisions of virtually all D&O policies. As it is relatively rare for a lawsuit naming directors and officers not to also name their corporate principal, this means that in most claims brought against insured directors and officers and the uninsured corporation, the D&O carrier with a relative exposure allocation clause in its policy is allowed to deny the portion of defense and settlement costs it thinks were caused by the relative liability exposure of the uninsured company.

As D&O insurers began selling entity coverage within their policies, allocation based on the insured or uninsured status of people and companies was rendered increasingly irrelevant. However, many lawsuits against corporate directors and officers and the companies they serve also allege claims or theories of action that are not covered by D&O policies, such as breach-of-contract actions.

If a D&O policy allows the insurer to deny coverage for the part of defense and settlement costs attributable to the insureds’ relative exposure for these uninsured claims, the allocation provision is really an exclusion, applicable to many of the lawsuits for which corporate policyholders thought they were buying complete coverage.

It is a nasty surprise for an insured to learn that, when sued for clearly covered D&O losses, the plaintiff's inclusion of some throwaway, noncovered theory means the carrier will pay only part of the defense and part of the settlement. Some allocation clauses try to ease the pain by stating that allocation applies only to settlements or judgments, and not to defense costs.

Others provide that where the policyholder allows the insurer to control the defense and settlement of the lawsuit, the carrier will waive allocation for defense expenses and pay 100 percent of fees and costs, on the premise that the insurance company can then better control legal fees.

Still others state that where the insurer and insureds cannot decide on a mutually agreeable allocation formula for defense expenses and settlement costs, the issue is resolved by some expedited arbitration procedure, or resolution is postponed to the end of the claim.

It is critical at the point of sale, before writing the premium check, that a company understand the impact of having an allocation clause in its D&O policy, and which kind of allocation clause erodes the value of the coverage the least.

The D&O policy that does not allocate away part of the attorneys' fees and defense costs is far more valuable than the policy that does. The corporate policyholder does not want to discover that its D&O policy has a restrictive allocation clause, and will not pay the whole freight of a high-exposure lawsuit, when management and the board are first absorbing the impact of recently filed litigation.

Avoiding this result means discussing allocation with the broker when the insured has the greatest bargaining power, when alternatives to a draconian allocation provision can be negotiated: before committing to purchase coverage.

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