

PAY ATTENTION TO THE ALLOCATION ISSUE

D+O policies often aren't specific regarding payments

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The purpose of a Directors & Officers ("D & O") insurance policy, like any other insurance policy, is to transfer risk from the insured to the insurer. D & O suits often contain multiple claims

develop where the insurer deems particular allegations within a claim covered and other allegations within the same claim as uncovered, or particular defendants covered and others uncovered.

In circumstances where the insurer has limited its indemnity obligation to fewer claims or parties than a pleading reflects,

and uncovered parties.

Allocation Provisions

Some D & O policies contain a specific allocation provision. One example of an allocation provision reads as follows:

"If the Insureds who are afforded coverage incur an amount consisting of both Loss that is covered by this Policy and also Loss that is not covered by this Policy because such Claim includes both covered and uncovered matters or covered and uncovered parties, then coverage shall apply as follows:

(1) Defense Costs: one hundred percent (100%) of reasonable and necessary Defense Costs incurred by such Insured from such Claim will be considered covered Loss; and

(2) Loss other than Defense Costs: all remaining Loss incurred by such Insured from such Claim will be allocated between covered Loss and uncovered Loss based upon the relative legal exposures of the parties to such matters."

Often, however, the applicable D & O policy is silent as to the allocation method. In situations where the policy does not contain an appropriate allocation provision, the courts have employed either the relative legal exposure test or the larger settlement rule, or some variation of the two, in allocating loss under the policy.

Relative Legal Exposure

In the absence of an allocation provision within a D & O policy, several courts have applied the "relative legal exposure" standard. The relative legal exposure test seeks to ascertain the potential liability of the parties at the time of settlement. Pursuant to this method of allocation, the insurer and insured are required to



against multiple defendants, including the directors or officers themselves as well as the corporate entity.

Often, the D & O policy is the only protection for an officer or director in avoiding significant personal exposure in these suits. Moreover, situations can

understanding the allocation issue is critical. For example, if a suit containing covered and uncovered claims were to settle, the proportion of loss to be paid by the insurer is squarely at issue.

Typically, settlement agreements, even if reduced to writing, do not assign specific amounts to each settling defendant, or identify specific amounts paid for each settled claim.

Therefore, a thorough understanding of the available methods of allocation as applied to D & O insurance policies is necessary in order to secure the maximum amount of indemnity in suits involving covered and uncovered losses or covered

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use their best efforts to determine a fair allocation of payments between covered and uncovered losses (or covered and uncovered parties). The uncovered losses (or uncovered parties) are then the sole responsibility of the insured. See *Pepsi Co. Inc., v. Continental Casualty Co.*, 640 F.Supp. 656, 662 (S.D.N.Y. 1986). The test is exceedingly fact specific.

The Court in *Pepsi Co. v. Continental Casualty Co.* further articulated that once an insured has presented a claim under the policy based on a good faith settlement, the insurer then bears the burden of proving that all or a portion of the total paid in settlement is excluded from the policy coverage. It is imperative that the insured first demonstrate that the settlement was entered into in good faith. In order to successfully demonstrate good faith, the insured must comply with policy provisions regarding settlement. The two provisions that apply directly to settlements and which are contained in nearly every D & O policy are the (1) consent to settle clause; and the (2) consent to pay clause.

Consent to Settle. The consent to settle clause usually includes language as follows:

“No Insured shall settle any Claim, incur any Defense Costs, or otherwise assume any contractual obligation or admit any liability with respect to any Claim without the Company’s written consent, which shall not be unreasonably withheld. The Company shall not be liable for any settlement, Defense Costs, assumed obligation or admission to which it has not consented.”

Pursuant to the language above, an insured must keep the insurer apprised of all developments regarding the possibility of settlement. In turn, the insurer must not withhold its consent for settlement unreasonably.

Consent to Pay. The consent to pay clause usually includes language as follows:

“The Company may make any investigation it deems necessary and may, with the consent of the Insured, make any settlement of any Claim it deems expedient. If any Insured withholds consent to any settlement acceptable to the claimant in accordance with the Company’s recommendation, the Company’s liability for Loss, including Defense Costs, from such Claim shall not exceed:

(a) the amount of the Proposed Settlement plus Defense Costs incurred up to the date of the Insured’s refusal to consent to Proposed Settlement of such Claim; plus;

(b) eighty percent (80%) of any Loss, including Defense Costs, in excess of the amount referenced in paragraph (a) above, incurred in connection with such Claim.”

Essentially, the insured cannot unreasonably withhold its consent which would act to prevent the insurer from making a reasonable and expedient settlement of a claim.

If the parties are unable to agree on allocation in applying the relative legal exposure method, factors which a court will likely analyze include: (1) which claims were the most likely to succeed; (2) the amounts of the respective damages sought; and (3) the testimony of underlying counsel to determine the appropriate allocation.

Larger Settlement Rule

In the absence of an allocation provision within a D & O policy, a minority of courts have applied the somewhat more objective larger settlement rule. Pursuant to this method of allocation, responsibility for any portion of the settlement should be allocated away from the insured party *only* if the acts of the uninsured party are determined to have increased the settlement. In essence, this standard allows complete indemnity for covered and uncovered parties unless the insurer can show an independent and

additional basis for liability on the part of the uncovered defendants.

Maximizing Indemnity

D & O policies are bought for the purpose of insulating directors and officers, and sometimes the corporate entity itself, from risk. The goal of every insured should be to secure complete defense and maximize indemnity. An insurer held accountable for as much loss as possible ensures that the insured bears the lowest possible financial burden as a consequence of settlement or judgment. Accordingly, certain steps should be employed to maximize recovery for indemnity.

When a suit is filed against a business and its officers and directors, careful consideration should be given to the allocation issue, particularly if the suit contains both covered and uncovered claims or covered and uncovered parties. The insured should determine whether an allocation provision exists. Absent an allocation provision, the insured must undertake a choice of law analysis to determine which jurisdiction’s law will apply. Once choice of law has been settled, the insured must then understand which theory of allocation the particular jurisdiction follows. In the event the relevant jurisdiction follows the larger settlement rule, the burden is on the insurer to show why the entire settlement should not be covered. In addition, prior to settling a D & O claim, the insured should consult with a coverage attorney to assist in the insurance analysis and strategy.

Thus, in the absence of a clear allocation provision within a D & O policy, an understanding of the relative legal exposure test and the larger settlement rule will enable your business and its officers and directors to maximize their insurance recovery. ■