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Protecting D&O Claims from Rejection

By Finley Harckham

After devastating losses in the economic meltdown, many financial institutions face a second, potentially catastrophic disaster: suits by shareholders and investors.

The last line of defense against crippling liability from those suits is a company's directors and officers insurance, along with professional, fiduciary or management liability (collectively "management") insurance.

Unfortunately, if a claim is not barred from coverage under a policy exclusion, insurers may try to manufacture grounds for a coverage denial because of the policyholder's conduct after the claim has been submitted.

Policyholders must be very careful not to let their eagerness to resolve suits that threaten their survival create grounds for the denial of coverage.

D&O and management insurers frequently seek to avoid coverage on the ground that the policyholder failed to cooperate with their investigations of a claim or deprived them of the right to "associate" in the defense or settlement of suits. These defenses generally allege failure by the policyholder to provide necessary information.

Some insurers abuse their cooperation right by making burdensome requests for documents and information, and then using any resistance from the policyholder as an excuse to deny coverage or refuse to consent to a settlement. To avoid this pitfall, policyholders should invite the insurers to meet periodically to discuss developments in the suits and offer to make all nonprivileged documents available for inspection. These efforts should be carefully documented in letters to the insurers to create a strong record of cooperation.

In addition, the policyholder can blunt, if not avoid, the argument that it deprived its insurers of a right to associate in the defense by inviting them to offer their views as to how the cases should be defended. Chances are, the response will be "Act like a reasonable uninsured company would." This gives the policyholder the freedom to proceed on a rational basis.

Claims that an insurer was denied its right to associate in the settlement of an action can arise when the insurer has not participated in settlement discussions for whatever reason. These claims can also arise when the insurer has participated but asserts that its involvement was limited by the policyholder.

The policyholder should inform the insurers of any plans to mediate or otherwise settle a case, and it should consider any requests made by the insurers to participate in that process. At the same time, the policyholder should ask for a clear statement of what role the insurers intend to play in the settlement process.

In addition to granting insurers the right to "associate," most policies require insurer consent for settlements but state that the consent cannot be withheld unreasonably. Insurers frequently refuse to agree to settlements negotiated by the policyholder and then try to avoid coverage by arguing that the policyholder had no right to settle without their consent.

Whether or not an insurer has unreasonably withheld consent to a settlement may depend on a number of factors, including the cooperation and right to associate issues discussed above.

In addition, even if an insurer refused to participate in the settlement process and never committed to providing coverage, it may argue it had the right to accept or reject a settlement. One court recently held that a "preliminary" denial of coverage did not relieve the policyholder from its obligation to obtain the insurer's consent to a settlement.

This potential problem can be dealt with by conditioning any settlement on insurer approval, while reserving the policyholder's right to waive that condition if insurer consent is not given.
If the plaintiffs will not accept a conditional settlement, the agreement should not be consummated without first presenting it to the insurers. Failure to give the insurer a reasonable opportunity to consider a proposed settlement can result in the forfeiture of coverage.

For many decades policyholders have entered settlements with primary insurers for less than policy limits, secure in the knowledge that, under the law and insurance industry practice, they could then recover from their excess insurers as long as their liability exceeded the full amount of primary coverage. That sense of security may now be misplaced.

In the last few years some excess insurance companies have convinced courts that their obligations are not triggered unless and until there has been full exhaustion of underlying coverage. As a result, a policyholder settles with its primary and lower-level excess insurers at some risk that by doing so it will forfeit its higher-layer coverage, which might never be triggered, because of nonexhaustion of underlying limits.

The only way to enter such settlements without risk is to obtain the consent of all higher-level carriers. Without that consent, which may come at a price, the policyholder must carefully analyze its excess policy wording in light of applicable law or refrain from entering such settlements.

No matter how unreasonable and annoying, insurers' efforts to avoid coverage obligations must be taken seriously and handled carefully.

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