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Even with Side A and Side B D&O coverage and a difference in conditions policy, payment of defense costs may not occur.

D&O Insurance — Are You Getting the Coverage You Thought You Bought?

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Companies want to protect their directors and officers (executives) from the costs of defending claims and from having to pay any judgment entered against them arising out of their corporate positions. For individual directors and officers accused of wrongdoing, however, collection on directors and officers (D&O) insurance claims is highly problematic; the beleaguered executive often must run a gauntlet of rescission attempts, interlocutory appeals, and arbitration proceedings stacked against the policyholder. This article examines the pitfalls of insurance recovery on Side A coverage, which protects individual directors and officers, and on difference in condition (DIC) policies, which purport to protect directors and officers when Side A and Side B coverage of a traditional D&O policy fails.

Problems With Side B Coverage

A company often will agree to indemnify its executives against D&O claims, either as part of the employment contract or generically in the company's by-laws. The company can buy insurance to reimburse it for such indemnification; this is called Side B D&O insurance. Such indemnification is limited by the company's employment agreement or internal policies, by the statutes governing the company, and by common law. For example, in some states, there may be obstacles to indemnification for gross negligence in supervising the affairs of the company. Similarly, arguments may be made that to indemnify executives for intentional misconduct or for an award of punitive damages offends public policy.

Side A Coverage to the Rescue?

To deal with this problem, many companies buy Side A D&O insurance. A typical Side A insuring clause provides that the insurer "shall pay on behalf of each [executive] all Loss for which the [executive] is not indemnified by the [company] and which the [executive] becomes legally obligated to pay on account of any Claim made against him …" In addition to filling some of the holes in Side B coverage, Side A coverage will kick in when the company that is sued along with its executives is bankrupt and is — or claims to be — unable to meet its indemnification obligation to its executives.

Side A coverage does not provide all the protection that many companies wish to give their executives — or many executives may wish to have their companies provide for them. Many insurance companies will argue for a narrow reading of the insuring provisions and a broad reading of the exclusionary provisions. For example, environmental claims, and claims which are prosecuted by the company against the executive, may be excluded, depending upon the terms of the Side A coverage form. And while Side A policies generally provide for reimbursement of defense costs, insurance companies often take the position that they need not reimburse until there has been an adjudication requiring them to do so and reserve the right to recover such costs if there is a final adjudication of the underlying claims adverse to the executive.

When Side A and Side B Fail, Try DIC

Recently, companies have been purchasing difference in conditions insurance policies, seeking to provide protection when the Side A and Side B coverage fails. Such policies ostensibly provide coverage where the company refuses to indemnify its executives or is financially unable to do so or where there are categorical exclusions, such as for pollution losses or for punitive damages. DIC policies also may provide for advancement of defense costs even when the claim alleges dishonesty or illegal personal profit and may not include a reimbursement right for the insurance company even if the executive is found liable or guilty. The bulk of these DIC policies are sold in Bermuda and include provisions mandating arbitration of any dispute in a forum outside of the United States.

Many insurance companies will argue for a narrow reading of the insuring provisions and a broad reading of the exclusionary provisions.

First, we explore the explosion of decided cases in which insurance companies seek to avoid paying defense costs as they are incurred to or on behalf of executives who are the beneficiaries of Side A coverage. Then, we explore arguments put forward by insurance companies that sell difference in conditions policies to avoid such payments despite explicit inclusion of coverage for the payments in the policies. To the author's knowledge, every dispute over DIC coverage has been adjudicated in arbitration in England, where confidentiality is the rule even as regards the determination of the arbitration, and thus, there is simply no available or citable body of precedent.

Coverage of Defense Costs Under Side A Policies

Assume that an executive is sued by shareholders alleging that she has received payments from her company that were not properly authorized, thus defrauding the company, and is indicted for the same allegations. Her company declines to advance defense costs, leaving her to pay the always-significant legal fees herself. She seeks coverage from the insurance company providing Side A coverage.

Often, coverage will be declined. The insurance company will take the position that, in a typical policy, its obligation is limited to reimbursement for defense costs; that the time of reimbursement is not specified in the policy; that if the claim is adjudicated against the executive, coverage is excluded; and that if there is an adjudication against the executive, it is likely that the executive will be judgment-proof — therefore, a right of recoupment, which may be written into the policy or may be implied as a matter of law, will be fruitless. Furthermore, the insurance company will take the position that it can rescind the policy, at least as regards the executive making the claim, because of material misstatements in the application. We discuss each in turn.

The insurance company's obligation is one of reimbursement, not advancement of defense costs.

- The "No Contemporaneous Reimbursement" Argument

  The great majority of appellate courts have held that insurance companies must make contemporaneous payment of defense costs. The payment obligation "arises at the time the insured becomes 'legally obligated to pay'," because "the only reasonable interpretation of the loss clause in the D & O policy is that the insurer's obligation to pay accrues when the insured incurs the obligation, not after it has paid a judgment." (See *Federal Insurance Company v. Kozlowski.*[1])

- The "Rescission" Argument

  An equally great majority of appellate courts has held that an insurance company cannot unilaterally rescind the insurance policy by simply declaring that the behavior underlying the charges against the executive was not revealed in the application for insurance, and thus, there was a material misstatement in the application. The dominant view, expressed in the *Kozlowski* decision, is that unless and until there is adjudication by a court that there was a material misstatement in the application, the insurance company is bound by the contemporaneous payment rule.

  Further, where the insurance policy contains a severability provision — as did the policy in the *Kozlowski* case — the insurance company cannot rescind unless the executive seeking reimbursement "participated, directly or indirectly, in misrepresenting facts to induce [the insurance company] to issue the policy." It should be noted that the *Kozlowski* court's holding on this point is not unchallenged; there is a body of American case law ruling that a material misstatement that, in fact, was relied upon by the insurance company will allow a court to void the entire policy, thus depriving "innocent" executives of the reimbursement for defense costs that they thought they had, or, at least, to void coverage as to "guilty" executives.

Is Side A Defense Cost Coverage Illusory?

So what is the problem, at least in states that share the New York approach enunciated in *Kozlowski*? Precisely that the insurance company's obligation is one of reimbursement, not advancement of defense costs. This is an invitation to the insurer to refuse contemporaneous payment; all it risks is paying some interest if the insured is exonerated, while if there is a finding of liability or guilt in the underlying case, the insurance company may never have to pay. And, as indicated, even if an insured, having made the very sizable payments required to defend civil or criminal fraud charges, has the financial resources to pay attorneys to sue his or her insurance company for reimbursement, the course of litigation is long and rocky.

If an indictment is involved, it may be impossible to avail oneself of the contemporaneous payment decisions. For, as the court held recently in *Combs v. International Insurance Co.*,[2] in order to trigger the immediate payment obligation, the insured must submit legal bills, and the insured's criminal lawyer will never allow the insured do so lest it be deemed a waiver of Fifth Amendment rights. And even if the bills are submitted, discovery by the insurance company is inevitable; any inquiry into the subject matter of the representation by counsel necessarily will bring an invocation of the Fifth Amendment.

This quandary was litigated in the *Kozlowski* case. There, the judge who rendered the decision on immediate payment in the executive's favor nevertheless held that until the insurer was supplied with detailed bills, no payments had to be made. The trial judge indicated to counsel that she would order payment upon presentation of detailed bills and would stay discovery in order to preserve the executive's privilege against self-incrimination, but on the advice of his criminal defense attorneys, the bills were withheld and, thus, no payments were made. Concededly, this quandary only comes up where reimbursement is sought for defense fees in a criminal case, but after all, that's one of the situations for which such insurance was purchased.

Further, at least in states such as New York, an order of a trial-level court that an insurance company must make contemporaneous defense cost payments is subject to an interlocutory appeal. The effect is to prolong the litigation process such that the underlying claims against the executive reach final judgment before the insurance company actually makes a payment. If the executive loses in the underlying case, then the fraud and personal profit exclusions to coverage are triggered, and the insurance company never pays. The effect is that a truly recalcitrant insurance company risks nothing more than some interest payments if it brings a declaratory judgment action for rescission and loses.

Coverage of Defense Costs Under DIC Policies

Now, assume that our beleaguered executive is insured under a DIC policy. After losing the underlying civil or criminal case, and either never having received reimbursement for defense costs from the Side A insurance company or having had to pay back under the recoupment requirement, the executive seeks payment of defense costs from the DIC issuer.

The executive likely will be met with a blizzard of arguments. The DIC insurance company will argue that the very facts that form the basis of the civil or criminal judgment against the executive justify unilateral rescission, since they were not included in the application. If there was no formal application completed, but as is frequently the case, the company was required to provide a warranty that no executive knew of any unrevealed facts that might reasonably lead to a claim being made against any executive, the DIC insurance company will argue that the severability provisions of the policy do not apply to the warranty. Therefore, an omission by, for example, the chief financial officer (CFO) of the "fact" that he stole from his own company, the insurance company will argue, voids coverage for every executive, or at least every executive "guilty" of the same misconduct, even though reimbursement of defense costs is specifically not subject to a wrongful acts or personal profit exclusion. The standard DIC provision that the policy is not rescindable with respect to acts of others, the insurer will argue, protects only executives who did not commit the "bad acts," who, by definition, would receive reimbursement ultimately in any event.

The DIC insurance company will argue that the very facts that form the basis of the judgment against the executive justify unilateral rescission.

If, as often happens, there was a renewal without either a new application or a new warranty, the DIC insurance company will argue that failure to update the warranty before the renewal date is a fresh material misstatement. And even if there was public knowledge of the underlying claims before a renewal, the insurance company will argue that specific notice of the claims by the executive is required under the policy, despite the fact that it is the company that employed the executive — and is now suing him or her — that had the reporting obligation under the policy.

Does Defense Cost Coverage Exist?

There is no way to know whether actual claims that have been made by executives in the hypothetical situation we have set out here have been adjudicated because of the confidentiality rule in English arbitrations. But there is reason to fear that beneficiaries of coverage under DIC policies, at least as regards claims for reimbursement of defense costs, realistically have no such coverage at all.

- First, under the standard arbitration provisions in these policies, the substantive law of New York is to govern, but it is English arbitration panels that will apply that law.

- Second, the arbitration provisions in these policies deny the insured the benefit of New York insurance regulations and explicitly reject the rule that ambiguities in coverage are to be construed against the insurance company.

- Third, the arbitration tribunal is composed of one arbitrator selected by each party; those two arbitrators in turn select a third. If they cannot agree on the third arbitrator, the third arbitrator is appointed by a judge of the English High Court. The effect likely is that a U.S. executive will face a tribunal chaired by an English arbitrator, schooled in the jurisprudence of a judicial system notoriously favorable to the insurance industry.

Warning: DIC Policy May Not Be Worth the Cost

The author has made informal inquiry of other attorneys who regularly represent insureds in disputes about D&O coverage. While all, presumably, are bound by the English confidentiality rules and, thus, cannot discuss particular representations, none have reported success in challenging a denial of coverage for defense costs under a Bermuda DIC policy. This should give a risk manager or CFO pause before investing in such an offshore policy. After all, what are the gaps in coverage that a DIC policy purports to close other than the lack of coverage for defense costs incurred in an unsuccessful defense? The other selling points for a DIC policy — coverage where the executive's company refuses to reimburse or is financially unable to do so — can be handled by a standard Side A policy.

Endnotes

1. *Federal Insurance Company v. Kozlowski*, 792 N.Y.S.2d 397 (New York Appellate Division 2005), quoting from the United States Courts of Appeal for the Third and Eleventh Circuits.
2. *Combs v. International Insurance Co.*, 354 F.3d 568 (Sixth Circuit Court of Appeals 2004).

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