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Pitfalls In Pursuing D&O, Fiduciary Liability Claims

Law360, New York (May 22, 2009) -- Today, many financial institutions face potentially devastating liabilities as a result of shareholder or investor suits arising out of the economic crisis. The very survival of many of these companies will depend upon their ability to successfully defend these lawsuits or, more likely, to settle them using their directors and officers (D&O) liability insurance or fiduciary liability coverage.

Unfortunately, in addition to the exclusions and limitations found in their insurance policies, these companies may also have to contend with coverage denials based upon their conduct after the claim has been submitted.

D&O and fiduciary liability insurers frequently seek to avoid coverage on the ground that policyholders have failed to cooperate with their investigations of claims 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 in a timely manner. Policyholders must be very careful not to let their eagerness to resolve suits that threaten their survival create grounds for the denial of coverage.

Policyholders also increasingly face coverage denials from excess insurers based upon settlements entered into with lower level carriers. The excess insurers argue that their coverage obligations are contingent upon the full payment of underlying limits, and two recent court decisions agree with them.

The Duty to Cooperate

All D&O and fiduciary liability policies require that the policyholder cooperate with the insurer by providing information and documents when requested. This obligation can be an annoying distraction from a company’s efforts to defend the suits against it, but it must be taken seriously.

Some insurers abuse their right to cooperation by making unreasonably 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 their insurers to meet periodically to discuss developments in the suits against them 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.

The Right to “Associate” in Defense and Settlement

Many D&O and fiduciary liability policies give the insurer the right to “associate” in the defense or settlement of a suit. Sometimes insurers invoke this right without prior notice to complain that they have been shut out of the development of defense strategy or excluded from the settlement process.

A 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 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 settlement discussions.

Insurer Consent to Settle is Required

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 enter into an agreement without their consent.

The policyholder who wishes to quickly settle a case might face resistance from a primary insurer whose limits would be called upon to pay, and a company that wants to “clear its good name” by fighting to the bitter end may face opposition from excess insurers who could be exposed to a large verdict.

It may be impossible to achieve a consensus on how to proceed, but consultation will at least provide protection against a subsequent denial of coverage.

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.

If the insurers do not participate in the settlement process for whatever reason, the policyholder should still assume that it needs their consent before a deal is consummated.

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.

Forfeiture of Excess Coverage by Settling with Lower Layer Policies

For many decades policyholders have entered into 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 excess insurance companies have convinced courts in California and Michigan that their obligations were not triggered unless and until there has been full exhaustion of underlying coverage. Comerica Inc. v. Zurich American Ins. Co., 498 F.Supp.2d 1019 (E.D. Mich. 2007); Qualcomm Inc. v. Certain Underwriters at Lloyd's, London, 161 Cal. App. 4th 184, 73 Cal. Rptr. 3d 770 (Ct. App. 2008).

Additional cases raising this issue are sure to follow. Therefore, 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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