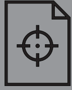

FINE PRINT

Who Gets Paid When the D&O Insurance Is Not Enough?

by Diana Shafter Gliedman , Ethan W. Middlebrooks and Jamie O'Neill

When Sam Bankman-Fried was found guilty of seven counts of criminal activity associated with the downfall of the cryptocurrency exchange FTX, his conviction made front-page news. But while it may not have made headlines, SBF's battles were not limited to fighting prosecutors from the Southern District of New York: The former crypto king also filed suit against one of FTX's excess directors & officers insurance companies in the Northern District of California, alleging that it had wrongly denied coverage and failed to cover his legal expenses. Shortly after, Daniel Friedberg, FTX's former general counsel and chief regulatory officer, sought to join the lawsuit, alleging that the depletion of the company's $20 million D&O policy by other executives such as SBF was unfair and left nothing for his own defense.

While Bankman-Fried ultimately dismissed his lawsuit, Friedberg's situation presents a crucial question applicable to D&O insurance and insurance in general: How should funds be allocated among policyholders under a D&O insurance program when multiple policyholders have claims under the same policies that exceed the available limits of liability?

D&O policies typically contain a priority of payments provision, favoring directors and officers over the company. However, different jurisdictions apply different rules with regards to the payment and potential exhaustion of D&O policies. These include, primarily: 1) the first judgment rule, 2) the first to settle rule and 3) equitable allocation. For each claimant to D&O insurance proceeds, understanding these rules and how they impact potentially competing policyholders facing non-global settlement (or fighting over limited limits available for defense costs) may be the difference between obtaining satisfactory coverage and losing out to former colleagues or the corporate entity.

First to Judgment: In the past, some courts used the "first to judgment" rule, where those parties who first obtain judgments against the insurance claimant receive priority in payment from insurance proceeds. This rule, however, has fallen out of favor due to the prevalence of bad faith claims against insurance companies and the length of such litigation. While there is authority suggesting this rule may still be considered in some states, such as Oklahoma, this rule only applies when a final judgment is issued and does not address settlements or defense payments.

First to Settle: The majority of jurisdictions now follow the "first to settle" or "first-come, first served" rule. This rule generally allows a policyholder to selectively settle with the support of insurance proceeds, regardless of whether all potential claims and claimants are known or resolved at the time of settlement, even if it means depleting or exhausting available policy limits. New York, Maryland, North Carolina and Texas are among the states that follow this rule.

Once policy limits are exhausted, the insurance company's duties under the policies typically are completed, including any duty to defend or reimburse defense payments. Thus, while the "first to settle" rule promotes efficiency in the settlement of claims and benefits policyholders who have the opportunity to settle, this rule can raise fairness concerns to co-defendants/co-policyholders who remain enmeshed in litigation (such as Daniel Friedberg).

RISK MANAGEMENT

Reprinted with permission from *Risk Management*.
Copyright © 2023 Risk and Insurance Management Society, Inc.
All Rights Reserved.
www.rmmagazine.com

In New York and Texas, for example, an insurance company typically may settle on a first-come basis if it acts in good faith. Courts in these states have recognized that the rule encourages prompt reporting of insurance claims and that any settlement benefits every claimant because it decreases the total liability exposure in the underlying lawsuit. But an insurance company's refusal to contribute to a reasonable settlement in "first to settle" jurisdictions may expose the company to bad faith failure to settle. Because of possible conflicting interests, it is not uncommon for an insurance company to demonstrate preference for global settlements.

Under certain circumstances, a policyholder may prefer the "first to settle" rule, especially when prompt access to funds is crucial. The rule also permits quicker resolution and allows claimants who act promptly to secure a portion of the insurance proceeds without dealing with prolonged litigation and uncertainty.

Equitable Allocation: A minority of jurisdictions, including California, Montana, and Wisconsin, follow the "pro rata" or "equitable allocation" approach, where insurance limits are divided in a way that reflects each claimant's relative legal exposure. All claims must be presented before an insurance company can start making payments. If there is no settlement among all the possible claimants, then each policyholder must wait until the resolution of litigation of each claim before they may recover any of the insurance proceeds.

Under this rule, an insurance company that settles with one claimant without leaving enough of the policy limits for other claimants is exposed to a claim of bad faith. However, an insurance company might be protected from bad faith if it rejects a settlement offer that potentially could leave one or more policyholders without coverage.

WHEN THE INSURANCE COMPANY MOVES FIRST

Insurance companies facing a complex D&O claim involving limited policy proceeds and multiple claimants may introduce a fourth option by filing an interpleader action. Interpleader is a mechanism that permits a party that possesses property or funds to join multiple claimants into a single judicial proceeding and ask the court to determine allocation of the funds among the claimants. Filing an interpleader action is often seen as an admission by the insurance company of its obligation to pay claims and is considered in many jurisdictions to be the safest strategy to prevent accusations of bad faith. But such a filing can delay a policyholder's access to insurance proceeds and result in lower payments per policyholder, thus impeding the ability of some or all to settle.

The benefit of applying one rule over another (to the extent the policyholder has a choice) will depend on the policyholder's circumstances and whether they are interested in achieving an immediate settlement (thus favoring a "first come, first serve" jurisdiction) or preserving coverage for a future settlement or defense costs (thus favoring equitable allocation). The policyholder also should consider other possible coverage issues when weighing jurisdictions. However, one lesson is clear: When purchasing D&O insurance, companies need to secure sufficient limits of liability to ensure all directors and officers (as well as the company) are covered in the event of a lawsuit or investigation. R

Diana Shafter Gliedman, a shareholder with Anderson Kill's New York office, represents policyholders in actions ranging from small insurance coverage disputes to multi-party, multi-issue insurance coverage litigations, with an emphasis on CGL insurance, directors & officers liability insurance, professional liability insurance and employment practices liability insurance. **Ethan W. Middlebrooks** is an attorney in Anderson Kill's New York office and concentrates his practice in insurance recovery and commercial litigation. He has assisted policyholders on a broad range of matters, including first-party property and construction-related claims, as well as municipal-related concerns. **Jamie O'Neill** is a law clerk (pending admission) in Anderson Kill's New York office. She focuses her practice on insurance recovery.

RISK MANAGEMENT

Reprinted with permission from *Risk Management*.

Copyright © 2023 Risk and Insurance Management Society, Inc.

All Rights Reserved.

www.rmmagazine.com