CARLTON FIELDS

# Financial Coverage Issues: Obtaining D&O Proceeds

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**I. Introduction** Directors and officers (D&O) policies, like all insurance contracts and contracts in general, are governed by the specific wording unique to each contract. Nonetheless, there are several issues that can arise as to the type and scope of coverage afforded under D&O policies that are common to policies with varied wording. We discuss several of those issues below. **II. D&O Policies as "Reimbursement Policies" A. Reimbursement of D&Os – Side A Coverage** A typical D&O policy includes at least two main insuring clauses, often referenced as Side-A coverage and Side-B coverage. Side-A coverage is intended to protect the individual D&Os[1] of the insured company, providing direct coverage for loss paid by the individuals. Side-A coverage generally provides that the insurer will pay on behalf of the D&Os any "loss" — however that term is defined in the particular policy — resulting from any "claim" (as defined in the policy) made against the D&Os for a "wrongful act" (as defined by the policy). Side-A coverage is most often implicated when the insured company has not or cannot indemnify the D&Os. For example, in some states, corporations are prohibited by law from indemnifying their D&Os for settlements or judgments paid in connection with shareholder derivative lawsuits. In that case, the D&O insurer providing Side-A coverage would reimburse the individual D&Os for any covered loss. For example, *in TLC Beatrice International Holdings, Inc. v. CIGNA Insurance Co.*, No.97-Civ. 8589(MBM), 1999 WL 33454 (S.D.N.Y. Jan. 27, 1999), several directors and the estate of a deceased director of the insured corporation were named as defendants in a derivative action filed in Delaware Chancery Court. The case settled with a significant contribution from the estate. *Id.* at *2. Thereafter, the board of the insured resolved to indemnify the directors and the estate for their litigation expenses. *Id.* However, the amount contributed toward the settlement by the estate of one of the defendant directors was excluded from indemnification. *Id.* The estate made a claim under the Side-A coverage portion of the D&O policy, which the insurer denied, in reliance on a policy exclusion for "any payment for Loss in connection with any Claim or Claims made against the insureds … for which the insureds may be indemnified by the Company for damages, judgments, settlement, costs, charges or expenses incurred in connection with the defense of any action, suit or proceeding…." *Id.* at *3. It was undisputed that the plain meaning of this exclusion was that a director may not make a direct claim under Side-A unless the insured corporation is prohibited from indemnifying the director under the corporation's bylaws or applicable state law. *Id.* The court concluded (citing section 145(b) of the

Delaware Corporate Code) that "Delaware law does not empower a corporation to indemnify directors for sums paid in settlement of a derivative suit." *Id.* at *7. As a result, the insurer was not entitled to rely on the above-quoted exclusion, and the court denied the insurer's motion for judgment on the pleadings.*Id.* **B. Reimbursement of Insured Corporation — Side B Coverage** Side-B coverage, on the other hand, generally refers to reimbursement of the insured corporation itself for loss that the corporation is required or permitted to, or in fact has, reimbursed or indemnified the individual D&Os. Generally, an insurer's reimbursement obligation under Side-B coverage will not be triggered until the insured corporation has first indemnified its D&Os for their defense costs. *See, e.g., Owens Corning v. Nat. Union Fire Ins. Co.*, 257 F.3d 484 (6th Cir. 2001) (where Delaware corporation brought action against its insurer under D&O policy seeking to recover amounts corporation paid to indemnify its directors and officers for settlement of shareholder class action, and insurer denied coverage because the indemnification was allegedly improper under state law, court noted that the insurer "provided insurance against liabilities of the directors, rather than against those of the company generally" and that "the combined effect (and reasonable intent) of an indemnification provision and a D&O policy is to shift the risk of directorial acts first to the corporation, but then on to the insurer"); *MacMillan, Inc. v. Federal Insurance Company*, 741 F. Supp. 1079 (S.D.N.Y. 1990). In *MacMillan*, the policy's Side-B insuring clause provided insurance to the insured corporation for payments for which it "grant[ed] indemnification" to the directors and officers, as permitted or required by law. *Id.* at 1081. The court reasoned: Were [the insured corporation] able to recover under the Executive Indemnification clause of the Policy without actually granting indemnification to the former officers and directors in accordance with the required procedures, then the governing Delaware law would clearly be circumvented.The corporation would be able to obtain reimbursement from its insurer for expenses without the required corporate determination that the expenses were incurred by the officers and directors in good faith and in a manner not opposed to the best interests of the corporation. The Executive Indemnification clause is clearly intended to protect the insurer from such an open door to mischief. *Id.* at 1083. Moreover, Side-B coverage generally does not include reimbursement to the insured corporation for its own losses, as opposed to those of its directors or officers. *See e.g., Perini Corp. v. Nat'l Union Fire Ins. Co.*, No. CIV. A. 86-3522-S, 1988 WL 192453 (D. Mass. June 2, 1988) (where insured corporation sought to recover — under a "Directors and Officers Liability and Corporate Reimbursement" policy — all legal fees and expenses incurred in defending itself and two of its officers in a lawsuit, the court found that the policy only provided insurance for claims made against the insured corporation's D&Os, not claims made directly against the corporation). It should be noted that since that time, however, the market place has responded to the issue of allocation in the context of expenses in two major ways. The first is the introduction of agreed allocation percentages (often 100%) for defense costs incurred in a suit involving both covered and non-covered claims. The second is the introduction of broader forms that include one or more additional insuring clauses that provide direct coverage to the corporation for its expenses for certain types of claims. **III. "Advancement" of Defense Costs A. Advancement of Defense Costs vs. Duty to Defend** D&O policies, particularly those designed for larger public companies, typically do not include a "duty

to defend" by the insurer. Rather, the insured is tasked with the obligation (and control) of the defense. The policy then provides for the advancement of defense costs, rather than the assumption of the defense by the insurer. This provision allows the insureds to select their preferred counsel. Historically, the duty to indemnify the insured loss was determined under the contract in the same way for indemnifying defense expenses as it was for indemnifying an ultimate settlement or judgment. In recent years, however, a number of courts have allowed the influence of case law surrounding insurers' obligations under a duty to defend — often summarized by courts as "the duty to defend is broader than the duty to indemnify" — to impact the court's determination of coverage for indemnification of defense costs. *See McCuen v. Am. Cas. Co.*, 946 F.2d 1401, 1407 (8th Cir.1991). "[S]tate courts generally have viewed an insurer's duty to advance defense costs as an obligation congruent to the insurer's duty to defend, concluding that the duty arises if the allegations in the complaint could, if proven, give rise to a duty to indemnify." *Federal Ins. Co. v. Sammons Fin. Grp., Inc.*, 595 F. Supp. 2d 962, 976 (S.D. Iowa 2009) (*citing Acacia Research Corp. v. Nat'l Union Fire Ins. Co.*, No. 05–501, 2008 WL 4179206, at *11 (C.D. Cal. Feb. 8, 2008)); *Hurley v. Columbia Cas. Co.*, 976 F. Supp. 268, 275 (D. Del. 1997); *American Chem. Soc. v. Leadscope, Inc.*, No. 04AP–305, 2005 WL 1220746, at *4–8 (Ohio Ct. App. May 24, 2005). Analogizing — or finding "congruent" — the duty to advance defense costs to the duty to defend is significant, because case law relating to the duty to defend is more commonly developed in the context of personal and general liability policies, where defending an individual in an automobile accident or under a homeowners policy is at stake. State appellate courts have consistently broadened the duty to defend, while maintaining a tighter definition — related to the policy wording — for the duty to indemnify. For example, under Georgia law: [a]n insurer's duty to defend turns on the language of the insurance contract and the allegations of the complaint asserted against the insured …. If the facts as alleged in the complaint even arguably bring the occurrence within the policy's coverage, the insurer has a duty to defend the action. However, ... where the complaint ... does not assert any claims upon which there would be insurance coverage, the insurer is justified in refusing to defend the insured's lawsuit. *Forster v. State Farm Fire & Cas. Co.*, 307 Ga. App. 89, 704 S.E.2d 204 (2010). Thus, where the insurance contract includes a provision that theinsurerwill defend even groundless, false, or fraudulent suits, an insurer may have a duty to defend under circumstances where the complaint against the insured sets forth false allegations that may affect the determination of coverage. *See Penn-Am. Ins. Co. v. Disabled Am. Veterans, Inc.,* 268 Ga. 564, 564, 490 S.E.2d 374, 376 (1997). Generally, in making a determination of whether to provide a defense, an insurer is entitled to base its decision on the complaint and the other facts of which it has been made aware. *Colonial Oil Indus. Inc. v. Underwriters*, 268 Ga. 561, 562, 491 S.E.2d 337, 338 (1997). Therefore, if the complaint on its face shows no coverage, but the insurer is aware of facts that would place the claim within the policy coverage (for example, the true date of the accident is within the policy period even though the date alleged is not), the insurer has an obligation to consider those facts. *Id.* at 561, 491 S.E.2d at 338-39. Thus, applying duty to defend principles to indemnification of defense expenses may have the effect of broadening significantly the obligations of the D&O insurer. On the other hand, other recent cases have held that the duty to advance defense costs and

the duty to defend are separate and distinct obligations, and that an insurer's duty to advance costs should be subject to more stringent principles than those applied to the duty to defend. *See, e.g., Petersen v. Columbia Cas. Co.*, No. SACV 12-00183 JVS(ANx) (C.D. Cal. Aug. 21, 2012).[2] In *Petersen*, an attorney and his former firm were sued for malpractice by former clients. The firm met the self-insured retention, and the firm's liability insurer paid all of the defense costs above the retention amount for both the attorney and the firm. After the malpractice suit settled, the firm served an arbitration demand on its former attorney to recover the retention amount and other fees. The attorney submitted the arbitration dispute to the firm's professional liability carrier, who denied the claim. The attorney then filed a coverage action against the insurer. The policy provided that "the Assureds and not the Company have the duty to defend Claims" and that "the Company on behalf of the Assureds shall Advance Claim Expenses…." On cross motions for summary judgment, the attorney argued the duty to advance defense costs was "sufficiently analogous" to the duty to defend and, applying the duty to defend standard, that he only needed to show a "possibility that there [was] a covered claim" in order to trigger the insurer's obligation to advance defense costs. The insurer, in turn, argued that the "possibility of coverage" standard and other rules of law governing a duty to defend policy did not apply to a duty to advance policy. Rather, the insurer argued "that the case should be evaluated as a normal coverage dispute, more similar to a duty to indemnify." The court found that the policy at issue was not consistent with the broader duty to defend and that the attorney had the burden of establishing that the underlying claims were within the basic scope of coverage. The court based its finding on policy provisions providing for: (1) the claims expenses to be advanced subject to several conditions, including the insured's obligation to obtain the insurer's consent to reasonable attorneys' fees and to settlements; (2) allocation; and (3) an explicit disclaimer of any duty to defend. The court ultimately concluded that the insurer was not required to advance the defense costs. This issue is not settled. As noted earlier, the marketplace responded to issues of allocation of defense costs between covered and non-covered persons or claims by more specific wording, often including an agreed allocation percentage. The duties of an insurer in connection with defense of a lawsuit, however, are largely based on state law and, with the exception of either specific disclaimers of a duty to defend, or the addition of the "false or fraudulent" allegation wording, there has been little change in the policy wordings to address this issue. Thus, the standard applied to the duty to advance defense costs, whether analogous to the principles applied to the duty to defend, or to those applied to the duty to indemnify, will likely depend on established precedent in the particular jurisdiction. **B. Advancement of Defense Costs for Pending Litigation** Generally, an insurer obligated to advance defense costs must do so as they arise, rather than at the resolution of the underlying litigation, and any ambiguity in the policy relating thereto will be construed against the insurer as the drafter of the policy. *See, e.g., Little v. MGIC Indem. Corp.*, 836 F.2d 789 (3d Cir. 1987) (holding that policy was ambiguous as to whether it imposed upon insurer a duty to pay insured's defense costs as they were incurred, and under Pennsylvania law, policy thus had to be construed against insurer to require it to pay insured's defense costs as they became due); *Nat'l Union Fire Ins. Co. v. Brown*, 787 F. Supp. 1424 (S.D. Fla. 1991) *aff'd* 963 F.2d 385 (11th Cir. 1992) (holding that insurer was required to pay defense costs as they were incurred by insureds, rather

than foregoing payment until underlying suits were adjudicated or settled); *G-I Holdings, Inc. v. Reliance Ins. Co.*, No. 00-CV-6189, 2006 WL 776809 (D.N.J. Mar. 22, 2006) (citing *Little* in holding that the insurer had a duty to advance defense costs subject to the final outcome of the coverage litigation and rejecting the insurer's argument that because the court had yet to resolve whether the underlying allegations implicated the policy, a declaration regarding the existence of a duty to advance defense costs was premature). **C. Recoupment of Defense Costs Advanced** Because an insurer is generally required to advance defense costs as they become due and before a final determination as to coverage under the policy, as noted above, D&O policies providing for a duty to advance defense costs often contain a provision allowing the insurer to recoup any defense costs it advances if it is ultimately determined that the loss was not covered and, thus, the insured was not entitled to have its defense costs paid by the insurer. *See, e.g., Vigilant Ins. Co. v. Credit Suisse First Boston Corp.*, 10 A.D.3d 528, 782 N.Y.S.2d 19 (2004) (where insured brought action against its insurers to recover amount of settlement which represented the disgorgement of funds improperly acquired through violations of various securities regulations, which the court found was not covered, and the insurer counterclaimed, the court held that "[w]hile, under certain circumstances, the insurers must advance defense costs incurred by the insured in connection with a claim, the insured is obligated to repay such advance payments upon a finding that it is not entitled 'to payment of such Loss.' Thus, defense costs are only recoverable for covered claims."). Whether an insurer can recoup advanced defense costs can depend on both the policy language itself and the case law precedent within a given jurisdiction, which may require more than an insurer simply having reserved its right to recoup defense costs. *See, e.g., Illinois Union Ins. Co. v. NRI Const. Inc.*, 846 F. Supp. 2d 1366 (N.D. Ga. 2012) (where CGL insurer sought declaration of no duty to defend or indemnify insured in underlying litigation and reimbursement for all fees and costs incurred in defending insured against underlying claims, court held that insured impliedly consented to insurer's reservation of rights; and, in a matter of first impression in Georgia, insurer's right to reimbursement of defense fees paid, where it is determined that the insurer had no duty to defend, is justified under either an unjust enrichment or implied-in-fact contract theory); *United Nat. Ins. Co. v. SST Fitness Corp.*, 309 F.3d 914 (6th Cir. 2002) (following affirmance of declaratory judgment that CGL insurer had owed no duty to defend insured corporation against claims of patent infringement, unfair competition, and unjust enrichment, insurer moved for award of defense costs paid under reservation of rights, and court held that insurer was entitled to recoup from insured its costs of defending underlying action because insurer had reserved its right to do so). *But see, General Agents Ins. Co. v. Midwest Sporting Goods Co.*, 215 Ill. 2d 146, 166, 828 N.E.2d 1092, 1104 (2005) (acknowledging that a majority of jurisdictions have held that an insurer is entitled to reimbursement of defense costs when (1) the insurer did not have a duty to defend, (2) the insurer timely and expressly reserved its right to recoup defense costs, and (3) the insured either remains silent in the face of the reservation of rights or accepts the insurer's payment of defense costs, but nevertheless chooses to follow the minority rule and refuses to permit an insurer to recover defense costs pursuant to a reservation of rights absent an express provision to that effect in the insurance contract). **IV. The "Final Adjudication" Clause** D&O policies often include certain exclusions that are only triggered upon a "final adjudication." The

following exclusion for criminal, deliberate, or fraudulent acts provides an example: The Insurer shall not be liable to make any payment for Loss in connection with any Claim made against an Insured ... arising out of, based upon or attributable to the committing of any deliberate criminal or deliberate fraudulent or dishonest act, or any willful violation of any statute, rule or law, if any *final adjudication* establishes that such deliberate criminal, deliberate fraudulent or dishonest act or willful violation of statute, rule or law was committed.... (Emphasis added.) Current case law is inconclusive as to whether a final adjudication that would support application of the above exclusion must be in the underlying litigation or whether it may be in other litigation. At least one court has held that a separate criminal action involving the same wrongful acts may provide the "final adjudication" necessary to apply the exclusion to related civil claims for which coverage is sought. *See Herley Industries, Inc. v. Federal Ins. Cos., Inc.,* No. 08-5377, 2009 WL 2596072 (E.D. Pa. Aug. 21, 2009). In *Herley*, an insurance coverage dispute arose out of a criminal action, a securities action, and a shareholders' derivative action against the insured. The insured sought coverage from its insurer for the costs of defending all three actions. *Id.* at *1. The insurer contended that the fraud/willful violation exclusions of the policy barred coverage for the insured's defense of the civil actions because of the guilty plea entered in criminal action. The insured argued that the guilty plea was not a final adjudication that would trigger the exclusion. *Id.* at *9. The trial court rejected this argument. The court considered whether the civil actions were "based upon, arising from, or in consequence" of the deliberately fraudulent misconduct to which the insured pleaded guilty in the criminal action. *Id.* at *10. The court noted that "but for" causation has been held to satisfy the "arising out of" language under Pennsylvania law, and concluded that "but for" the insured's deliberately fraudulent misconduct, the claims would not have arisen and then civil actions would not have been filed. Thus, the securities and derivative actions were barred from coverage under the policy. *Id.* at *11. Similarly, a Delaware court has stated explicitly (albeit in dicta) that final adjudication contemplated by the policy at issue referred to the underlying action giving rise to the coverage dispute. *See AT&T v. Clarendon America Ins. Co.*, No. 04C-11-167-JRJ, 2008 WL 2583007 *1, *7 (Del. Super. June 25, 2008) ("The 'adjudication' contemplated in the policy does not ... mean an adjudication within the coverage dispute. It means an adjudication in the underlying action.... The 'cause of action so adjudicated' is not the coverage dispute; it is the underlying action giving rise to the coverage dispute.") Note, however, that the court was distinguishing between an earlier adjudication in the coverage action versus an adjudication in the underlying action; it did not consider whether the final adjudication could come from some other action with similar issues. Moreover, it is unclear whether the final adjudication must arise in litigation, or can derive from some other type of proceeding. In *Bear Wagner Specialists, LLC v. National Union Fire Insurance Co.*, 897 N.Y.S.2d 668 (N.Y. Supp. 2009), the policy contained an exclusion for claims "arising out of, based upon or attributable to the committing in fact of any criminal, fraudulent or dishonest act, or any willful violation of any statute, rule or law." An SEC investigation found that the insured broker-dealer had violated federal securities laws, and investors filed civil actions against the insured alleging that they suffered damages as a result of the insured's unlawful trading practices. The court held that the insurer had no duty to defend the insured because the allegations of the underlying complaints fell

within the policy's exclusion. *Id.* The court did not discuss whether a final adjudication was necessary, so it is unclear whether an SEC investigation alone would constitute a final adjudication for purposes of this exclusion. **V. Coverage for Punitive, Exemplary and Multiplied Damages** Whether coverage is provided for punitive, exemplary and multiplied damages will depend not only on the language of the policy itself, but also on the law of the relevant jurisdiction. Some jurisdictions hold (or have established by statute) that coverage for punitive damages is against public policy as a matter of law, regardless of specific policy language providing insurance for punitive damages. *See, e.g., Pub. Serv. Mut. Ins. Co. v. Goldfarb*, 53 N.Y.2d 392, 398, 425 N.E.2d 810, 813 (1981) (holding that, although the policy specifically stated that the insurer will "pay on behalf of the Insured named in this certificate all sums, including punitive damages, which the Named Insured shall become obligated to pay …", under no circumstances could the insurer be compelled to indemnify the insured for punitive damages because to allow insurance coverage for such damages is totally to defeat the purpose of punitive damages). Other courts have held that insuring against punitive damages is only against public policy when the insured is directly liable, but not when the insured is only vicariously liable. *See, e.g., Country Manors Ass'n, Inc. v. Master Antenna Sys., Inc.*, 534 So. 2d 1187 (Fla. Dist. Ct. App. 1988). In *Country Manors*, the court noted that while public policy prohibits insurance coverage of punitive damages, such coverage is not precluded when the insured himself is not personally at fault, but is merely vicariously liable for another's wrong. *Id.* at 1191. However, in this case, the court further reasoned that a corporation can only act through its officers and agents. Since it was the conduct of the directors, acting in their capacity as such, that gave rise to the punitive damages claim, their acts were indistinguishable from the acts of the corporation itself. The court concluded that since the association's liability was direct and not vicarious, public policy precluded insurance coverage for punitive damages. *Id.* Noting that the policy specifically excluded coverage for "fines or penalties imposed by law, or matters which may be deemed uninsurable under the law," the court also held that treble damages are "fines or penalties imposed by law or matters which may be deemed uninsurable under the law" and were therefore not covered. *Id.* at 1195. Under Georgia law, punitive damages are insurable. *See, e.g. Greenwood Cemetery, Inc. v. Travelers Indem. Co.*, 232 S.E.2d 910, 914 (Ga. 1977) ("Punitive damages is a legal liability and accordingly insurance against such damages is expressly authorized."); *Fed. Ins. Co. v. Nat'l Distrib. Co., Inc.*, 203 Ga. App. 763, 417 S.E.2d 671 (1992) (holding that insurance coverage of punitive damages does not contravene Georgia public policy). **VI. Conclusion** Read the contract. The policy is the starting point for any coverage analysis. Business people know how their obligations are bound by contracts in their day-to-day business, but for some reason, people often see insurance as uniform and one-dimensional, and seek quick answers to complex questions without looking at the contract wording. The court opinions discussed in this and similar seminars often reveal trends in interpretations of certain provisions that may be favorable to policyholders. Your presenters at this seminar are among the best policyholder attorneys in the entire region, but I believe they would give you the same advice. Never assume that the latest court decision you have read in the news will apply to your insurance contract. Always start with the contract wording, because that is where your insurer will start. And if the contract wording does not support coverage for a claim, you are likely to find resistance from the insurer, regardless of

the latest case decision from some other state or court. So if we can leave you with one take-away today, it would be, “read your contract.”

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1 For ease of reference, “directors and officers,” and the various shortened versions — “Ds and Os,” etc. — are simply written as “D&Os.”
2 This opinion is discussed more fully on Kevin LaCroix’s blog, Kevin LaCroix’s blog, The D&O Diary, available at http://www.dandodiary.com/

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