Defense Cost Issues under D & O Policies
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INTRODUCTION
An insurer’s duty to defend, based on policy language and interpretive case law, is well established. In most states, the duty to defend is broader than the duty to indemnify and is based on potential coverage as opposed to actual coverage for the claims asserted. Most courts utilize a version of the four corners rule to analyze the scope of the duty to defend. There are significant consequences for an insurer who breaches the duty. For this reason, it is important to be familiar with the duty to defend under the law of the state implicated by the policy at hand.

Many directors & officers liability policies (“D & O policies”) are different than general liability policies, primarily because they do not include a duty to defend the insured. D & O policies expressly state that the insured and not the insurer has the responsibility to defend a covered claim and provide that the insurer will reimburse the insured for defense costs incurred. The insured is given the right to select counsel, subject to the reasonable approval of the selection by the insurer. Defense costs, either by definition or allocation clauses are limited to covered claims.

Specific state case law interpreting D&O policies is sparse. Thus, this article explores how jurisdictions across the country have applied the traditional duty to defend rules to the interpretation of D&O policies. Most courts that have addressed the issue have recognized that the duty to defend and the duty to reimburse defense costs are discreet concepts imposing different obligations on the insurer. However, courts assessing the duty to advance defense costs generally do so using standards that are the same or similar to those employed to ascertain whether an insurer has a duty to defend, i.e., by looking at whether the allegations of the complaint in the underlying lawsuit assert a potentially covered claim.

For example, under New York law, where a contract of insurance includes the duty to pay for the defense of its insured, that duty is a “heavy” one. The duty is independent of the ultimate success of the suit against the insured. The duty to pay defense costs exists whenever a complaint against the insured alleges claims that may be covered under the insurer’s policy. The duty to pay defense costs is construed liberally and any doubts about coverage are resolved in the insured’s favor.

California courts have determined that the rules establishing a duty to defend are not applicable for determining a duty to advance defense costs. In Jeff Tracy, Inc. v. U.S. Specialty Ins. Co., the policy at issue disclaimed the duty to defend, only allowed consenting to defense costs to be considered a loss, and provided for allocation of defense costs when covered and uncovered losses were involved. The insured was obligated to provide its own defense. The court determined these conditions were inconsistent with the broad duty to defend standard and rejected the insured’s argument that the “potential for coverage” standard should govern. Instead, the court held that an insured must establish that the underlying claims were within the basic scope of coverage before the insurer was required to advance defense costs. It is difficult to ascertain how the California standard differs from the traditional four corners rule. A subsequent decision, Legacy Partners, Inc. v. Clarendon American Ins. Co., allowed a form of the “potentiality” standard to be applied for a duty to pay for defense costs. There, the court distinguished Jeff Tracy and found that an insured bears only the burden of proving potential coverage in order to receive reimbursement of defense costs.

The primary difference between a duty to defend policy and a duty to advance defense costs policy relates to the defense of uncovered claims. A duty to defend policy requires that the insurance company advance all of its insured’s defense costs, even if only a portion of the lawsuit alleges covered claims. In contrast, a duty to advance defense costs policy only obligates the insurer to pay the pro-rata share of the costs based on the percentage of litigation attributable to covered entities and covered claims. The issues arising from the allocation clause allocate are discussed later on in this article.

Reimbursement of Defense Costs Are Due When Incurred
Many D & O policies provide that the insurer shall advance defense costs prior to the final adjudication of the
underlying claim. Others are silent as to when reimbursement is due. Cases which have addressed the timing of reimbursement of defense costs when the policy is silent have uniformly held that the insurer’s obligation to reimburse attaches as soon as the defense costs are incurred. The rationale is that to hold otherwise would not provide insureds with protection from financial harm that insurance policies are presumed to give.9

Consistent with the above rationale, the courts have held that the failure to receive defense costs under a professional liability policy at the time they are incurred “constitutes ‘an immediate and direct injury” sufficient to satisfy the irreparable harm requirement for purposes of receiving injunctive relief.10

D & O policies contain criminal acts and personal profit exclusions which pursuant to their express terms do not apply until a final and non-appealable judgment or adjudication established the insured committed the excluded conduct.13 The court in Little determined the insurer’s duty to pay defense costs arose contemporaneously with the insured’s obligation to pay those costs. The court, reading the language of the exclusion, found that the dishonesty exclusion’s language supported this conclusion, as it protected the insured from exclusions from coverage until a final adjudication of dishonesty occurred. The D & O policy at issue in Little also provided that in the event it was finally established that insurer has no duty to indemnify, the insured agreed to repay to the insurer the advanced defense costs.14 The insurer contended that this clause meant that the insurer had the discretion to advance defense costs, while the insured contended that the insurer still had the obligation to pay costs as they were incurred. The court found that each side’s reading of the policy was a reasonable one and, as a result, there was ambiguity in the policy language. As any legitimate ambiguity must be resolved against the insurer, the court in Little concluded the policy must be construed against the insurer to require it to pay Little’s defense costs as they come due, subject to its conditional right to reimbursement.”15 The contemporaneous advancement principle outlined in Little has been followed in federal courts.16

Defense of Covered and Uncovered Claims and the Duty to Allocate

D & O liability policies often include provisions that limit the insurer’s obligation to pay “loss” (damages and defense expenses) to amounts incurred in the defense or resolution of covered claims. Accordingly, if an action incorporates both covered and uncovered claims, the parties must apportion the costs so that that insurer “need only pay for amounts generated in the defense of covered claims.”17

Given that D & O policies differentiate between covered and non-covered claims, courts have recognized that insurers may “contract out” of the default rule of contemporaneous advancement of all defense costs incurred.18

An insurer may contract out of the default rule by specifically and explicitly excluding the underlying claims from coverage with unambiguous policy language.19 For example, in Am. Cas. Co. of Reading, Pennsylvania v. Rahn, the D & O policy required that the claims be made during the coverage period for the policy to apply. The underlying claims were made after the policy period expired, consequently, they were “specifically and explicitly” excluded from coverage and the insurer properly refused to pay the expenses.20

Additionally, if a lawsuit only seeks damages that are uninsurable, the insurer is not liable to reimburse any defense costs spent defending the claims, even if the claims are eventually determined to be meritless.21

Although D & O policies differentiate between covered and non-covered claims, some courts have found that when coverage of the underlying claims is disputed the default rule of contemporaneous payment applies.22 However, such advances of defense costs are subject to recoupment by the insurer if it is ultimately determined no coverage is afforded.23

Some courts have allowed the insurer to allocate defense costs between covered and uncovered claims while the lawsuit and defense is ongoing. The term “allocation” refers to the process of determining the amount of defense costs, settlements, or judgments attributable to covered claims. Allocation provisions were originally incorporated into policies that provided coverage for claims against the directors and officers, but not policies that provided coverage for claims against the corporation. These provisions have resulted in litigation between insurers and insureds. Disputes can arise where a lawsuit against the insured includes covered and uncovered claims or where both the insured and other uninsured parties are found liable. In such cases it can be difficult to determine the
amount of defense costs, settlements, or judgments attributable to covered claims. Allocation provisions were originally incorporated into policies that provided coverage for claims against the directors and officers, but not policies that provided coverage for claims against the corporation. These provisions have resulted in litigation between insurers and insureds. Disputes can arise where a lawsuit against the insured includes covered and uncovered claims or where both the insured and other uninsured parties are found liable. In such cases it can be difficult to determine the amount of the eventual award that is attributable to the insured. Moreover, this determination can also be difficult where cases are settled out of court, and one lump sum is paid to the plaintiffs.

Early D & O policies contained allocation provisions under which the insurer and the insured were merely required to “use their best efforts to determine a fair and proper allocation.” Because such provisions lacked clarity, courts fashioned their own approaches in determining the proper allocation of defense costs.

The Maryland Court of Appeals first announced the “reasonably related rule” in Continental Cas. Co. v. Board of Educ. of Charles County. Under this rule, “[s]o long as an item of service or expense is reasonably related to the defense of a covered claim, it may be apportioned wholly to the covered claim.” The court articulated the following standard for when an expense is “reasonably related” to a covered claim: “Legal services and expenses are reasonably related to a covered count if they would have been rendered and incurred by reasonably competent counsel engaged to defend a suit against the [insured] arising out of the same factual background as did the [actual] suit but which alleged only the matters complained of in [covered] counts.”

Stated another way, under the reasonably related rule, a D & O insurer must show that costs do not relate to the defense of a covered claim in any way to avoid the obligation of providing a particular defense cost.

In addition to the reasonably related rule, the courts have adopted one of two distinct approaches for calculating reimbursement for plaintiffs seeking recovery for settlement costs under D & O policies. On one hand, the “relative exposure” rule allocates settlement amounts according to the relative risk of exposure and proportional fault of the parties. The relative exposure rule involves “a somewhat elaborate inquiry into what happened in a settlement and who really paid for what relief.” On the other hand, the “larger settlement” rule, a variation of the reasonably related rule, involves a simpler inquiry. The larger settlement rule allows allocation of settlement costs “only where the settlement is larger by virtue of wrongful acts of uninsured parties.” Under this rule, allocation is appropriate only if a corporate entity’s independent exposure accounts for a portion of the settlement sum, in which case said portion is excluded from coverage.

The Ninth Circuit applied the larger settlement rule in Nordstrom, Inc. v. Chubb & Son, Inc., affirming a 100% allocation of a settlement to the insured on the grounds that the corporation’s liability was based on the actions of the directors and officers. This decision expanded the nature D & O insurance protection, and resulted in the D & O insurer being liable for the uninsured corporation’s exposure.

In response to the advent of the larger settlement rule, the D & O industry responded in two ways. First, many D & O policies now include entities coverage, which essentially renders allocation unnecessary when the corporation and directors and officers are named in a lawsuit. Second, D & O policies typically include detailed allocation clauses that require the parties to negotiate an allocation agreement. In the event that the parties are unable to reach an agreement, the insurer may be required to advance the percentage of loss not in dispute and submit to arbitration on the allocation amount in dispute. As a result of these modifications, litigation involving allocation provisions has decreased significantly.

The Eighth Circuit recently clarified the method of allocating coverage where settlement costs arose out of two separate suits in UnitedHealth Group Inc. v. Executive Risk Specialty Insurance Co. et al. Where an insured settles two cases, one of which is not covered, the insured must establish an allocation that goes beyond speculation. The insured may prove allocation by providing (a) testimony from the attorneys in the underlying actions; (b) other evidence from the underlying lawsuits; (c) expert testimony evaluating the underlying lawsuits; (d) a review of the underlying transcripts; or (e) “other admissible evidence.” These factors are considered to determine how a reasonable party would have allocated the claims at the time of settlement.

Right to Select Counsel and Control the Defense of the Underlying Claim

Under a D & O policy an insured has the responsibility of selecting and appointing counsel from the onset of the claim. Most policies give the insurer the right to associate with the defense and approve defense strategies, expenditures, and settlements. However, these polices typically provide that the insurer may not unreasonably withhold approval of the insured’s choice of counsel. Where a breach of the duty to defend has occurred, the insured is free to choose any a reasonable type of representation.

An insurer who breaches the duty to defend is “in no position to object to defense-related expenditures that are supported by the record and that are not patently unreasonable.” Additionally, D & O policies often include a pre-approved panel of counsel, and if the policy holder sticks to the list, the selection is automatically approved. Many policies provide that the insurer’s consent is needed to go off the list, and sometimes such consent is absolute, while other times it is not to be unreasonably withheld.

By extricating themselves from involvement in the underlying action, and preserving their right to subsequently disclaim expense reimbursement for non-covered claims, D & O carriers can
and do charger lower premiums than their duty to defend counterpart. However, as mentioned, D & O insurers generally have the right to maintain some involvement in the litigation and participate in the selection of counsel. Thus, D & O policies provide insurers the dual advantage of exercising some control over the litigation, while also avoiding the duty to provide the defense.

**Exhaustion of Policy Limits**

Most D & O policies are written on a defense cost “inside the limits” basis, meaning that covered defense costs erode the policies’ liability limits as they are incurred. Furthermore, defense costs and other loss, which typically includes damages, judgments, and settlements, are typically subject to the D & O policy’s limit of liability. Because defense costs tend to be high in lawsuits involving claims against director and officers, this frequently results in defense costs totally exhausting the D & O policy’s limit of liability before any damages, judgments, or settlements may be paid.

Provided that the applicable D & O policy language regarding payment of defense costs against the limit of liability is clear, courts have recognized that a D & O insurer is not required to continue to pay the cost of defending underlying claims after defense costs have exhausted the limit of liability set forth in the policy. If the policy is ambiguous as to whether defense costs are included in the limit of liability, however, courts have declined to permit a D & O insurer to discontinue paying defense costs or coverage after the policy limit is reached.

It is worth noting that other D & O policies contain separate limits for defense and indemnification. Thus, a carrier could find itself in a situation where the defense limits have been exhausted, but it still has a duty to indemnify.

In conjunction with exhaustion of a primary policy’s limits, it is important to consider the relationship between the primary and any excess D & O insurance policies. To protect against exposure to large losses, large corporations frequently buy “towers” of coverage, meaning they have a primary policy and multiple excess insurance policies.

The concept of “bridging the gap” may arise when excess policies are implicated. There may be a gap in coverage created by a settlement contribution from a primary policy insurer that does not exhaust the primary policy’s limit of liability, although the total settlement amount exceeds the limit of liability because the insured pays a portion of the settlement. Courts have enforced language in some D & O excess policies requiring “actual payment” of losses by the primary insurer, such that the insured cannot bridge the gap to trigger excess coverage. However, some D & O policies do not contain “actual payment” language, so the insured could bridge any gaps in coverage if necessary. In addition, some types of D & O excess policies offer coverage that “drops down” under certain circumstances.

**Conclusion**

D & O policies present unique issues for claims handlers and attorneys. Given the relative dearth of state-specific case law regarding D & O policies, decisions from various jurisdictions provide guidance on handling the issues commonly presented by D & O policies.

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**Endnotes**


18. See e.g., Commercial Capital Bankcorp. Inc. v. St. Paul Mercury Ins. Co., 419 F. Supp. 2d 1173, 1180-81 (C.D. Cal. 2006) (“[A] properly-drafted contract provision … abrogate[s] the default rule of contemporaneous payment”); Pan Pac. Retail Properties, Inc. v. Gulf Ins. Co., Case No. 03-CV-679 WQH, 2004 U.S. Dist. LEXIS 28534, at *42 (S.D. Cal. July 14, 2004) (holding that insurer was entitled to allocate defense costs because policy language contracted out of the default rule where policy stated “Insurer shall advance on a current basis Defense Costs which the Insurer in its discretion believes to be covered under this Policy”); Clifford Chance Ltd. Liab. P’ship v. Indian Harbor Ins. Co., 14 Misc.3d 1209(A), 836 N.Y.S.2d 484 (N.Y. Sup. Ct. 2006) (holding that insurer was entitled to allocate defense costs because policy language contracted out of the default rule where policy stated “the insured and insurer will use their best efforts to determine a fair and appropriate allocation of Loss between that portion of Loss that is covered under the Policy and that portion of Loss that is not covered under this Policy”).


24. 302 Md. 516, 489 A.2d 536 (1985)

25. Id. at 534.

26. Id. at 532.


31. Caterpillar, 62 F.3d at 960.

32. Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424, 1432 (9th Cir. 1995).

33. Id.

34. 870 F.3d 856 (8th Cir. 2017).


36. Id.


39. See, e.g., Helfand v. National Union Fire Ins. Co., 10 Cal. App. 4th 869, 880-84, 13 Cal Rptr. 2d 295 (Cal. Ct. App. 1992); In re Enron Corp. Secs. v. Belfer, Civil Action No. H-01-3624, 2006 U.S. Dist. LEXIS 38845, at *28-40 (S.D. Tex. June 12, 2006) (finding that the D & O insurer was permitted under the policy language and Texas law to terminate its participation in the defense of the insured’s claims upon settlement of actions involving other directors and officers that would have the effect of exhausting the limit of liability under the policy, and rejecting a pro se motion for coverage by an insured former officer seeking an equitable share of the insurance proceeds).


43. See New Appleman, § 37.22.

44. See id.