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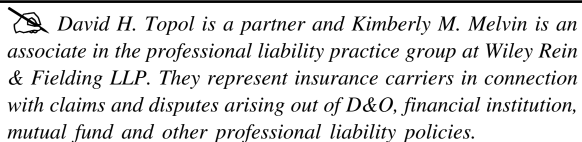
The Danger of Playing With House Money: The Case Against Collusion Between D&O Insureds and Shareholder Claimants

by David H. Topol and Kimberly M. Melvin


David H. Topol is a partner and Kimberly M. Melvin is an associate in the professional liability practice group at Wiley Rein & Fielding LLP. They represent insurance carriers in connection with claims and disputes arising out of D&O, financial institution, mutual fund and other professional liability policies.

I. INTRODUCTION

Although D&O policies provide coverage against certain types of loss, they are drafted in manner that addresses two potentials for mischief on the part of some insureds and their counsel who might otherwise view the policy as "house money" to be used for purposes other than the vigorous defense of litigation and settlements or judgments based on actual case values. So long as a case can settle within policy limits, with sufficient money available to pay millions of dollars in defense costs, some insureds may be content to settle for inflated amounts unrelated to the merits of the underlying litigation even though doing so drives up settlement values for future cases, further emboldens the plaintiffs' bar and increases insurance premiums. In an effort to control this incentive, D&O insurers include in the insurance contract provisions requiring their insureds to cooperate in the defense and settlement of any litigation in order to minimize the overall exposure of the case.

D&O insurers also face the danger of moral hazard — "that the insured will be induced by the fact that he has insurance to commit the act against which he has insured and thereby escape the costs of the act while reaping its benefits."[1] Without appropriate limitations and exclusions, D&O policies could provide an incentive to directors and officers to engage in wrongful acts while taking comfort in the fact that the D&O insurer will make the damaged parties whole. The resulting risks would be unsustainable for insurers and unpalatable as a matter of public policy. Thus, D&O policies contain exclusions that bar coverage for insuring intentional wrongdoing and improper profiteering — while at the same time providing protection for directors and officers who are falsely accused of intentional wrongdoings or who are sued for non-intentional acts.

These anti-collusion provisions and anti-fraud/intentional conduct exclusions are plainly set forth in the terms of D&O insurance policies and agreed to by sophisticated parties advised by knowledgeable brokers. In an article in the July/August 2004 issue

of Coverage, however, John H. Mathias, Jr. and Timothy Burns ignore these provisions of the D&O policies and advise insureds to "closely align" their interests with those of shareholder claimants in order to "maximize the amount of insurance proceeds" used to settle underlying litigation. Mathias and Burns's arguments suffer from three fundamental defects.

First, Mathias and Burns's argument that insureds should, in effect, collude with claimants to maximize policy proceeds flies in the face of the numerous provisions in the D&O policy that expressly preclude such conduct. D&O policies require insureds to act, as many insureds do, in good faith by vigorously defending litigation, cooperating with their insurers and not increasing the insurer's exposure. These provisions are intended to align the insurer's and the insureds' incentives to prevent insureds from treating the D&O policy as "house money" that they can draw down on to settle litigation regardless of whether the settlement amount is justified on the merits.

> ***"First, Mathias and Burns's argument that insureds should, in effect, collude with claimants to maximize policy proceeds flies in the face of the numerous provisions in the D&O policy that expressly preclude such conduct."***

Second, Mathias and Burns erroneously assert that a D&O insurer "stands in the shoes" of the insureds and that it is therefore "sanctimonious" for an insurer to rely on exclusions in the policy, such as the ones applicable to deliberate fraud or personal profiteering, to deny coverage. A D&O policy is not a performance bond, however, and a D&O insurer has no more obligation to insure embezzlement or fraud than a property insurer has to insure against arson.

Third, Mathias and Burns ignore the common interest that insureds and insurers share in effectively defending against lawsuits by securities claimants, many of which have little merit. If the proceeds of D&O policies are viewed as "house money" to be turned over to plaintiffs and the plaintiffs' bar, then plaintiffs will have an incentive to keep bringing securities lawsuits. Indeed, the plaintiffs' bar could prey on the adversarial dynamic between D&O insurers and their insureds espoused by Mathias and Burns. If, however, insureds defend litigation in the same way they would in the absence of coverage — as they are obligated to do under the D&O policy — then plaintiffs may be deterred from bringing these lawsuits, which harm insureds by making it more expensive to acquire D&O insurance, by generating adverse publicity for the insured entity and by diverting the attention of directors and officers from effectively running their company.

II. INSUREDS ARE REQUIRED TO COOPERATE WITH INSURERS

D&O insurers confront the problem that some insureds and the counsel they have selected may be unwilling to defend a lawsuit vigorously when they can settle with house money. There is a risk that an insured may act differently in handling litigation when its own money is at stake (*e.g.*, if a case is likely to settle either below the retention or above the limits of liability) than if the case will be resolved only with insurance proceeds. Indeed, Mathias and Burns urge precisely this approach when they advise that the D&O policy should "guide [the] litigation decisions" of defense counsel and plaintiffs' counsel.

In an effort to ensure that insureds defend litigation appropriately, rather than using house money to "maximize" the amount of insurance proceeds available to resolve the claim, D&O policies contain a number of provisions governing the relationship between the insurer and insureds that seek to align the parties' incentives. Mathias and Burns do not even mention these provisions, let alone explain how their recommendations can be squared with these provisions of the D&O policy.

A. Cooperation and Association Clauses

Virtually all D&O insurance policies allow the insurer to associate in the defense of underlying litigation and require the insureds to provide to the insurer "such information, assistance and cooperation" as the insurer may request. This provision is sufficiently important that "it cannot seriously be contended that insureds would not be required to disclose contents of any communications they had with defense counsel representing them on a claim for which insurers had the ultimate duty to satisfy."[2] When an insured fails to cooperate with an insurer[3] or to permit it to associate in the defense of the litigation, the insured's conduct violates the D&O policy, prejudices the insurer and vitiates coverage for the claim at issue.

The cooperation and association clauses serve a number of important purposes. To begin with, they ensure that the insurer receives sufficient information to evaluate the claim in order to determine whether the case is being effectively defended and to evaluate the exposure of the case. In some instances, it may be possible to achieve an early resolution of the case that, even with a substantial payment, benefits the insureds by providing a prompt resolution and benefits the insurer by enabling some savings from its policy limits. In other instances, the information provided to the insurer may reveal that the underlying litigation is largely without merit. In those cases,

the exchange of information required by the cooperation clause may enable the insurer to identify and follow up on a need to strengthen the defense by, for example, adding appropriate expert witness support at an early juncture.

A second important function of these D&O policy provisions is "to protect the insurer's interest and prevent collusion between the insured and injured person."[4] *Youell v. Grimes*[5] provides an extreme example of the type of collusion that insurers seek to guard against. In that case, the court considered the application of the cooperation clause to a company that was sued for securities fraud and sought coverage under a D&O policy. The insurer consented to the selection of defense counsel, who ultimately negotiated a $410,000 settlement of the securities suit. Before the settlement was finalized and approved by the court, however, the policyholder filed for bankruptcy under Chapter 11 and designated a representative of the estate. The estate representative subsequently withdrew the motion to approve the settlement, informed the securities plaintiffs that the policyholder's files contained "every smoking gun memo imaginable" and that "$410,000 is not an adequate amount to settle all claims," filed an answer in the securities suit admitting liability, and agreed to settle the suit for $1.7 million. The court agreed with the insurer that those actions constituted a material breach of the cooperation clause, reasoning that the higher settlement was a result of the actions by the estate representative and that the admission of liability "precluded the underwriters from effectively defending" the claim.[6]

Although Mathias and Burns advocate a slightly more subtle form of collusion, their recommendations still result in a breach of the cooperation clause. D&O insurers can and do agree to settlements up to policy limits when presented with full and complete information demonstrating that the payment is appropriate in light of the facts of the case and the exposure faced by the insureds. Insurers are not, however, obligated to pay unwarranted amounts simply because a policy has high limits, and an insurerd should not be permitted to work with claimants to achieve such a result.

B. Not Increase the Insurer's Exposure

D&O policies also often contain a provision barring the insureds from "taking any action that in any way increases the insurer's exposure." Yet Mathias and Burns urge insureds to take a number of steps for the very purpose of increasing the insured's exposure. For example, they suggest that insureds with plaintiffs to "soften the insurers' negotiation position" so as "to put an insurer at risk for extra-contractual damages." Similarly, they suggest that insurers seek to have plaintiffs "structur[e] their allegations to avoid aiding an insurer's attempts to rescind a D&O policy or exclude the securities lawsuits based on the deliberate fraud exclusions." If insureds align their interests with those of the claimants to "maximize" the amount of insurance proceeds, however, they clearly violate this provision of the policy.

C. Consent to Settlement

D&O insurance policies also require insureds to obtain the insurer's consent prior to settling a claim, and the failure to obtain consent precludes coverage.[7] Although many policies provide that consent "not unreasonably be withheld," the insureds must demonstrate the reasonableness of a settlement and the mere fact that the company, for business reasons, wants to overpay for settlement at the insurer's expenses does not provide grounds for settlement.[8]

D. Insured v. Insured Exclusion

Insurers also used the insured v. insured provision in D&O policies to guard against potential collusion. Although the precise formulation varies by insurer, almost all D&O policies preclude coverage for claims brought by, or with the assistance, of the policyholder company, its officers or directors.

One of the purposes of this provision is to prevent insureds from making the insurer step into its shoes for "friendly or collusive lawsuits where a company tries to convert its D&O policy into a corporate errors and omissions policy."[9] In one case, a court held that where a former officer and director of a company provided "active assistance" to plaintiffs who had brought a derivative lawsuit, the insured v. insured exclusion of the policy precluded coverage.[10]

E. Duty of Good Faith and Fair Dealing

In addition to the specific policy provisions discussed above, insureds have an implied duty of good faith and fair dealing. One commentator has noted,

> In the modern insurance context, the duty of good faith and fair dealing is considered to be a *mutual* duty of the insured and the insurer and generally applies to the conduct of the parties in the context of the insurance contract.[11]

As a part of its implied duty, "the insured is expected not to provide false or misleading information to the insurer in the application for the policy or in the event of a claim under the policy or otherwise cooperate with the insurer in the event of a claim."[12] Although typically raised as a defense to a bad faith claim by an insured, some jurisdictions recently have "recognize[d] an insurer's right to sue the insured for breach of the covenant of good faith

and fair dealing."[13] If insureds work together with claimants to "maximize" the amount of insurance proceeds, as proposed by Mathias and Burns, they violate their implied duty of good faith and fair dealing.

> ***"If insureds work together with claimants to 'maximize' the amount of insurance proceeds, as proposed by Mathias and Burns, they violate their implied duty of good faith and fair dealing."***

III. D&O POLICIES ARE NOT PERFORMANCE BONDS

A D&O policy generally provides (i) liability coverage payable directly to the directors and officers for liability resulting from their wrongful acts when indemnification is not permitted or not available due to insolvency and (ii) coverage payable to the corporation/insured entity to reimburse it for indemnification provided to their directors and officers for claims against them. Some D&O policies also provide liability coverage payable directly to an insured entity for its wrongful acts although this coverage is typically limited to securities claims in policies issued to publicly traded companies.

Whether or not there is coverage for any particular claim, however, depends on the exact language of the policy to which the insurer and the insured agreed. Through various terms, conditions and exclusions, the parties to an insurance contract define the exact contours of the insurance coverage purchased and the contractual duties imposed on the parties. For example, D&O policies generally exclude certain types of risk that insurers do not want to or cannot as a matter of public policy insure (*e.g.*, criminal acts, intentional acts, personal profit), as well as matters covered by other policies (*e.g.*, bodily injury, matters noticed under other insurance policies).

> ***"An insurer does not act 'sanctimoniously' when its declines to cover what is specifically excluded by the terms of the policy purchased by the insureds."***

Mathias and Burns's assertion that "the insurance company has agreed to stand in the shoes of its allegedly wrongdoing insureds to the full extent of its policy's limits of liability" ignores the fact that the insureds paid for an insurance contract that includes provisions that exclude coverage for certain types of conduct. That an insurer agreed to defend and indemnify a director against a lawsuit alleging negligence does not mean that the insurer intended to provide coverage for deliberate fraud. Yet Mathias and Burns ignore the existence of these types of exclusions in D&O policies, arguing, for example, that "insurers have asserted" that D&O policies do not afford coverage for deliberate securities fraud. An insurer does not act "sanctimoniously" when its declines to cover what is specifically excluded by the terms of the policy purchased by the insureds.

After all, the entities and individuals insured by D&O policies are sophisticated contracting parties with substantial bargaining power advised by knowledgeable brokers well versed in the contours of D&O policy forms. Corporations weigh the costs and benefits of various policy forms in the market place (and their terms, conditions and exclusions), and purchase the policy that best suits their and their directors' and officers' needs. As such, it is untenable for insureds to cry foul when insurers seek to enforce the terms of the policy that they purchased. Holding contacting parties to the terms of their agreement is a fundamental tenant of contract law that applies with equal force in the insurance context.

Moreover, adherence to the plain meaning of the terms of insurance contracts allows the insurance market to function properly. Entities throughout the country, including the commercial, government and insurance industries, conduct their affairs with the expectation that the courts will enforce contracts as written. As the California Supreme Court has observed, judicially created insurance coverage leaves other "insureds to bear the expense of increased premiums necessitated by the erroneous expansion of their insurers' potential liabilities."[14]

In addition to the express exclusions in D&O policies, there are public policy reasons why deliberate fraud and personal profit is uninsurable. Absent exclusions for such conduct, the incentive for improper behavior would be enormous. A CEO of a company could intentionally lie about the company's financial condition in order to profit from the sale of stock options and know that even if he were sued as a result, the insurer would fund his loss. The CFO of the company could embezzle $5 million and sleep comfortably knowing that the insurer will protect him if a derivative suit is filed seeking return of the money. Directors and officers may well have an interest in being defended against suits alleging deliberate fraud when the allegations are untrue, which is why many D&O policies provide that the fraud be established "in fact" or after a "final adjudication." But directors and officers do not have a legitimate interest in being insured for engaging in intentionally unlawful conduct any more than a homeowner should be insured for arson or an automobile driver for deliberately running over an estranged spouse.

Potentially more problematic would be the loss of

incentive to prevent such conduct in the first place. One of the effects of the fraud exclusions in D&O insurance policies is to promote corporate fraud prevention. Because there is no coverage for intentionally fraudulent conduct, corporations have a further incentive to adopt policies and practices to avoid such fraud. As such, D&O policies bolster the deterrent effect of the securities laws and other corporate regulations. If a corporation could pass on the costs of a director's deliberate fraud to the insurance industry, then it would have less incentive to actively police and prevent such conduct.

Burns and Mathias also erroneously argue that where an application for D&O coverage contains material misrepresentations, insurers may seek to rescind the policy and thereby "avoid their duties" under the policies. Again, this argument flies in the face of basic principles of contract law. If a party to a contract makes a material misrepresentation when entering into a contract on which the second party relies, the second party is generally entitled, as a matter of law, to rescind the policy.[15] In the case of D&O policies, "[t]he general financial condition of the corporation in the present as well as the past is very important to an insurance company's decision to issue D&O liability coverage."[16] Since there is an asymmetry of information, D&O insurers generally require representations as to the insured entity's financial condition. Accordingly, an insurer does not "avoid its duties" when this information, on which it relied, proves to be false. Instead, in such circumstances, the insurer is prudently enforcing its rights.

IV. INSURERS AND INSUREDS HAVE A COMMON INTEREST

Mathias and Burns's analysis fails even to acknowledge the common interest shared by insurers and insureds. Both insurers and insureds are damaged by the willingness of the their common foe — the plaintiffs' bar — to bring what in many cases are meritless lawsuits in an effort to extort attorneys fees and unwarranted settlement dollars from companies and their insurers even in the absence of misconduct.

The severity and frequency of claims under professional liability policies, particularly D&O policies, have trended upward in recent years. Although the Private Securities Litigation Reform Act ("PSLRA"), enacted in 1995, sought to reduce the number of securities class action suits, it has failed to do so. Moreover, the recent high-profile corporate restatements and scandals have resulted in enormous market capitalization losses and the growing number of institutional investor plaintiffs has added a new dynamic to attempts to resolve securities lawsuits. At the same time, the settlement amounts in securities cases has skyrocketed in recent years. According to the Cornerstone Research Class Action Study, excluding the unique Cendent Corporation settlement and adjusting for inflation, the average post-PSLRA settlement through 2003 was $18.6 million — nearly two and half times larger than the pre-PSLRA average settlement amount of $7.8 Million.[17] Moreover, according to Cornerstone, there was a 55% increase in average estimated plaintiff-style damages for cases that settled in 2003 ($1.5 billion) versus 2002 ($954 million).[18]

Significantly, these costs do not fall on the shoulders of insurers alone. Insureds are required to satisfy retentions, deductibles or coinsurance and pay for settlements in excess of policy limits. They also face the potential for higher premiums and retentions or deductibles as insurers face greater exposure from securities lawsuits. Moreover, companies and their directors and officers face a high cost from litigation apart from the expense of litigating and defending the litigation. Litigation requires directors and officers to divert substantial time and effort from running their businesses. Companies face negative press and the resulting stock price drop that accompanies litigation, particularly when the litigation results in a large pay out — whether covered or not under a D&O policy.

Insureds should therefore be working with their insurers to defend aggressively securities litigation, not working with claimants to maximize insurance proceeds, as Mathias and Burns advocate. By capitulating, particularly when the underlying case is weak, insureds will only embolden securities plaintiffs to file more lawsuits in the search of more easy paydays.

> ***"Insureds should therefore be working with their insurers to defend aggressively securities litigation, not working with claimants to maximize insurance proceeds, as Mathias and Burns advocate."***

V. CONCLUSION

Mathias and Burns have taken the concept of using house money to a whole new level by advocating that insureds collude with the plaintiffs to, in their words, "soften" the insurers' negotiating position and "to bring maximum leverage to bear upon insurers." Their recommendations are inconsistent with a number of provisions in D&O policies, which Mathias and Burns simply ignore, that require insureds to cooperate with their insurers, not the plaintiffs. These provisions ensure that litigation is effectively defended, thereby avoiding incentives for plaintiffs to

bring unwarranted litigation that is harmful to both insureds and insurers.

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[1] Richard Posner, *An Economic Theory of Criminal Law*, 85 Colum. L. Rev. 1193, 1203 n.20 (1985).

[2] *Waste Mgmt., Inc. v. Int'l Surplus Lines Ins. Co.*, 579 N.E.2d 322, 328 (Ill. 1991).

[3] *See, e.g., Century Indem. Co. v. Aero-Motive Co.*, No. 1:02-108, 2004 U.S. Dist. LEXIS 18969 (W.D. Mich. May 18, 2004) (Michigan law); *Charter Oak Fire Ins. Co. v. Coleman*, 273 F. Supp. 2d 903, 908 (W.D. Ky. 2003) (Kentucky law); *Youell v. Grimes*, 217 F. Supp. 2d 1167, 1173 (D. Kan. 2002) (Kansas law); *Bogatin v. Fed. Ins. Co.*, No. 99-4441, 2000 U.S. Dist. LEXIS 8632 (E.D. Pa. June 21, 2000) (Pennsylvania law); *Cincinnati Ins. Co. v. Irvin*, 19 F. Supp. 2d 906, 910 (S.D. Ind. 1998) (Indiana law); *Employers Reinsurance Corp. v. E. Miller Ins. Agency, Inc.*, 773 N.E.2d 707 (Ill. App. Ct. 2002) (Illinois law); *Paxton Nat'l Ins. Co. v. Brickajlik*, 522 A.2d 531, 532 (Pa. 1987).

[4] *Youell*, 217 F. Supp. 2d at 1173; *see also Waste Mgmt.*, 579 N.E.2d at 327.

[5] *Youell*, 217 F. Supp. 2d at 1170.

[6] *Youell*, 217 F. Supp. 2d at 1174.

[7] *See, e.g., Cent. Bank v. St. Paul Fire & Marine Ins. Co.*, 929 F.2d 431 (8th Cir. 1991) (Missouri law); *Aero-Motive Co.*, No. 1:02-108, 2004 U.S. Dist. LEXIS 18969; *TLC Beatrice Int'l. Holdings, Inc. v. Cigna Ins. Co.*, No. 97-8589, 2000 U.S. Dist. LEXIS 2917 (S.D.N.Y. Mar. 14, 2000) (New York law); *Gribaldo, Jacobs, Jones & Assoc. v. Agrippina Versicherunges A.G.*, 476 P.2d 406 (Cal. 1970).

[8] *See Charter Oak Fire Ins. Co. v. Color Converting Indus. Co.*, 45 F.3d 1170, 1172 (7th Cir. 1995) (business risk not insured under insurance policies).

[9] *Conklin Co., Inc. v. Nat'l Union Fire Ins. Co.*, No. 4-86-860, 1987 U.S. Dist. LEXIS 12337 (D. Minn. Jan. 23, 1987).

[10] *Vol. Hosp. of Am., Inc. v. Nat'l Union Fire Ins. Co.*, 859 F. Supp. 260, 263 (N.D. Tex. 1993).

[11] 14 Couch on Insurance 3d § 198:16 (collecting cases) (emphasis added).

[12] *See* 14 Couch on Insurance 3d § 198:16 (citations omitted).

[13] *Certain Underwriters of Lloyd's v. Gen. Acc. Ins. Co.*, 909 F.2d 228, 233 n.2 (7th Cir. 1990) (recognizing that "[a]lthough courts historically have not been receptive to [breach of duty of good faith and fair dealing] suits [by insurers], recent cases seem to recognize that the covenant of good faith and fair dealing is a two-way street").

[14] *Garvey v. State Farm Fire & Cas. Co.*, 770 P.2d 704, 711 (Cal. 1989).

[15] *Republic Ins. Co. v. Masters, Mates & Pilots Pension Plan*, 77 F.3d 48, 52 (2d Cir. 1996) ("Under New York law, binding in this diversity action, an insurance policy issued in reliance on material misrepresentations is void from its inception.").

[16] *Am. Int'l. Specialty Lines Ins. Co. v. Towers Fin. Co.* No. 99-2727 (WK)(AJP), 1997 U.S. Dist. LEXIS 22610 (S.D.N.Y. Sept. 12, 1997) (quoting *Shapiro v. Am. Home Ass. Co.*, 584 F. Supp. 1245, 1249 (D. Mass. 1984)).

[17] Laura E. Simmons & Ellen M. Ryan, "Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2003" at 2 (Cornerstone Research 2004).

[18] L. Simmons & E. Ryan, "Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2003" at 4.

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