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Client Alert

Insurance Coverage & Recovery Practice Group

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Time to Elevate Insurance Provisions That Allocate Loss: Enhancing Coverage Under Executive Risk Liability Policies

One of the primary functions of an executive risk liability policy, such as a directors and officers ("D&O") liability policy, is to protect companies from the risk of covering costs incurred in the defense of its corporate officers and directors pursuant to indemnification agreements. However, most D&O policies only provide coverage for claims against officers and directors resulting from conduct undertaken in their "capacity" as an officer or director of the company, and do not cover claims resulting from conduct undertaken in their "personal" capacity or in their capacity as an officer or director of an unaffiliated company. In other words, a corporate D&O policy is not a personal umbrella liability policy that officers and directors can tap into whenever they get sued.

In cases where there is a clear delineation between when the officer or director is acting in his or her "corporate" or "insured" capacity versus his or her "personal" or "uninsured" capacity, this is a non-issue because the corporate bylaws will not require the company to pay for the defense of liabilities unrelated to the company—e.g., a personal civil dispute or a dispute arising out of the director's role in an unaffiliated company. But the line between indemnifiable and non-indemnifiable conduct is not always so clear, especially in situations where an individual serves as a director or officer at multiple affiliated companies controlled by the same corporate parent. To complicate matters further, companies increasingly guarantee broad indemnification rights to their officers and directors and provide indemnification "to the fullest extent permitted by law." Thus, companies tend to err on the side of caution, and in favor of indemnification, when this line is blurry.

Some D&O policies will include "allocation" provisions that seek to address what happens if a director or officer incurs both covered and uncovered "loss," whether for defense costs or a settlement / judgment. The importance of such a provision was highlighted in a recent decision from the Northern District of Georgia in *SavaSeniorCare, LLC v. Beazley Ins. Co., Inc.*, 195 F. Supp. 3d 1293 (N.D. Ga. 2016). In that case, the court granted the policyholder's motion for judgment on the pleadings regarding the interpretation of an allocation provision—the key coverage issue in a $20 million insurance claim, underscoring the importance of negotiating defense

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costs allocation provisions in D&O policies that are aligned with corporate bylaws guaranteeing indemnification to directors and officers.

I. *SavaSeniorCare, LLC v. Beazley Ins. Co., Inc.* demonstrates the critical role an allocation provision can play in coverage of defense costs.

SavaSeniorCare, LLC v. Beazley Ins. Co., Inc. arose out of an insurance coverage dispute between SavaSeniorCare, LLC ("Sava") and its insurers under a D&O policy for recovery of defense costs incurred by Sava in defending lawsuits brought against Sava and two of its former officers and directors, Leonard Grunstein and Murray Forman. The plaintiffs in the underlying lawsuit asserted fifteen separate causes of action alleging that Sava and these former officers engaged in misconduct that damaged real estate investor Rubin Schron and other entities under his control ("Schron Plaintiffs"). Specifically, the Schron Plaintiffs alleged Grunstein and Forman were directors of Sava and that they breached duties to Schron in the course of structuring various transactions between Sava and the Schron Plaintiffs. The Schron Plaintiffs also alleged that Grunstein and Forman used their positions as Schron's outside counsel and outside investment advisor, respectively, to influence Schron in business deals in which Grunstein and Forman had a conflict.

In addition to paying its own defense costs, Sava ultimately paid millions of dollars for Grunstein and Forman's defense costs in the underlying action pursuant to their indemnification agreements with Sava. Sava then sought reimbursement of these defense costs from its insurers under the D&O policy. The insurers, however, focused on the allegations in the Schron Plaintiffs' complaint regarding wrongful acts that Grunstein and Forman allegedly committed on behalf of entities other than Sava, and denied coverage for Sava's indemnification of Grunstein and Forman on the basis that the claims in the underlying action "did not allege wrongful acts against Grunstein and Forman in their capacities as 'Insured Persons.'" Under the D&O policy, "Insured Persons" included "any person who has been, now is or shall become a duly elected director or a duly elected or appointed officer or Manager of the Company."

In the ensuing coverage litigation, Sava sought recovery from its insurers—Zurich American Insurance Company ("Zurich") and Beazley Insurance Company, Inc. ("Beazley")—for more than $20 million in defense costs incurred in the underlying litigation. Beazley denied coverage based on its argument that the bulk of the defense costs that Sava paid for Grunstein and Forman had nothing to do with their service as Sava directors and officers, even though Sava's indemnification agreement required Sava to pay for 100% of their defense. Sava filed a motion for judgment on the pleadings seeking a ruling on this coverage defense.

In its motion, Sava asserted that all of the costs incurred in defense of Grunstein and Forman were covered pursuant to the following "Allocation Provision" in the policy:

> If the Insureds incur both Loss covered by this policy and loss not covered by this policy either because a Claim against the Insureds includes both covered and uncovered matters or because a claim is made against both Insureds and others (including the Company in a Claim other than an Employment Practices Claim), then 100% of such Defense Costs will be considered covered Loss and all other such loss shall be allocated by the Insured Persons, the Company and the Underwriter between covered Loss and uncovered loss based upon the relative legal exposure of the parties to covered and uncovered matters.

Sava argued that through this "Allocation Provision" its insurers agreed they "would not seek to allocate any uncovered Defense Costs of the Insureds, and instead pay 100% of such Defense Costs, as long as there is at least one alleged Wrongful Act against the Insureds, even if there are other alleged Wrongful Acts against the Insured, or others, that would not be covered under the Policy." In other words, since at least some of the claims asserted against

Grunstein and Forman in the underlying lawsuit were based on conduct allegedly undertaken as directors of Sava, all of Sava's costs in paying for their defense under their indemnity agreements were covered, even those costs that were incurred in the defense of "uncovered matters." Beazley argued in response that the "plain language of the Allocation Provision does not provide coverage of the defense costs" because Grunstein and Forman are not the "Insureds" referenced in the Allocation Provision, and thus did not incur any loss covered by the policy.

The Court, however, rejected Beazley's argument and found "Grunstein and Forman were sued in their capacity as Insured Persons." In reaching this conclusion, the Court held "of the eleven claims alleged against Grunstein and Forman, three relate to conduct that plausibly could not have been performed by Grunstein and Forman absent their relationship to Sava" and, therefore, the "allegations against Grunstein and Forman relating to their duties as directors and officers are . . . 'covered matters' as referred to in the Allocation Provision." Ultimately, the Court agreed with Sava that the "Allocation Provision requires Beazley to pay 100% of the costs incurred in defending Grunstein and Forman" in the underlying litigation, subject to the limits of its policy.

II. An Ounce of Enhancement is Worth A Pound of Cure.

In the absence of a policy provision addressing the issue of allocating defense costs between insured and uninsured parties, or insured and uninsured claims, courts generally require the parties to allocate defense costs according to one of two rules. Courts applying the relative legal exposure test require that the parties allocate defense costs based on the "relative legal and financial exposures" of the respective parties, following the reasoning of the court in *PepsiCo, Inc. v. Continental Casualty Co.*, 640 F. Supp. 656, 662 (S.D.N.Y. 1986). However, there is little case law explaining the factors that parties and courts should consider when assessing relative exposures between insureds and uninsureds. Other courts have adopted a more policyholder-friendly "larger settlement rule," under which the insurer must pay 100% of all defense costs, unless the uninsured party had a separate, independent basis for liability from the insured party. *See, e.g., Caterpillar Inc. v. Great Am. Ins. Co.*, 62 F.3d 955 (7th Cir. 1995). This rule recognizes that a plaintiff's addition of multiple uninsured parties to a complaint may or may not increase the insured's exposure, and in practice is more likely to result in full reimbursement for directors' and officers' defense costs.

In light of these competing allocation methods, allocation provisions have been modified in some insurers' standard policy forms, so it is important to pay attention to the fine print of the provisions. Some of these provisions simply provide for application of the relative legal exposure test, and require the policyholder to initiate arbitration in the event of a dispute with the insurer about what is fair. Others may specify one allocation methodology for allocation of settlements, and another methodology for allocation of defense costs. Still others, like the provision in Sava's policy, are crafted to avoid side-disputes about which indemnified claims are covered and which are not, so that the company and its officers and directors can stay focused on their defense. Like many provisions in any insurance policy, defense cost allocation provisions in D&O policies are often negotiable, and many insurers will include the type of provision Sava had in its policy for a nominal, or no additional, increase in premium.

As *SavaSeniorCare, LLC v. Beazley Ins. Co., Inc.* demonstrates, these types of enhancements can sometimes be the key to reimbursement of significant defense costs a company will pay to defend its officers and directors pursuant to its bylaws or other contractual indemnification obligations. Accordingly, it is prudent for companies to periodically review the terms and conditions in its D&O insurance program to determine if there may be additional enhancements that could be added. Even a seemingly small addition can result in a significant coverage enhancement.

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