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The New York Insurance Department Will No Longer Approve D&O Policies Lacking "Duty-to-Defend" Coverage Feature


John F. McCarrick, Partner


Nick Pearson, Partner


Maurice Pesso, Associate


Peter de Boisblanc, Associate

Executive Summary

The New York Insurance Department has long prided itself for being an activist state regulator for insurance business underwritten in the world's financial capital. In a surprise development, the Insurance Department has waded into an area thought not to be an area of controversy or dispute: defense arrangements under D&O policies. It remains to be seen whether this first effort by the Insurance Department to more closely regulate D&O insurance contracts is indicative of further regulatory actions to come.

The Department recently refused to approve a D&O policy form that obligates policyholders to arrange and direct their own defense. The legal basis for this refusal was the subject of an opinion letter from the Department's Office of General Counsel issued in October 2008. In light of the Department's previous approval of such policy forms, this can only be seen as a fundamental change of regulatory policy affecting New York licensed D&O insurers who underwrite public company D&O insurance. (Contrary to some commentators' view, however, the Department has not taken a new position on the separate issue of whether D&O policies may contain a "defense costs within policy limits" provision.)

Public company D&O policyholders have long viewed their right to select their own choice of defense counsel and to direct their own defense as a non-negotiable coverage feature. Under the Department's current position, policy forms submitted for approval must state that the defense of D&O claims is to be provided by D&O insurers (although policy forms providing policyholders a limited ability to associate in their own defense may be approved). It remains to be seen whether the Department's new position will face fiercer opposition from D&O insurers that would potentially face expanded defense obligations or from D&O policyholders that would potentially face a materially shrunken role in their own defense of D&O claims.

Frequently Asked Questions:

1. Q. What D&O policy wording changes must D&O insurers seeking New York Insurance Department approval for admitted D&O policy wordings include in filed wordings?
   A. In order to obtain approval of new D&O policy wordings, D&O insurers must draft D&O policies with the following new features:
      a. The new D&O wording must affirm that the insurer owes a "duty-to-defend" claims to which the policy applies.
      b. The new D&O wording may not contain provisions allocating coverage for defense costs between covered and uncovered loss.

2. Q. Are both primary and excess D&O policies affected by this new position?
   A. Although both primary and excess admitted D&O policies subject to future approval by the New York Insurance Department must reflect that the coverage provided is "duty-to-defend" in nature and both will bear the added Loss costs attendant to this new coverage requirement, the additional obligations will affect the primary D&O insurer most immediately.

3. Q. Are D&O policies now subject to approval in New York obligated to treat defense costs as a coverage obligation outside the policy's stated limit of liability?
   A. Presumably, because the Department did not expressly address this issue, defense costs within or inside limits provisions are still permitted, and so this coverage feature is not affected by the Department's recent change in position.

4. Q. Does the Department's change in position affect D&O policies already approved or issued in New York?
   A. Existing policies previously issued to insureds on approved forms should not be affected by the OGC opinion, which does not have the force of law or regulation. Likewise, the issuance of new, non-"duty-to-defend" policies on forms previously approved by the Department should not be affected by the OGC opinion, but it is likely that the Department will seek to adopt, by regulation, a prohibition on the future sale of non-"duty-to-defend" D&O policies in New York.

5. Q. Who has the right to challenge the Department's recent change in position, and how does that need to be accomplished?
   A. First, an affected party (either a policyholder or a D&O insurer) may file an Article 78 proceeding in New York court seeking to compel the Department to approve non-"duty-to-defend" D&O policy forms on the ground that the argument presented in the OGC opinion letter is a flawed interpretation of the law. Alternately, a group of affected parties may initiate lobbying efforts to push through legislation specifically granting insurers the right to underwrite non-"duty-to-defend" D&O policies.
6. Q. What are D&O insurers underwriting New York business obligated to do in the near term?
   A. Licensed D&O insurers seeking approval of previously-unapproved D&O policy forms in New York will need to ensure that those policy forms explicitly recognize that the D&O insurer owes a "duty-to-defend" reported claims.

Background: "Duty-to-Defend" Policies v. Indemnity Policies

The phrase "duty-to-defend" is a term of art in the insurance industry with roots in the common law. In general terms, the "duty-to-defend" refers to an insurer's duty to hire and compensate defense counsel and any other necessary professionals when an insured party is named in a lawsuit (or other proceeding) for which coverage is available. D&O policies underwritten for public companies originally were underwritten as "indemnity" policies that did not impose any kind of contemporaneous defense or defense funding obligation on the D&O insurer, and instead required D&O insurers to include defense costs when tallying up its overall obligation to pay "Loss" after a covered claim had been fully resolved. This arrangement worked reasonably well when D&O insurers were providing reimbursement coverage to policyholder corporations (i.e., reimbursing the corporation for its advancement/indemnification payments to or on behalf of its directors or officers) because solvent corporate policyholders could afford to wait until the end of a D&O claim before seeking reimbursement of its D&O payments from the insurer. However, when the corporate policyholder was insolvent or otherwise unable to provide advancement or indemnification (e.g., in connection with a shareholder derivative lawsuit, where indemnification may be prohibited), the at-risk insureds were the directors and officers themselves – and the concept of waiting until the end of the lawsuit to recover their payments and defense costs was decidedly unattractive.

To address this issue, D&O insurers modified their policy wordings to provide that for purposes of so-called "Side-A" claims (where no corporate advancement or indemnification was available), the D&O insurers would advance defense costs, while still maintaining a strict indemnity obligation for reimbursement of "Side-B" indemnification payments. Over time, D&O insurers dropped the "indemnity-only" requirement for Side-B claims too, and D&O insurance policies generally obligated the D&O insurers to advance covered defense costs for all D&O claims – whether covered by Side-A or by Side-B of the D&O policy.

Significantly, however, D&O insurers continued to treat the D&O coverage as "duty-to-reimburse" (albeit contemporaneously) and did not transform the coverage into "duty-to-defend" coverage. This is a distinction with a difference, in that "duty-to-reimburse" coverage was intended to allow D&O insurers to allocate between covered and non-covered claims for relief, and between covered and non-covered parties – primarily to protect the D&O policy from dilution through payments for uncovered matters and uncovered parties.

The right of D&O insurers to seek an allocation between covered and uncovered claims for relief was first seriously limited in 1985 by the Maryland Supreme Court, which ruled that allocation of defense costs could not be undertaken if the defense of uncovered matters was "reasonably related" to the defense of covered matters. *See Continental Cas. Co. v. Bd. of Educ. of Charles County*, 489 A.2d 536 (Md. 1985).

In more recent cases, courts have continued to make it very difficult for insurers to withhold payment of defense costs prior to a judicial finding of no coverage. *See, e.g., Federal Ins. Co. v. Kozlowski*, 18 A.D.3d 33, 792 N.Y.S.2d 397 (1st Dep't 2005). The court in *Kozlowski* stated:

> This Court has recognized that under a directors and officers liability policy calling for the reimbursement of defense expenses, as in *Gon* and *Okada*, "insurers are required to make contemporaneous interim advances of defense expenses where coverage is disputed, subject to recoupment in the event it is ultimately determined no coverage was afforded." The duty to pay "arises at the time

the insured becomes 'legally obligated to pay.'" The contemporaneous payment of defense costs is required because "[t]he only reasonable interpretation of the loss clause in the . . . [directors and officers] Policy is that the insurer's obligation to pay accrues when the insured incurs the obligation, not after it has paid a judgment." Thus, while Federal must pay defense costs as they are incurred in the securities action and the criminal proceeding, its ultimate liability for such costs is only with respect to such liabilities as fall under the coverage provided. To the extent such liabilities are excluded from coverage by the personal profit exclusion, Federal is not required to pay for defense costs. Since this allocation cannot be made at this juncture and the duty to defend is broader than the duty to indemnify, Federal must pay all defense costs as incurred, subject to recoupment when Kozlowski's liabilities, if any, are determined. 18 A.D.2d at 42 (citations omitted).

The *Federal v. Kozlowski* case identified another leverage issue important to D&O insurers: recoupment. Under non-"duty-to-defend" policies, a D&O insurer can reserve its right to seek recoupment of defense costs paid by the D&O insurer prior to a court finding of no coverage. Depending on the overall amount of defense costs previously advanced by the D&O insurer, the prospect of being required to repay those amounts could well impact a D&O policyholder in deciding whether or not to settle with the D&O insurer and on what terms. Jurisdictions are divided on whether an insurer has a similar right of recoupment under a "duty-to-defend" arrangement.

Although the specific rights and duties of insurers under insurance policies vary according to specific policy language, the following are general conceptual differences between indemnity policies and "duty-to-defend" policies:

1. In indemnity policies, the insured retains and manages defense counsel and controls the litigation (including settlement negotiations); in "duty-to-defend" policies, the insurer has each of these rights and duties. Notably, however, depending on the applicable policy language of both indemnity and "duty-to-defend" policies, the insurer or insured, respectively, may retain some say in the choice of counsel, management of counsel and control of the litigation.
2. "Duty-to-defend" policies generally impose a duty on the insurer to defend a claim entirely if any portion or aspect of the claim is covered; case law interpreting indemnity policies generally upholds the rights of insurers to allocate between covered and uncovered aspects of claims.
3. "Duty-to-defend" policies require insurers to bear – on a first dollar basis – the costs of litigation (deductibles are typically applied at the time of settlement); in indemnity policies, the insured must cover the initial costs of litigation until the self-insured retention is exhausted, and then seek reimbursement from the insurer for amounts incurred in excess of the retention.
4. "Duty-to-defend" policies require the insurer to pay for the defense of a claim until a court (or arbitrator) finds that the insurer owes no coverage obligation. At that point, in certain jurisdictions, the insurer's only right is to discontinue paying defense costs.[1] In a "duty-to-advance" situation, the insurer can reserve the right to later seek recoupment of previously-advanced defense costs if it is later determined that the claim at issue is not covered.

The OGC's Opinion Letter

Opinion letters issued by the Office of General Counsel are not legally binding. In addition, while the Department's opinion letter signals that the Department will decline to approve non-"duty-to-defend" D&O policy forms going forward, this opinion letter in no way alters or modifies the contractual terms of insurance policies that have already been approved and issued to insureds.

On October 16, 2008, the Office of General Counsel of the New York State Insurance Department issued an opinion letter that advised that "a D&O liability policy may not include a provision that places the duty to defend upon the insured, rather than the insurer." This opinion letter was in response to an inquiry from an insurance company whose D&O policy filing was denied.

In the fairly lengthy discussion portion of the opinion letter, the Department references three legal grounds for its decision, New York Insurance Law § 1113, New York Insurance Law § 3420, and Regulation 107. As set forth below, these legal grounds provide relatively weak support for the Department's conclusion. However, even if the Department's opinion letter lacks a strong legal basis, New York licensed insurers seeking approval for new D&O policy forms nevertheless must comply with the Department's position, or risk that their forms will be denied approval.

New York Insurance Law § 1113

The Department first seeks to support its conclusion by referencing Section 1113(a)(13) of the New York Insurance Code, which defines "personal injury liability insurance" (of which D&O liability is a type) as "insurance against legal liability of the insured, and against loss, damage or expense incident to a claim of such liability ...." The Department states that, pursuant to this statutory language, D&O insurance must "include coverage for legal defense costs associated with a covered claim." Of course, this basic statement provides little to no support for the Department's position, because both non-"duty-to-defend" and "duty-to-defend" D&O policies provide coverage for "legal defense costs associated with a covered claim." There does not appear to be any reason to conclude that Section 1113(a)(13) mandates that D&O policies place the "duty-to-defend" on insurers.

New York Insurance Law § 3420

In further support of its decision, the Department asserts that New York Insurance Law § 3420 "evidences a New York public policy" of protecting "a potential liability policy claimant from being denied compensation under the policy due to failings of the insured." In distinguishing between "policy claimant" and "insureds," the Department likely is asserting that this public policy serves to protect insured parties other than the insured entity (i.e., individual directors or officers). In short, the Department appears concerned that, under an indemnity policy, the actions of an insured entity can undermine another insured party's ability to obtain insurance coverage for defense costs.

Regardless of whether the Department accurately states the public policy underlying Section 3420, the Department appears to be ignoring the fact that many policy provisions unrelated to the "duty-to-defend" create the possibility that the actions of the insured entity or a single insured party could undermine coverage for other insured parties (e.g., provisions permitting the insurer to rescind a policy based on misrepresentations made in the policy application). In addition, the fact that the Department can only point to an implied "public policy" underlying Section 3420, rather than an explicit provision of the text of Section 3420, suggests that Section 3420 provides, at best, weak support for the Department's position.

Regulation 107

The Department also references Regulation 107 (11 NYCRR §71, et seq., last amended in 1997), in support of its position that a D&O insurance policy must place the "duty-to-defend" on the insurer. The Department, in quoting Regulation 107, asserts that the "duty-to-defend" consists of "more than simply paying defense costs" and entails "providing a proper defense." Notably, however, Regulation 107 only regulates whether a policy may place defense costs "inside" the limits of liability (i.e., provide that defense costs reduce or exhaust the policy's limits of liability), and does not regulate whether a policy must contain a "duty-to-defend." It is therefore puzzling that the Department relies upon this provision in asserting that D&O insurance policies should contain a "duty-to-defend."

In addition, the Department cites Regulation 107 for the proposition that D&O policies may not "limit the availability of insurance coverage for legal defense costs." The Department appears concerned that indemnity policies "limit the availability for legal defense costs" because they (1) require insureds to take charge of the defense as a condition to coverage, (2) require insureds to absorb the administrative costs of the litigation, and (3) they permit the insurer to allocate between covered and uncovered matters. As explained above, Regulation 107 does not address the issue of whether D&O policy forms must contain a "duty-to-defend." Similarly, Regulation 107 does not regulate whether D&O policy forms may contain allocation provisions. As such, the Department appears to be interpreting Regulation 107 more broadly than is justified.

Defense Costs Within Limits

It is important to remember that the Department's opinion letter is a response to a specific question: whether a "D&O liability policy [may] include a provision that places the duty to defend upon the insured rather than the insurer." We do not believe that the opinion letter addresses the issue of whether a D&O policy may contain a "defense costs within limits" provision. Indeed, "duty-to-defend" provisions are separate and distinct from provisions that place defense costs "inside" or "outside" policy limits, and although certain "duty-to-defend" policies reserve those policies' limits of liability solely for settlements or judgments, many "duty-to-defend" policies place defense costs "inside" limits of liability, and such defense costs do erode and/or exhaust policy limits. Thus, the Department's position that it will not approve new non-"duty-to-defend" D&O policy forms, does not, in itself, indicate that the Department will not approve new "defense costs within limits" D&O policy forms.

Moreover, although the Department's opinion letter references Regulation 107 for the proposition that liability policies may not "limit the availability of legal defense costs," the Department's opinion letter also explicitly acknowledges that Regulation 107 contains certain exceptions, including an exception for D&O policies. Given that the Department has not specifically addressed whether or not "defense costs within limits" provisions are proper, and given that it has not disavowed Regulation 107, insurers should assume that Regulations 107 remains in force and that "defense costs within limits" provisions that comply with Regulation 107 will be approved.

The Insured's Control Over the Litigation

Although the Department clearly states that new D&O insurance policy forms must place the "duty-to-defend" on the insurer, the Department's opinion letter also indicates that it may approve policy forms that grant control over selection of defense counsel and participation in the defense to the insured. The Department's letter states that it "conceivably would approve a policy filing under which the insured has an option to exercise some degree of control over or significant participation in the defense of a claim, provided that the insurer maintains the ultimate duty to defend."

Conclusion

Unfortunately, the Department's position will create new obligations for D&O insurers that decide to write D&O policies placing the "duty-to-defend" on the insurer. Under "duty-to-defend" policies, insurers are liable for additional "administrative costs" in managing litigation (even to the extent that the Department permits control over the litigation to be transferred to the insured). Most importantly, however, whereas D&O insurance policies typically permit an insurer to

allocate between covered and uncovered matters, under the common law applicable to "duty-to-defend" policies, and the Department's clear edict in its opinion letter, insurers will now be responsible for defending 100% of a claim even where only a portion of that claim is covered. It is not yet known how these changes will affect premium pricing for D&O policies going forward.

In addition, insurers that issue "duty-to-defend" D&O policies to public company insureds will face significant legal uncertainties as they, for the first time, will be subject to the body of law governing "duty-to-defend" policies. While D&O underwriters and claims handlers are familiar with the body of case law addressing defense costs issues arising in non-"duty-to-defend" D&O policies, they likely are not as well-versed in "duty-to-defend" case law. Equally importantly, given that there is little "duty-to-defend" case law in the D&O context, courts will be required to apply, by analogy, "duty-to-defend" case law precedent from other contexts (i.e., environmental liability insurance) to potentially non-analogous D&O situations. As such, New York D&O insurers who issue "duty-to-defend" D&O policies to public companies will be charting new territory.

The Department's position on this issue is widely viewed as unfortunate and harmful to insurers and insureds alike. Although D&O insurers, brokers and policyholders are still absorbing and considering the Department's revised position, we foresee a few different possible responses. First, an affected party (either an insured or an insurer) may file an Article 78 proceeding in New York court seeking to compel the Department to approve non-"duty-to-defend" D&O policy forms on the ground that the argument presented in the OGC opinion letter is a flawed interpretation of the law. In this regard, the Department explicitly acknowledges, in its opinion letter, that there is no case law support for its position: "[n]o New York case has addressed the Superintendent's authority under the Insurance Law to require a D&O policy to place the duty to defend upon the insurer." Further, as explained above in this advisory, the Department provides little to no support for its position in the New York Insurance Law or in the Department's Regulations. Second, a group of affected parties may initiate lobbying efforts to push through legislation specifically granting insurers the right to underwrite non-"duty-to-defend" D&O policies. In the meantime, however, it appears that licensed D&O insurers seeking approval of new D&O policy forms in New York will need to ensure that those policy forms place the "duty-to-defend" on the insurer. A murkier question is whether the Department intends to take steps to try to preclude insurers from continuing to write D&O policies on previously approved policy forms that do not place the "duty-to-defend" on the insurer.

1 At least one court in New York has addressed this issue. *See Gotham Ins. Co. v. GLNX, Inc.*, No. 92 Civ. 6415 (TPG) (S.D.N.Y. 1993) (holding that an insurer with a duty to defend may recoup defense costs upon a finding of no coverage).

Boston ma | Ft. Lauderdale fl | Hartford ct | Madison nj | New York ny | Providence ri | Stamford ct
Washington dc | West Palm Beach fl | Wilmington de | London uk | Hong Kong (associated office)

John F. McCarrick, Partner	212.912.2786	jmccarrick@eapdlaw.com
Nick Pearson, Partner	212.912.2798	npearson@eapdlaw.com
Maurice Pesso, Associate	212.912.2838	mpesso@eapdlaw.com
Peter de Boisblanc, Associate	212.912.2904	pdeboisblanc@eapdlaw.com

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Edwards Angell Palmer & Dodge

750 Lexington Avenue
Boston, MA 10022
Tel 212.308.4411
Fax 212.308.4844
eapdlaw.com