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How to Negotiate Allocation of Responsibility Issues Under D&O Policies

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It is a classic "good news/bad news" scenario. The "good news" is that the D&O insurer for the corporate directors you are defending has acknowledged that coverage is in place. The "bad news" is that the insurer is refusing to pay more than a small "allocated" share of the directors' defense and settlement costs.

"Allocation" in the insurance world refers to the percentage of defense and settlement costs that an insurer pays when a lawsuit filed against its insured involves a mix of covered and uncovered claims or parties. Insurers will frequently try to negotiate an allocation agreement at the front end of a claim.

"Caution" should be the insured's watchword. Any agreement reached with the insurer on allocation can have a substantial impact on how much the insurer ultimately pays to resolve that claim, and how much is deemed uninsured (and thus is the responsibility of the client). A typical strategy for the insurer is to negotiate an agreement that assigns to it only a limited percentage of the defense and settlement costs calculated so that its allocated share never, or barely, exceeds the policy's self-insured retention.

For example, assume a D&O insurer negotiates a 50% allocation under a policy with a self-insured retention of $100,000. If the insured incurs defense and settlement costs totaling $250,000, the insurer's allocated share of loss would be only $25,000 (i.e., $250,000 X 50% = $125,000 minus the $100,000 self-insured retention = $25,000). The purpose of this article is to summarize the basic law in California governing allocation under a D&O policy to assist litigators when negotiating allocation agreements with a client's D&O insurer.


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1. "Reasonably Related Test"

The leading precedent in California on the allocation of defense expenses under a D&O policy is *Safeway Stores, Inc. v. National Union Fire Ins. Co.,* 64 F.3d 1282 (1995) (applying California law). In this case, Safeway Stores and its directors and officers were named as defendants in several shareholder lawsuits arising out of a leveraged buy-out. The trial court had allocated 75% of the defense expenses to the insured directors, with the remaining 25% allocable to Safeway, whose corporate liability was not covered by the D&O policy.

The Ninth Circuit Court of Appeals reversed the trial court's allocation, holding that the defense fees should have been allocated 100% to the directors (and thus to the insurer). The court adopted the "reasonably related" test for allocation of defense expenses under a D&O policy, under which "[d]efense costs are . . . covered by a D&O policy if they are reasonably related to the defense of the insured directors and officers, even though they may also have been useful in defense of the uninsured corporation." *Id.* at 1289. While this test is criticized by insurers as offering a "free ride" to uncovered parties, *Safeway Stores* is the leading case in California on the issue of allocation of defense costs under D&O policies, and is a key tool in negotiating allocation agreements with insurers.

Although *Safeway Stores* involved allocation between covered and uncovered parties, there is a strong argument that the "reasonably related test" discussed in that decision should also apply to allocation between covered and uncovered claims. While no California case has yet squarely addressed this issue, it is notable that one of the two cases cited by the Ninth Circuit in *Safeway Stores* as authority for the reasonably related test involved an allocation between claims, not parties. See, *Continental Cas. Co. v. Bd. of Education of Charles County*, 489 A.2d 536, 545 (Md. 1985) (allocation between tort and contract counts). Furthermore, the "reasonably related" test mirrors other apportionment rules that are applied by California courts in analogous contexts such as attorney fee awards. *See, Reynolds Metals Co. v. Alperson*, 25 Cal.3d 124, 129-130 (1979) (attorney fees need not be apportioned when incurred for representation of an issue common to both a cause of action for which fees are proper, and one in which they are not allowed).

2. Defense-Cost Audit

Another effective tool in allocating defense costs is a "defense-cost audit." Even where the "reasonably related" test has been brought to an insurer's attention, the insurer may still try to insist upon some arbitrary allocation on the presumptive ground that certain defense fees and costs must surely relate to uninsured parties and claims. A defense-cost audit involves the listing of all defense invoice entries (fees and costs) on an Excel spreadsheet, with a notation from defense counsel next to each entry indicating whether the fee or expense is "reasonably related" to the defense of the insured defendants against covered claims. Such audits will frequently reveal a far higher insured allocation percentage than the arbitrary allocation proposed by the insurer, and leave the insurer with little room to maneuver in its effort to reduce its coverage obligations.

3. Defense and Prosecution

A final point about defense expenses relates to the situation where the insured defendants have filed a cross-claim. Does the insurer have to pay the fees and costs of prosecuting the cross-claim? The general rule is that a liability insurer is not obligated to prosecute a cross-complaint on behalf of its insured. *James 3 Corp. v. Truck Ins. Exch.*, 91 Cal.App.4th 1093, 1104-1105 (2001). However, to the extent any fees and costs associated with the prosecution are reasonably related to the defense, there is a strong argument they should be borne by the insurer pursuant to the "reasonably related" test enunciated in *Safeway Stores*. *See also*, *State of California v. Pacific Indem. Co.*, 63 Cal.App.4th 1535, 1548 (1998) (CGL insurer that breached its duty to defend was responsible for those fees incurred by the insured on its cross-complaint that the insured proved were "related" to the defense).

4. "Larger Settlement Rule"

In both *Safeway Stores* and another decision that applied Washington law (*Nordstrom, Inc. v. Chubb & Sons, Inc.*, 54 F.3d 1424 (1995)), the Ninth Circuit Court of Appeals addressed how to allocate a settlement under a D&O policy. In each case, the court applied the "Larger Settlement Rule" to a settlement involving both insured directors and uninsured defendants.

Pursuant to the "Larger Settlement Rule," a D&O insurer must pay the entire settlement unless it can demonstrate that: (1) uninsured defendants were potentially liable for a claim for which the insured directors and officers lacked any responsibility; or (2) the settlement was higher by virtue of the uninsured defendants' potential liability.

Application of this rule in *Safeway Stores* meant that no allocation was permissible since neither of the uninsured defendants faced any liability that was independent of the liability faced by the insured directors. Likewise, in *Nordstrom*, the entire settlement was covered since the uninsured defendant did not incur any liability that was not concurrent with that of the insured directors and officers.

As noted above, *Safeway Stores* and *Nordstom* addressed settlement allocation in the context of a claim involving insured and uninsured parties, and not covered and uncovered claims. Where both covered and uncovered claims are alleged against an insured, it is unresolved what allocation rule would be applied by the California courts. There would seem to be no analytical reason, however, why the "Larger Settlement Rule" should not apply to this situation as well. Unless the uncovered claims increase the value of the settlement or allege entirely different damages, no allocation should occur.

5. Allocation Clauses

Some D&O policies now contain a provision that purports to address how loss is allocated when uncovered parties or claims are intermingled in the claim. For example, the policy may require that the insured and insurer use their "best efforts" to determine a fair and proper allocation of defense and settlement costs. However, *Safeway Stores* almost entirely undermined the efficacy of such "best efforts" provisions by holding that they merely require that an allocation analysis be undertaken - not necessarily an actual allocation. *Safeway Stores,* 64 F.3d at 1289.

Other insurance policy provisions mandate allocation based upon a "relative liability exposure" analysis, or may provide for arbitration or other alternative dispute resolution mechanisms to handle allocation disputes while the insurer "advances" what it deems to be an appropriate amount of allocated loss. No California court has yet undertaken to allocate a loss pursuant to such a provision, although a federal trial court recently held that an express allocation provision was enforceable. *Commercial Capital Bankcorp, Inc. v. St. Paul Mercury Ins. Co.*, 419 F.Supp.2d 1173 (C.D. Cal. 2006).

The point is that as with any insurance issue, the policy must be thoroughly reviewed to determine whether it contains any provisions that might impact upon an allocation analysis.

6. Subrogation

An insurer is not necessarily without rights against uninsured parties who benefit from either the "reasonably related" test or the "Larger Settlement Rule." Neither of these tests precludes the insurer from pursuing subrogation or equitable indemnity rights against a party who contributed to the loss and who incidentally benefited from the defense or settlement of a claim. See, *Raychem Corp. v. Federal Ins. Co.*, 853 F.Supp. 1170, 1183 (N.D. Cal. 1994).

Conclusion

D&O insurers frequently try to allocate defense and settlement costs to minimize, or even avoid, liability on a claim. Insureds should reject such efforts on the ground that no allocation is permissible unless the defense or settlement costs are increased by the presence of uncovered claims or parties.▲