

California Insurance Law Coverage Newsletter for Attorneys

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DIRECTORS AND OFFICERS LIABILITY POLICY; INSURER ALLOCATION AND REIMBURSEMENT PROVISIONS ARE CONTRARY TO PUBLIC POLICY IN CALIFORNIA

§ D49:3.1. Insurer provision for cost of defense and settlement

The NIC Insurance Company DIRECTORS AND OFFICERS LIABILITY INSURANCE POLICY recently made available to the public contains the following provisions for cost of defense and settlements.

A. The insureds shall not incur cost of defense, or admit liability, offer to settle, or agree to any settlement in connection with any claim without the express prior written consent of the insurer, which consent shall not be unreasonably withheld. The insureds shall provide the insurer with all information and particulars it may reasonably request in order to reach a decision as to such consent. Any loss resulting from any admission of liability, agreement to settle, or cost of defense incurred prior to the insurer's consent shall not be covered hereunder. See **§ N19 NO-VOLUNTARY-PAYMENT CLAUSE; § C116 COOPERATION CLAUSE; § P76 PRE-TENDER EXPENSES.**

COMMENT [No voluntary payment provision]: This provision, or similar provisions in a D&O policy are provisions prohibiting an insured from making voluntary payments without the insurer's consent. Typically, a breach of this provision occurs, if at all, before the insured has tendered the defense to the insurer. The duty to defend after tender is a continuing one, arising on tender of defense and lasting until the underlying suit is concluded, or until it has been shown that there is no potential for coverage. The 'temporal limits' of the

insurer's duty to defend falls between tender of the defense and conclusion of the action. [*Belz v. Clarendon America Ins. Co.*, 158 Cal. App. 4th 615, 626-627, 69 Cal. Rptr. 3d 864 (2d Dist. 2007)] **§ D85:31, Duration of duty to defend where potential coverage exists, § D4 TEMPORAL.**

Purpose of insurer requiring insurer's prior consent to expenditures

The purpose of provisions requiring an insurer's prior consent to the expenditure of defense costs and permitting the insurer to assume the defense of any claim are common to all liability insurance policies. Their purpose 'is to prevent collusion' as well as to invest the insurer with the complete control and direction of the defense, 'compromise of suits or claims'. [*Belz v. Clarendon America Ins. Co.*, 158 Cal. App. 4th 615, 626-627, 69 Cal. Rptr. 3d 864 (2d Dist. 2007), citing *Gribaldo, Jacobs, Jones & Associates v. Agrippina Versicherungen A.*, 3 Cal. 3d 434, 449, 91 Cal. Rptr. 6, 476 P.2d 406 (1970)]

OBSERVATION: The insurer therefore retains substantial control over the defense notwithstanding the fact that the insured has the right to select defense counsel with the consent of the insurer.

B. The insureds, and not the insurer, have the duty to defend all claims, provided that the insureds shall only retain counsel as is mutually agreed upon with the insurer. See **§ D49**

DIRECTORS AND OFFICERS LIABILITY POLICY (D & O) [§ D49:1.3 Exclusions]

C. The insurer shall at all times have the right, but not the duty, to associate with the insureds in the investigation, defense or settlement of any claim to which coverage under this policy may apply. Compare **§ D85 DUTY TO DEFEND**.

D. If a claim made against any insured includes both covered and noncovered matters, or is made against any insured or others, the insured and the insurer recognize that there must be an allocation between the insured and uninsured losses. The insureds and the insurer shall use their best efforts to agree upon a fair and proper allocation between the insured and uninsured loss. See *Continental Cas. Co. v. Board of Educ. of Charles County*, 302 Md. 516, 489 A.2d 536, 545 (1985) ("So long as an item of service or expense in the underlying litigation is reasonably related to the defense of a covered claim, it may be apportioned wholly to the covered claim."); *Telxon Corp. v. Federal Ins. Co.*, 309 F.3d 386, 389-390 (6th Cir. 2002) (same as *Continental Cas. v. Board of Education; Safeway Stores, Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 64 F.3d 1282, 1289 (9th Cir. 1995) (following *Continental Cas.*, and "reasonably related test"); *Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1424, 1433 (9th Cir. 1995) (Larger settlement rule" applied; allocation only applies if the corporate liability is independent from the directors and officers liability and that such independent liability increased the settlement amount.)).]

E. The insurer shall advance costs of defense prior to the final disposition of any claim, provided such claim is covered by this policy. Any advancement shall be on the condition that:

1. the appropriate retention has been satisfied, provided, however, this condition shall not apply in the event of the financial insolvency of the company [See **§ S18 SELF-INSURED RETENTION (SIR)**];
2. any amounts advanced by the insurer shall serve to reduce the limit of liability stated in item 3 of the declarations to the extent they are not in fact repaid;
3. the company and insured persons and

the insurer have agreed upon the portion of the cost of defense attributable to covered claims against the insureds.

California Supreme Court holdings from 1966 to 1997; allocation and apportionment under duty to defend insuring provisions in liability policies are contrary to public policy; D&O policies are liability policies as defined under Insurance Code § 108(a)

Insurance Code § 108(a)

Insurance Code § 108(a) [liability insurance] includes:

"Insurance against loss resulting from liability for injury, fatal or nonfatal, suffered by any natural person or resulting from liability for damage to property, or property interest of others, ..." (emphasis added)

OBSERVATION: A CGL policy under its insuring provision requires that there be an injury to property. *Waller v. Truck Ins.* (1995) 11 Cal.4th 1 [third party suit alleging only economic injury and not physical injury to tangible property does not give rise to coverage under the insured's CGL policy.] The CGL policy relates to the words "... or resulting from liability for damage to property" as described in Insurance Code § 108(a), above. The typical D&O third party suit does not allege 'property damage' but rather alleges 'economic losses'. Insurance Code § 108(a) provides for the existence of liability policies to insure the insured against claims which are damage to the '... property interest of others'. 'Economic loss' is also referred to as commercial losses or lost business profits. *Aas v. Superior Court* (2000) 24 Cal.4th 627, 642. Therefore a D&O policy is a liability policy. There are no separate provisions in the insurance code for D&O policies under the insurance code as there are for liability policies for auto (Insurance Code § 116). Generally see **§ N2 NATURE AND KIND OF RISK COVERED BY THE POLICY [§ N2:2]**.

The California Supreme Court has not rendered its view with regards to whether the sale of D&O policies containing unbargained for imposition of defense responsibilities being imposed upon the insured implicate public policy concerns similar to those discussed in the series of cases from *Gray v. Zurich* to *Buss v. Superior Court* [spanning the years 1966 to 1997 and to the present] See **§ P120 PUBLIC POLICY [§ P120:5 Duty imposed upon insurer by "court" independent of any statute]**. However, allowing the insurer to dictate "allocation" in a "mixed action" eliminates the insured's chance of vindication with support of resources and expertise of an insurer as well as eliminating the peace of mind and security that comes from knowing an insurer will defend against the claim, two foundational reasons for the existing public policy underlying the Supreme Court's "duty to defend" pronouncements in mixed actions involving liability policies. See **§ P126 PURPOSE AND OBJECT OF INSURANCE [§ P126:3 Duty to defend; liability insurance]; § C145 COVERED AND NONCOVERED CLAIMS AGAINST INSURED—DUTY TO DEFEND [§ C145:3.1 Public policy—Potentially covered claims distinguished from prophylactic duty-to-defend claims]**

COMMENT: It is to the advantage of the insurer in California not to be the provider of the defense under a liability policy. The protection of the rights of the insured to a defense under a liability policy has imposed expanded responsibilities upon insurers, some of which are outside the terms of the policy. The concept of the insurer not providing a defense but merely reimbursing the insured for D & O expenses which long predated *Gray v. Zurich* announced in 1966 has become an attractive product. The most that can be said about this practice of reimbursement is that it is an "old practice", one that is not understood, and often misunderstood. Just as the insurer desires to limit its reimbursement of expenses to covered matters, unilaterally allowing the insurer to apportion covered from noncovered causes, such was *exactly the same*

position of insurers back in 1966 when Gray v. Zurich was decided.

The insurer prevailed in the Court of Appeals in *Gray v. Zurich Ins. Co.*, holding: "The obligation of the insurer to defend an action ... is determined by reference to (1) the terms of the insurance policy, and (2) the language of the complaint brought against the insured. [49 Cal.Rptr. at 273]. No thought was given to "potential liability under the policy". The Supreme Court however in discussing its alternative holding stated: "We point out that the carrier must defend a suit which *potentially* seeks damages within the coverage of the policy; the Jones action was such a suit". (65 Cal.2d 263, 278). (emphasis by the Court). Nothing has changed. D & O is the last remaining throw back to the pre-Gray days. The practices under present day D & O adjustment practices are as they were under liability policies in 'mixed actions' pre-Gray. **Public policy.** A condition to the enforcement of insurance contracts is that they not violate public policy. See **§ P120 PUBLIC POLICY [§ P120:1 In general]**. As to a 'mixed' claim in which at least one of the parts is potentially covered and at least one of the parts is not, the insurer does not have a *contractual* duty to defend the claim in its entirety. NEVERTHELESS, the insurer has a duty to defend the entire 'mixed' action *imposed by law in support of the policy*. "To defend meaningfully, it must defend immediately. To defend immediately, it must defend entirely." [*Aerojet-General Corp. v. Transport Indem. Co.*, 17 Cal. 4th 38, 59, 70 Cal. Rptr. 2d 118, 948 P.2d 909 (1997)]. This duty is a *prophylactic duty*. [*Aerojet-General Corp. v. Transport Indem. Co.*, 17 Cal. 4th 38, 59–60, 70 Cal. Rptr. 2d 118, 948 P.2d 909 (1997)]. See **§ P111 PROPHYLACTIC**. The courts must bring the D & O policy under the umbrella of public policy protection of the public as it relates to the duty to defend for all insureds who likely were without knowledge that their policy would not provide a defense to the 'mixed' tort

action brought against them by the third party suit.

ILLUSTRATION: Attempted allocation of costs by insurer; rejected by the Supreme Court in duty-to-defend cases under CGL policies

In *Aerojet-General Corp. v. Transport Indemnity Co.*, 53 Cal. Rptr. 2d 398 (App. 1st Dist. 1996) [overruled by the Supreme Court in *Aerojet-General Corp. v. Transport Indem. Co.*, 17 Cal. 4th 38, 70 Cal. Rptr. 2d 118, 948 P.2d 909 (1997)] the insured, Aerojet, sought coverage and a defense under 50 policies issued to Aerojet from 1956–1984. At issue was whether \$26.6 million dollars incurred as site investigation costs were actually incurred in defense of the action as opposed to coverage for indemnity. The trial court allocated a portion of the defense costs to Aerojet itself due to the fact that Aerojet purchased policies from 1976–1984 with endorsements stating that Aerojet would pay its own legal defense fees and costs. The trial court ruled that Aerojet “is responsible for a co-equal allocation of the defense costs”. [53 Cal.Rptr.2d 398, 415] Aerojet contended judicial opinions establish that an insured is covered up to the policy limits for the full extent of its liability and need not pay a pro rata share for periods it was uninsured. [*Keene Corp. v. Insurance Co. of North America*, 667 F.2d 1034, 1047–1049 (D.C. Cir. 1981)] The insurers relied on a line of cases holding that the insured must bear a pro rata share of the cost of defense for periods during which the insured carried no insurance. [*Owens-Illinois, Inc. v. United Ins. Co.*, 138 N.J. 437, 650 A.2d 974, 995 (1994)] The trial court pointed to evidence, undisputed, that for an eight year period Aerojet made a deliberate business decision to assume its own cost of defense, including investigation and attorney's fees. [53 Cal.Rptr.2d 398, 416] The Court of Appeal accepted this evidence and upheld the trial court's allocation of defense costs. [53 Cal.Rptr.2d 398, 417] See **§ E20.03 ENTIRETY; § P113 PRO RATA DEFENSE.**

In the insurer's brief to the California Supreme Court [1997 W.L. 33559711], the insurers argued:

(1) Those who deliberately assume the risk of defending against claims during the years at issue, should now carry their

fair share of the burden, the precise ruling in the Court of Appeal (Brief pg. 46).

(2) An insurer such as Transport Indemnity need not defend for a 30 year period where the insurance covered only one year out of 30 years, the precise holding in the Court of Appeal (Brief pg. 48).

(3) Under the “other insurance” provisions, the insurers would be entitled to contribution from Aerojet under the principles of equity (Brief pg. 49–50).

All of these arguments were rejected by the Supreme Court in *Aerojet-General*. See **§ C145, COVERED AND NONCOVERED CLAIMS [§§ C145:3.1 – 145:7]** The Supreme Court held that property damage outside the policy period was covered where there are successive insurers on a risk involving continuous or progressively deteriorating property damage. See **§ S110, SUCCESSIVE LIABILITY POLICIES.**

ILLUSTRATION: [“mixed action” relating to both covered and noncovered claims involving CGL policies]; ‘mounting’ and ‘funding’ of a defense is what is bargained for

In *Buss v. Superior Court*, 16 Cal. 4th 35, 65 Cal. Rptr. 2d 366, 939 P.2d 766 (1997), twenty seven counts in the plaintiff's complaint against the insured were not covered and one count was covered under the CGL policy of the insured. The one covered count was for defamation which the insurer conceded had a *potential for coverage*. In the trial court Buss and Transamerica entered into an agreement that if a court orders Buss and Transamerica to share pro rata the expenses and fees Buss will reimburse Transamerica for said pro rata expenses and fees so ordered. With regards to the ‘duty to defend’ issue and with regards to ‘mixed actions’ containing covered, potentially covered and noncovered claims, the Supreme court stated: “It [insurer] *cannot parse the claims*, dividing those that are at least potentially covered from those that are not. To do so would be time consuming. It might also be futile: The plasticity of modern pleading allows the transformation of claims that are at least potentially claims into claims that are not, and vice versa. The fact remains; as to the claims that are at least

potentially covered, the insurer gives, and the insured gets, just what they bargained for, namely, the *mounting and funding of a defense*. But as to the claims that are not, the insurer may give, and the insured may get, more than they agreed, depending on whether defense of these claims necessitates any additional costs." (emphasis added) At footnote 11, Buss stated: "Compare *Scottsdale Ins. v. Homestead Land Development* (N.D. Cal. 1992) 145 N.R.D. 523, 532 (stating that "Over the past *four decades* California courts have sought to articulate doubt resolution rules that substantially reduce the likelihood that individual insureds will be left defenseless as a result of apparently self-serving decisions by carriers to deny a duty to defend pending resolution of substantive coverage issues)."

As evidence of the fact that insurers still offer "pro rata" or percentages of defense costs even in cases involving CGL policies, in *Haskel, Inc. v. Superior Court*, 33 Cal. App. 4th 963, 970, 39 Cal. Rptr. 2d 520 (2d Dist. 1995), Hartford offered the insured a pro rata defense and undertook to pay 13% of the defense costs. This was based upon the fact that Hartford covered the insured only from June 1974 to June 1977. This offer of 13% was made at a time after *Horace Mann Ins. Co. v. Barbara B.*, 4 Cal. 4th 1076, 1084, 17 Cal. Rptr. 2d 210, 846 P.2d 792 (1993), holding that if an insurer owes any defense it must be fully borne. The Court of Appeal in *Haskel Inc.* treated the 13% offer as the equivalent of a defense denial. [33 Cal.App.4th 963, fn. 9] See **§ P113, PRO RATA DEFENSE**.

ILLUSTRATION: Obligation of insurer to reimburse insured for all amounts incurred for defense expenses 'potentially covered' under the CGL policy

If an insurer owes any defense, it must be 'fully borne'. [*Haskel, Inc. v. Superior Court*, 33 Cal. App. 4th 963, 970, 39 Cal. Rptr. 2d 520 (2d Dist. 1995) (offer of 13% of expenses is not appropriate and is tantamount to denying an entire defense); *Horace Mann Ins. Co. v. Barbara B.*, 4 Cal. 4th 1076, 1084, 17 Cal. Rptr. 2d 210, 846 P.2d 792 (1993) (defense must be fully borne by insurer in a 'mixed action')]

ILLUSTRATION: Policy provision which is contrary to 'public policy' is void

A policy provision in conflict with a statute is void as in violation of statutory public policy. [*Daun v. USAA Cas. Ins. Co.*, 125 Cal. App. 4th 599, 610, 23 Cal. Rptr. 3d 44 (4th Dist. 2005)] See **§ P120 PUBLIC POLICY [§ P120:4 Policies contrary to public policy as expressed in a 'statute']**.

Where the law imposes a *prophylactic duty* [**§ P111 PROPHYLACTIC**] on the insurer to defend a 'mixed action' in its ENTIRETY, this mandate prevails over a policy that contains no such contractual obligation. [*Buss v. Superior Court*, 16 Cal. 4th 35, 61, 65 Cal. Rptr. 2d 366, 939 P.2d 766 (1997); **§ P120 PUBLIC POLICY [§ P120:5 Duty imposed upon insurer by 'court' independent of any statute]**]. The importance of imposing a 'complete and immediate defense' upon an insurer in a 'mixed action' is to relieve the insured of the burden of financing his or her own defense and then having to sue the insurer for reimbursement. [*State v. Pacific Indem. Co.*, 63 Cal. App. 4th 1535, 1556-1557, 75 Cal. Rptr. 2d 69 (2d Dist. 1998)] Where the defense provisions in a contract allow *unilateral apportionment* of reimbursable expenses and fees in a DIRECTORS & OFFICERS, this unilateral power prevents the insured from receiving a complete and immediate defense in violation of *public policy* as set forth in *Buss v. Superior Court*.

ILLUSTRATION: D&O policy with limited defense responsibility equates to a 'litigation policy'

A 'litigation policy' is a policy purchased to provide a defense without regard to indemnification. [*Downey Venture v. LMI Ins. Co.*, 66 Cal. App. 4th 478, 508, 78 Cal. Rptr. 2d 142 (2d Dist. 1998)] A D&O policy contains defense provisions imposing the duty to defend upon the insured with a right to reimbursement for litigation expenses is the same as a litigation policy. See **§ D85 DUTY TO DEFEND [§ D85:37.04 Litigation policy - duty to defend]**. The insurance code does not distinguish a D&O policy from a liability policy. [Insurance Code § 100 (Classes of insurance)] See **§ N2 NATURE AND KIND OF RISK COVERED BY THE POLICY [§ N2:2 Nature and kind of insurance]**. D&O liability insurance is a liability policy insuring against wrongful acts of the insured which causes personal injury, property damage, or property

interests of others. [Insurance Code § 108(a)] The only distinction between a CGL policy and a D&O policy with regards to defense of the insured is who hires the defense lawyer. As seen in **§ D49:3**, supra, insurers provide a complete defense in many D&O liability policies sold to the public.

Insurers are constantly attempting to limit the duty of defense obligations. Currently insurers are marketing liability policies which attempt to limit defense obligations to only those suits where there does not exist 'other insurance'. See **§ D85 DUTY TO DEFEND [§ D85:3(6) Insufficient language (excess umbrella policy)** Recently the modification has appeared in the 'insuring clause', the insurer attempting to insert 'excess defense provisions'. [*USF Ins. Co. v. Clarendon America Ins. Co.*, 452 F. Supp. 2d 972, 999 (C.D. Cal. 2006)] The District Court judge ruled the clause unenforceable as being tantamount to an 'escape clause'. See **§ O39 OTHER INSURANCE [§ O39:2.1 Types of 'other insurance' clauses** What would happen if there was other insurance under this attempted 'excess defense' provision? Who would provide the defense? What if the 'other insurer' contested the 'escape clause' provision and denied any defense obligation to the insured? Insurers cannot delegate their responsibilities under a liability policy to others. [*Merritt v. Reserve Ins. Co.*, 34 Cal. App. 3d 858, 882, 110 Cal. Rptr. 511 (2d Dist. 1973)]

OBSERVATION: Unconscionability. Allowing the insurer to dictate "allocation" in a "mixed" action involving an insured who was without knowledge that the insurer was not obligated to provide a defense appears unconscionable under the provisions of Civil Code § 1670.5. See **§ U6 UNCONSCIONABILITY** Unconscionability has both a 'procedural' and a 'substantive' element. Procedural and substantive unconscionability must both be present in order for a court to exercise its discretion to refuse to enforce a contract or clause under the doctrine of unconscionability. But they need not be present in the same degree. [*Armendariz v. Foundation Health Psychcare Services, Inc.*, 24 Cal. 4th 83, 114, 99 Cal. Rptr. 2d 745, 6 P.3d 669

(2000)]. If a court refuses to enforce the reimbursement provision of the D & O policy, this would leave the policy without a defense provisions. In that case, the court should be requested to 'presume' the policy includes a defense duty. [*Maryland Casualty Co. v. Nationwide Ins. Co.*, 65 Cal. App. 4th 21, 30, 76 Cal. Rptr. 2d 113, 119 (4th Dist. 1998)]. See **§ D85 DUTY TO DEFEND [§ D85:3 Liability policy makes no reference to a defense; policy is "presumed" to include a defense]**

"Procedural unconscionability" concerns the manner in which the contract was negotiated and the circumstances of the parties at the time. It focuses on factors of oppression and surprise. The oppression component arises from the inequality of bargaining power of the parties to the contract and the absence of real negotiation or a meaningful choice on the part of the weaker party. [*Morris v. Redwood Empire Bancorp*, 128 Cal. App. 4th 1305, 1319, 27 Cal. Rptr. 3d 797 (4th Dist. 2005)]. As stated in *Morris* [128 Cal App 4th 1305, 1321]:

"Procedural surprise focuses on whether the challenged term is hidden in a prolix printed form or is otherwise beyond the reasonable expectation of the weaker party."

"Substantive" unconscionability consists of an allegation of risks or costs which is overly harsh or one-sided and is not justified by the circumstances in which the contract was made. [*Samura v. Kaiser Foundation Health Plan, Inc.*, 17 Cal. App. 4th 1284, 1296-1297, 22 Cal. Rptr. 2d 20, 28 (1st Dist. 1993) (discussing reimbursement provision in Health Plan contract)]. In *Samura v. Kaiser*, reimbursement was sought for monies paid after the insured made a third party recovery. In the D & O policy the insurer seeks to unilaterally withhold the insured's request for reimbursement where the third party complaint [over which the insured has no control] alleges a 'mixed' action. The one-sidedness is seen in that the insurer has total control,

total discretion, its decision being based upon the third party complaint. The insured has no control over either the third party who drafted the complaint nor the insurer's decision making allocation.

Thus from the above, 'procedural' and 'substantive' unconscionability are present in the above context. There

exists 'surprise' and 'one-sidedness' which virtually makes the defense provisions 'illusory', eliminating the very purpose and reason for purchasing liability insurance. see **§ P126 PURPOSE AND OBJECT OF INSURANCE; § 12 ILLUSORY.**

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