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Notice, Cooperation, and Consent: Common Insurance Issues Arising in Delaware Deal Litigation

Corporate practitioners are adept at navigating the many challenges of expedited fiduciary and other deal litigation in Delaware's business courts. Their director and officer clients, however, may be more personally invested in securing D&O insurance coverage for that litigation. By considering the common issues arising at the intersection of corporate litigation and D&O insurance, corporate practitioners may improve practical outcomes for their director and officer clients.

by Gregory P. Williams and Margot F. Alicks

Deal litigation in the Delaware Court of Chancery typically involves the actions of fiduciaries, such as directors and officers. These individuals may seek legal advice concerning the three interrelated aspects of the support they enjoy via Delaware's "three-legged stool"[1] of protection, *i.e.*, exculpation, indemnification, and directors' and officers' (D&O) liability insurance. While the implications of particular D&O policies may require the advice of specialized coverage counsel,[2] and corporate litigators may craft their engagement letters to limit (or eliminate) any responsibility for advising on insurance coverage, at some point they may have to consider the issues arising at the intersection of D&O insurance and corporate litigation. We set forth below a general overview of those issues to guide corporate practitioners in navigating their clients' coverage when litigating actions involving D&O policyholders.

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Notice

Once retained to represent an insured in fiduciary or other deal litigation, practitioners might consider whether notice of a potential "claim"[3] under the relevant policies has been (or should be) given to the insurance carrier(s). Typically, D&O policies are "claims made" policies[4] requiring, as a precondition to coverage, that the insured provide notice of any claim for coverage under the policy.[5] The wording of the particular policy's notice clause, which usually incorporates by reference the defined terms "claim" and "wrongful act,"[6] will set the parameters for when and whether notice must be given. While corporate litigators may assume, as do many insureds, that a claim for coverage would only arise upon the initiation of formal litigation challenging a covered "wrongful act,"[7] an underlying claim sufficient to trigger the policy's notice clause may be as informal as a letter.[8]

Several common corporate practices may affect a policyholder's notice obligations. Accordingly, corporate litigators should be aware of the potential effects of these practices if they plan to advise directors and officers on preserving their D&O insurance coverage. For instance, submission of a demand letter seeking documents to investigate possible waste, mismanagement, or breaches of fiduciary duty pursuant to Section 220 of the Delaware General Corporation Law may trigger the notice requirement under specific policy language.[9] Recently, the Second Circuit held that an internal investigation of potential derivative claims by a special committee of the board of directors may similarly constitute a claim for coverage under certain D&O policy language.[10] Finally, expedited litigation seeking to enjoin a transaction may have specific implications for insureds' notice obligations under D&O policies. Because such litigation necessarily commences and concludes within a highly compressed timeframe, policyholders should promptly notify their D&O carriers of the expedited action. The notice should include a general description of the nature of expedited proceedings and a specific request that, because settlement discussions may take place in short order, the carriers provide an interim contact for cooperation with the insureds.

Cooperation

Once notice has been submitted, the next insurance consideration common in corporate litigation is the need for clients to "cooperate" with their D&O carriers. Unlike other types of liability coverage, D&O policies generally do not include a "duty to defend," which would require that the insurer itself undertake the defense of the underlying action.[11] Instead, D&O carriers undertake to reimburse or advance defense costs to the insured, who pay the initial costs and make the everyday defense decisions.[12] Because the insurer is not directly involved in the defense of the underlying action, such as selecting counsel,[13] the insurer may attempt to protect its interests through inclusion of a "cooperation clause." A generic cooperation clause might include the insurer's right to "effectively associate" with the insured in the defense and prosecution of any claim that is or may reasonably be subject to coverage.[14] This clause, along with certain related provisions (such as the "consent to settlement" clause, discussed below), is intended to "prevent collusion while making it possible for the insurer to make a proper investigation"[15] of the underlying claims.

While a cooperation clause typically will require the policyholder to provide the insurer with some level of information, the precise scope of the contractual duty to cooperate may vary substantially depending on the wording of the policy[16] and the demands of the insurer once a claim for coverage is submitted.[17] For instance, a cooperation clause may be so broad as to require that the policyholder provide to the insurer *all* information it requests, even privileged documents, which may be cause for concern in the underlying action. Corporate litigators who have undertaken to assist their clients in cooperating with insurers should be aware that certain courts have ruled that the attorney-client privilege and the work product doctrine[18] do not extend to information shared with an insurer because the defendants in the underlying action and their insurers are potential adversaries in future coverage litigation.[19] An argument may be made that privilege extends to an insured's (and its counsel's) communications with its insurer through the common interest doctrine.[20] However, there remains a potential discord between the insured's interests in the litigation[21] (*e.g.*, the ability to withhold an attorney's candid analysis of the risks in the underlying action) and in meeting preconditions to coverage (*e.g.*, cooperating with insurers by providing them with that information). By discussing these concerns with the insurer early in the representation, a litigator may be able to establish a mutually acceptable cooperation protocol that preserves privilege in the underlying action. Even if they are unable to establish such a protocol, however, corporate litigators should

consider these competing interests when formulating advice to their insured clients on how to satisfy their cooperation duties.[22]

Consent

When advising a client to settle an action, corporate litigators balance many factors, such as consideration for the settlement (*e.g.*, therapeutic or monetary benefits and the scope of releases), the potential for multi-jurisdictional requests for attorneys' fees,[23] reputational implications for their clients, and the need to reach an understanding with the opposing party concerning those and other issues. In light of how delicate and difficult this "Kabuki dance"[24] can be, insurance issues may get lost in the shuffle. Most often, corporate litigators are not delegated the task of addressing their clients' coverage. Even so, they should be aware that whomsoever is delegated that responsibility should attempt to avoid, depending on the facts and circumstances of the particular case, seeking the insurance companies' input only after all parties are finally able to reach a reasonable agreement. Unfortunately, such delay could threaten the policyholder's coverage.

D&O policies generally include a "consent clause" requiring that the insured obtain the express consent of the carriers not only to a stipulated final judgment, but also to entry into an informal memorandum of understanding subject to final court approval or any admission or assumption of liability. Even if it is not required by the particular policy language, practitioners may consider inviting insurers to participate in some manner in formal or informal settlement discussions before a final proposal is prepared.[25] Inclusion of the insurers in this process may protect against threats to coverage based on the cooperation or consent clauses, and may carry the potential added benefit of exposing the insurers to the true weaknesses in the case and the resulting risks of proceeding to trial. In addition, when insurers participate in the settlement process, they see firsthand the absence of collusion between plaintiffs and policyholders attempting to access the policy limits in settling the underlying action.[26]

An insured's failure to meet its obligations under the consent clause may risk coverage.

An insured's failure to meet its obligations under the consent clause may risk coverage. For example, in *Vigilant Insurance Co. v. Bear Stearns Cos.*,[27] Bear Stearns' insurer was released from any obligation to provide coverage where Bear Stearns failed to seek the insurer's consent prior to executing an $80 million "settlement-in-principle" subject to final court approval with the SEC, NASD, and NYSE. Because courts have shown a willingness to uphold an insurer's denial of coverage for an insured's failure to obtain consent prior to settlement,[28] corporate litigators should be cognizant of this issue prior to the commencement of settlement discussions in order to coordinate with whomsoever is responsible for the insurance aspect of the representation. An insured client's consent obligations may affect timing and other decisions regarding whether or not to commence a formal settlement process or informal settlement discussions. Finally, if practicable under the circumstances, consent should be obtained prior to entering into a memorandum of understanding, even though—like the "settlement in principle" in *Bear Stearns*—it is subject to Court of Chancery approval and is not, in that sense, "final."[29]

Regrettably, simply because consent is sought does not mean it will be given. Most consent clauses simply require that the insurer not "unreasonably" withhold its consent.[30] This language protects the insurer's bargained-for right to determine whether or not to grant its consent to a settlement, and, so long as it has reasonable grounds for withholding that consent, the insured directors and officers will likely have to accept its

position.[31] However, when a hard-won potential settlement is compromised by an insurer's unreasonable denial of coverage, policyholders are not without recourse. If coverage is clear and insurers still refuse to contribute to a reasonable settlement,[32] the insured may bring a bad faith action[33] against the insurers.[34]

Potential bad faith litigation may bring carriers to the negotiation table.

While the parameters of such bad faith litigation are outside the scope of this article,[35] the specter of potential bad faith litigation may bring carriers to the negotiation table. However, it understandably may not inspire a willingness to contribute the full policy limits. Often insurers will offer a compromise on the policy, contributing something less than the policy limits to the underlying settlement. This may be an advantageous outcome, depending on the circumstances of the particular case. However, if a policyholder accepts such a contribution below the primary policy limits, practitioners undertaking to advise their clients on these issues should be aware that such a decision may affect the availability of excess policy coverage. Indeed, as discussed below, excess carriers may refuse to contribute to any settlement until and unless the primary insurer has contributed its full policy limits.

Because certain excess policies, by their terms, are not triggered until and unless the primary limits are exhausted, a policyholder that agrees to accept less than the full primary limits in reaching a settlement may be choosing by implication to forego its excess limits. This may be the case even if the policyholder is willing to pay the difference between the primary's contribution and the policy limits. Some courts have sided with the excess carriers on this issue, upholding excess carriers' denial of coverage if the primary policy is not paid out in full.[36] The policyholder may best be served, therefore, by dealing with questions of how a settlement with the primary carrier might affect the availability of excess coverage when purchasing the policy, through negotiation of a "drop down" clause requiring excess carriers to contribute to a settlement even if the insured accepts amounts from the primary carrier below the primary limits.[37] If the policy lacks such a clause, there may be nothing for corporate litigators joining the fray after the fact to do, other than deal with the policy as it stands and advise the client accordingly.

Conclusion

The statutory and fiduciary issues that bring directors, officers, and corporate litigators together often overshadow the D&O policy provisions that are triggered through that litigation. Those provisions, however, may have a significant impact on the practical outcome for the policyholder directors and officers. By familiarizing themselves with the common issues discussed in this article, corporate practitioners can appreciate the effects of their litigation-driven decisions on the availability of their clients' coverage. In doing so, even those corporate litigators who follow the common practice of carving out insurance advice from the scope of representation may improve the services they offer, by facilitating coordination with counsel responsible for preserving their policyholder-clients' coverage. Through such coordination, corporate litigators may achieve superior practical outcomes for the directors and officers they represent both in and out of the courtroom.

Notes

1. *See* Norman Veasey, Jesse A. Finkelstein & C. Stephen Bigler, *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance, 42* Bus. Law 399 (1987).

2. For example, if coverage litigation ensues, counsel to the directors and officers in the underlying action may become necessary witnesses in the coverage action between those directors and officers and their insurers. *See*, *e.g.*, *Weitz Co. v. Ohio Cas. Ins. Co.*, 2011 WL 2535040, at *6 (D.

Colo. June 27, 2011) (holding that participation of counsel in the coverage action "precludes its later participation as witnesses. Thus, although [counsel may] not [be] necessary witnesses, if there is any possibility that [they] will [be] call[ed] to testify, they must step aside now as trial counsel [in the coverage action].").

3. Unlike a litigation claim, count or allegation, a "claim" pursuant to an insurance contract is a defined term generally referencing the requirements for a demand for coverage. For example, one definition provides: "'Claim' means any judicial or administrative proceeding, including any appeal therefrom, against a Director or Officer in which such Director or Officer may be subjected to a binding adjudication of liability for damages or other relief." *See* Bryna Rosen Misiura & Jeniffer A.P. Carson, "Directors' & Officers' Liability Insurance—The Fundamentals," *presented at* Sterling Education Services, LLC's Fundamentals of Liability Insurance Law in Massachusetts (Mass. Oct. 29, 2003). For the avoidance of confusion, we refer to this type of demand for coverage as a "claim for coverage" and to the formal or informal communication triggering that coverage as the "underlying claim."

4. *See Viking Pump, Inc. v. Century Indem. Co.*, 2 A.3d 76, 93 n.47 (Del. Ch. 2009) ("Unlike the occurrence-based insurance . . . , claims-made insurance protects the insured against claims made during the policy period as opposed to liabilities arising out of the policy period.").

5. Policies vary in the requirements of the "notice provision," some of which require "reasonable" notice while others specify the number of days within which notice must be given. *See generally* Misiura & Carson, "Directors' & Officers' Liability Insurance—The Fundamentals."

6. This term indicates which acts are covered under the insurance contract. A typical "wrongful act" definition might read: "any breach of duty, neglect, error, misstatement, misleading statement, omission or other act done or wrongfully attempted by the Assureds or any of the foregoing so alleged by any claimant or any matter claimed against them solely by reason of their being such Directors or Officers of the Company." Joseph Hinsey, *The New Lloyd's Policy Form for Directors and Officers Liability Insurance—An Analysis*, 33 Bus. Law 1961, 1966-67 (1977-1978).

7. If notice should have been, but was not, sent prior to initiation of litigation (for instance, where informal notice had been tendered to the insureds prior to the filing of a formal action), the insured client should determine whether the law governing the policy requires the insurer to establish prejudice arising from late notice. *See*, *e.g.*, *Friedland v. Travelers Indemn. Co.*, 105 P.3d 639, 643 (Colo. 2005) ("an ever-growing majority of jurisdictions . . . adopted the notice-prejudice rule, whereby late notice does not result in loss of coverage benefits unless the insurer proves prejudice to its interests by a preponderance of the evidence"); *cf. Argo Corp. v. Greater New York Mut. Ins. Co.*, 827 N.E.2d 762, 764 (N.Y. 2005) ("For years the rule in New York has been that where a contract of primary insurance requires notice 'as soon as practicable' . . . the absence of timely notice . . . is a failure to comply with a condition precedent which, as a matter of law, vitiates the contract.").

8. *See Admiral Ins. Co. v. SONICblue Inc.*, 2009 WL 1308905, at *2-3 (N.D. Cal. May 11, 2009) (analyzing whether various letters from noteholders and from the State of Wisconsin Investment Board constituted "claims" requiring notice to the insurer to preserve coverage).

9. For example, the policy at issue in *SONICblue Inc.* defined "claim" as "a written demand for monetary or non-monetary relief." 2009 WL 1308905, at *2. The court held that a demand pursuant to 8 *Del. C.* § 220 for information in order to "investigate possible waste, mismanagement, or breaches of fiduciary duties" was categorized as a "claim" under the policy requiring notice to the insurer because it described a breach of fiduciary duty and demanded that the insured "take action to cure the breach." *Id.* at *3.

10. The question of whether coverage extends to costs incurred in conducting such an investigation was recently addressed by the Second Circuit in *MBIA Inc. v. Federal Ins. Co.*, 652 F.3d 152 (2d Cir. 2011). There, a Connecticut corporation received such a derivative demand, but failed to take action before subsequent stockholder derivative litigation was filed. The corporation then formed a special litigation committee, which conducted an investigation into the claims at issue and thereafter intervened to seek dismissal of the derivative action. *MBIA*, 652 F.3d at 158. Despite the insurer's claim that the special litigation committee was not itself an "insured" and that its expenses could not be "defense costs" because of the inherent conflict of interest issues that would arise from that characterization, the court held that committee could have "independence of judgment" in the sense of "a lack of conflicts of interest" without "operat[ing] independently" of the insured company, as the insurer suggested. *Id.* at 164. The court held that the investigative costs were, therefore, "defense costs" covered by the total limits of the policy, rather than "investigative costs" restrained by the policy's specific sublimits for internal corporate investigations. *Id.* at 165-67.

11. For further information on the duty to defend, *see generally* William T. Barker & Ronald D. Kent, *New Appleman Insurance Bad Faith Litigation* (2d Ed. 2011) ("New Appleman").

12. *See*, *e.g.*, James D. Wing, *Ds&Os: Are They Really Covered?*, The John Liner Review, Vol. 24, No. 1 (Spring 2010).

13. Many insurers will, however, expect the opportunity to approve counsel, and some may provide the insured with a selection of pre-approved "panel counsel," and/or require submission of itemized bills specifically describing the services provided by the insured's counsel. This has implications for corporate litigators, who should review the

policies carefully and confirm early on whether the various insurers approve of his or her firm's representation of the insured in the matter and what, if any, other requirements the insurer may impose on the conduct of the representation. *See, e.g.*, *Abercrombie & Fitch v. Federal Ins. Co.*, Docket No. SOM L-1571-07 (N.J. Super. Ct. Law Div. Nov. 13, 2009) (insurer failed to pay certain of the policyholder's attorneys' fees because of the alleged failure of counsel to comply with insurer's litigation management guidelines).

14. This "right to associate" may provide, for example, that "[t]he insurer shall at all times have the right, but not the duty, to associate with the Directors or Officers in the investigation, defense or settlement of any Claim, to which this Policy may apply." *Caterpillar Inc. v. Great American Ins. Co.*, 864 F. Supp. 849, 859 (C.D. Ill. 1994), *aff'd as modified*, 62 F.3d 955 (7th Cir. 1995). Because the parameters of this right vary depending on governing law, the wording of the provision and the course of the parties' performance, it is beyond the scope of this article to attempt to define those parameters.

15. *See* Lee R. Russ & Thomas F. Segalla, 14 *Couch on Insurance* § 199:4 (3d ed.).

16. Because D&O policies are typically highly negotiated, the insureds may clarify the scope of their duty to cooperate *ex ante* by negotiating for specific requirements and limitations. *See, e.g.*, *First Fidelity Bancorp. v. Nat'l Union Fire Ins. Co.*, 1994 WL 111363, at *3 (E.D. Pa. Mar. 30, 1994) (noting that the primary policy had a cooperation clause requiring that the insured keep the primary carrier "informed of any developments in the underlying litigation," including "'full information and all particulars it may request,'" while the excess policy "specifically limited the documents that [the insured] would be required to produce to 'relevant non-privileged documents'").

17. *Id.*

18. In the case of an insurer paying the cost of an insured's defense (as is typically the case under D&O policies), coverage may be threatened if the insured's attorney refuses to share the bills—including entries reflecting attorney work product—despite the fact that the insurer has been held to be adverse to the insured with respect to these bills, thereby destroying that legal protection. *See* Richard C. Giller, *D&O Insurance: The Cooperation Clause and Privileged Communications*, Westlaw Journal on Corporate Officers & Directors Liability, Vol. 27, Issue 9 (Oct. 24, 2011).

19. *See generally id.*

20. *See, e.g., Lectrolarm Custom Systems, Inc. v. Pelco Sales, Inc*., 212 F.R.D. 567 (E.D. Cal. 2002); *Northwood Nursing & Convalescent Home, Inc. v. Cont'l Ins. Co*., 161 F.R.D. 293 (E.D. Pa. 1995); *In re* LTV Sec. Litig., 89 F.R.D. 595 (N.D. Tex. 1981).

21. Another relevant example might be an insured's choice with respect to waiving attorney-client privilege in order to assert a "reliance on the advice of counsel" defense.

22. As a practical matter, plaintiffs in the underlying action may choose not to press this issue since doing so would make any insurer-backed settlement challenging.

23. For a discussion of the issues arising from such split fee requests, *see generally In re Clarient, Inc. S'holders Litig.*, C.A. No. 5932-CS (Del. Ch. Aug. 2, 2011) (TRANSCRIPT); *see also In re Burlington Northern Santa Fe S'holder Litig.*, C.A. No. 5043-VCL (Del. Ch. Oct. 28, 2010) (TRANSCRIPT).

24. *In re Revlon, Inc. S'holders Litig.*, 990 A.2d 940, 945 (Del. Ch. 2010) (referencing a recurring pattern of settlement termed by now-Chancellor Strine in *Cox Communications* as the "Kabuki dance").

25. *See Hilco Capital, LP v. Federal Ins. Co.*, 978 A.2d 174, 178 (Del. 2009) (holding that because excess insurer was not invited to participate in the mediation and had a reasonable basis to withhold its consent to the settlement, it could deny coverage).

26. *See, e.g.*, *Nat'l Union Fire Ins. Co. v. Seafirst Corp.*, 1987 U.S. Dist. LEXIS 14284, at *3-8 (W.D. Wash. Mar. 26, 1987) (discussing the debate over the validity of a "covenant not to execute coupled with an assignment and settlement agreement").

27. 884 N.E.2d 1044, 1048 (N.Y. 2008).

28. *See also Federal Ins. Co. v. Arthur Andersen* LLP, 522 F.3d 740 (7th Cir. 2008).

29. Some policies may permit the insured unilaterally to settle within preset levels. Negotiating for higher levels *ex ante* may be a useful strategy in retaining the freedom to settle a later action.

30. Most consent clauses prohibit the insurer from unreasonably withholding its consent. *See, e.g.*, *Hilco Capital*, 978 A.2d at 180 (describing typical policy providing that the insurer's "consent shall not be unreasonably withheld").

31. *Id.* at 181 (considering "all the facts and circumstances in deciding whether [the insurer] had a reasonable basis to withhold its consent").

32. *Twin City Fire Ins. Co. v. Country Mut. Ins. Co.*, 23 F.3d 1175, 1179 (7th Cir. 1994) ("A standard provision in liability-insurance contracts gives the insurer control over the defense of any claim against the insured, and an implied correlative of this right is the duty not to gamble with the insured's money by forgoing reasonable opportunities to settle a claim on terms that will protect the insured against an excess judgment [beyond policy limits].") (footnote omitted).

33. *See*, *e.g.*, *Hilco Capital*, 978 A.2d at 178 ("The law … in Delaware, is that all contracts include an implied covenant of good faith and fair dealing. . . . [W]hen a contract gives one party discretion, 'it must not be exercised to deprive the other party of the benefit of the contractual relationship or evade the spirit of the bargain.' Thus, despite the fact that the Participation Clause in the Federal policy gave [the insurer] 'sole discretion' whether to participate in the settlement of any claim, [it] still had to exercise that discretion consistent with its covenant of good faith and fair dealing.").

34. *Federal Ins. Co. v. Infoglide Corp.*, 2006 WL 2050694, at *15 (W.D. Tex. July 18, 2006) ("An insurer only breaches its duty of good faith and fair dealing by denying a claim when the insurer's liability has become reasonably clear.") (citing *Arnold v. Nat'l County Mut. Fire. Ins. Co.*, 725 S.W.2d 165, 167 (Tex. 1987)). The standards and procedures applicable to such an action may vary from state to state. *See, e.g.*, *Safeco Ins. Co. v. Butler*, 823 P.2d 499, 505-06 (Wash. 1992) ("[T]he insurer has an 'enhanced obligation of fairness toward its insured.' That enhanced obligation imposes a duty beyond that of the standard contractual duty of good faith…. [A] violation results in a cause of action which arises from the contract and the fiduciary relationship, and which sounds in tort…. If the only remedy available were the limits of the contract, then there would be no distinction between an action for an insurer's wrongful but good faith conduct, and an action for its bad faith conduct. An insurer could act in bad faith without risking any additional loss. . . . An estoppel remedy, however, gives the insurer a strong disincentive to act in bad faith."); *cf. Tackett v. State Farm Fire & Cas. Ins. Co.*, 653 A.2d 254, 264 (Del. 1995) ("Where an insurer fails to investigate or process a claim or delays payment in bad faith, it is in breach of the implied obligations of good faith and fair dealing underlying all contractual obligations.").

35. For more details on what such suits might involve, *see generally* New Appleman.

36. *See, e.g.*, *Schmitz v. Great Am. Assur. Co.*, 2010 WL 2160748 (Mo. Ct. App. June 1, 2010) (holding that where a primary policy was not exhausted because the carrier settled with the insured below its policy limits, the excess carrier owed no coverage); *cf. Seafirst Corp.*, 1987 U.S. Dist. LEXIS 14284 (rejecting this argument because of needlessly extended litigation when excess carrier refused to settle).

37. Many companies choose to purchase Side A-Only difference-in-conditions ("DIC") coverage in order to avoid this issue. DIC policies are intended to "pay directors and officers amounts that the corporation and the underlying ABC insurer cannot be compelled to pay them due to legal limitations in their ability to advance or indemnify or due to policy terms limiting coverage." *See*, *e.g.*, James D. Wing & William E. Dixon, *Designing Liability Protection for Directors and Officers*, The John Liner Review, Vol. 25, No. 1, at 34 (Spring 2011). Insureds may rely upon DIC coverage when underlying primary and excess coverage is unavailable due to, for example, applicable exclusions.