

For More Information:

Richard Allen
202.772.2291
allenr@gotofirm.com

Ellen Katkin
202.772.1960
katkine@gotofirm.com

February 2009, No. 3

NEW YORK INSURANCE DEPARTMENT REQUIRES INSURERS TO INCLUDE A DUTY TO DEFEND IN DIRECTORS AND OFFICERS (“D&O”) POLICIES

By Jerold Oshinsky and Richard Allen

In a precedent-shattering decision, the New York State Insurance Department’s Office of General Counsel ruled that newly issued Directors & Officers (“D&O”) policies may not place the duty to defend upon the insured rather than the insurer. OGC Op. No. 08-10-07, October 16, 2008, available at <http://www.ins.state.ny.us/ogco2008/rg081007.htm>.

A typical feature of D&O policies provides that “it shall be the duty of the insureds and not the duty of the insurer to defend claims.” Instead of providing for a duty to defend, D&O policies have instead required insurers to pay defense costs, which are advanced to insureds before an ultimate determination of coverage for claims made against directors and officers.

D&O insurers have argued that the mere duty to pay defense costs is not subject to the same “potential for coverage” standard as the duty to defend, but that the duty to pay defense costs requires a covered claim rather than a claim that is merely potentially covered. D&O insurers also have argued in the past that they did not have a duty to investigate claims, choose defense attorneys, negotiate settlements, and otherwise administer to the defense of claims made against directors and officers.

With this new opinion, D&O insurers no longer will be able to avoid providing a full defense, including the payment of defense costs for potentially covered claims against directors and officers, as well as undertaking all of the other duties associated with the duty to defend.

The OGC opinion explains that because liability insurers have the duty to defend insureds and the payment of defense costs is an aspect of providing a defense, the Department requires D&O

Richard Allen is an associate based in the Washington, DC office of Gilbert LLP. He can be reached at 202-772-2291 or allenr@gotofirm.com.

Based in Washington, DC, with an office in Austin, Gilbert LLP is a law firm representing a wide range of clients, including corporations, partnerships, non-profit organizations and individuals in complex disputes, including high-stakes litigation, bankruptcy matters, class actions and ADRs. Best known for representing policyholder interests in insurance coverage matters, Gilbert LLP also has an active public interest practice that specializes in complex multi-plaintiff actions involving cutting-edge issues.

policies to cover the payment of defense costs. The opinion notes that “[a] D&O policy is a type of personal injury liability insurance,” then addresses New York Insurance Law § 1113(a)(13), which defines personal injury liability insurance as “insurance, against legal liability of the insured, and against loss, damage or expense incident to a claim of such liability.” The opinion explains that “[i]t has long been the Department’s view that the phrase ‘loss, damage or expense incident to a claim of such liability’ . . . includes the cost of defending against a claim covered by the policy. . . . By the plain terms of Insurance Law § 1113(a)(13), the conjunctive ‘and’ links personal injury liability insurance to incidental losses, damages, or expenses. For this reason, the Department requires personal injury liability insurance coverage, including D&O insurance, to include coverage for legal defense costs associated with a covered claim.”

The opinion specifically cites N.Y. Comp. Codes R. & Regs. tit. 11, Part 71 (Regulation 107) as support for the proposition that the duty to defend “entails more than simply paying defense costs.” As the opinion explains, “the regulation contemplates that the insurer ‘provide a proper defense.’ . . . A policy that places the duty to defend upon an insured would run afoul of Regulation 107 because it would limit the availability of coverage for legal defense costs. By placing the duty upon the insured, the policy would condition defense cost coverage upon the insured taking charge of the defense.”

In an additional aspect of the opinion, the OGC addresses the typical D&O provision that provides for an allocation of defense costs between covered and uncovered claims. Since the duty to defend requires an insurer to defend an entire case, the OGC also states that it would not approve a defense allocation provision. Thus, if part of a case against directors and officers potentially is covered by a D&O policy, the insurer must defend the entire case and pay all of the attorneys’ fees and costs.

In a general liability insurance policy, the costs of defense are usually paid in addition to policy limits. In contrast, a D&O policy usually includes defense costs within the policy’s limits of liability. A policy with such an approach to defense costs is sometimes referred to as a “wasting assets” policy. This ruling does not change the standard reduction of D&O policy limits by the payment of defense costs. The OGC opinion, however, places upon insurers the overhead cost of managing, controlling, and otherwise overseeing the litigation against directors and officers. These administrative costs do not erode the limits of liability of a D&O policy, although attorney’s fees and costs do erode those limits.

The OGC opinion specifies that the insurer’s responsibility to provide a defense does not preclude the insured from participating in its own defense. The OGC states that it would approve a policy in which the insurer and the insured agree to allow the insured to participate in its own defense, as long as the duty to defend ultimately remains with the insurer.

Questions remain as to the opinion’s enforceability, as well as its impact on the interpretation of existing policies. However, while the OGC’s opinion is not binding on courts, New York courts have held that such

opinions are entitled to great deference. *Northern Metropolitan Residential Healthcare Facility v. Novello*, 777 N.Y.S.2d 277, 281 (N.Y. Sup. 2004) (“[An agency’s] interpretation of its own regulations is entitled to great deference unless it is unreasonable or irrational”); *see also Mutual Redevelopment Houses, Inc. v. New York City Water Bd.*, 720 N.Y.S.2d 7, 8 (N.Y. App. Div. 2001) (“[t]he interpretation of regulations made by the agency responsible for their administration is generally to be accorded deference”). The opinion is additionally valuable as a clear statement of state public policy regarding the duty to defend.

In any event, the opinion promises exciting challenges for insurers and insureds whose D&O policies are subject to New York law.