The Metropolitan
Corporate Counsel®

www.metrocorpcounsel.com

Volume 18, No. 8 August 2010

When Is A Claim Not A Claim? New York Courts Reject Insurers' Restrictive Interpretation Of "Claim" Seeking To Limit The Defense Obligation Of Director & Officer Liability Policies

Thomas S. Novak

SILLS CUMMIS & GROSS P.C.

Director and Officer ("D&O") liability insurance policies usually define "claim" such that all counts of a lawsuit constitute a single claim. D&O policies also contain various exclusions for certain types of claims such as contractual liability, unfair competition, antitrust, professional liability and others. Based on the definition of "claim" in such policies, D&O insurers have historically taken a strict, literal interpretation of their policies and argued that because all the counts of a lawsuit comprise a single claim, if one of the counts of a complaint triggers an exclusion the entire lawsuit is excluded from coverage.

Thomas S. Novak

Corporate policyholders and their directors and officers, however, will be heartened by a recent line of New York cases that rejects D&O carriers' narrow interpretation of their policies and finds a duty to reimburse defense expenses even if one or more counts of the complaint are excluded by the policy. New York courts have imported principles from cases involving 'duty to defend' policies and applied them to broadly construe D&O carriers' duty to reimburse defense expenses even where one or more of the counts of the complaint is excluded by the policy.[1] Further, while New York courts will permit D&O carriers to apportion expenses between covered and non-covered claims, they have put the burden on the carriers to prove which expenses pertain to a conclusively non-covered claim. And if the carrier is unable to allocate expenses between covered and non-covered claims, or if an expense relates to both covered and non-covered claims, New York courts require the insurer to advance all defense expenses.

In its March 2010 decision in *West-Point International v. American International South Insurance Company*,[2] the New York Appellate Division's First Department found the carrier liable for costs of defending the insured and its directors against a suit which alleged, among other things, a claim for breach of contract which was excluded by the policy. The underlying action also alleged seven counts that did not involve a breach of contract by the insured. The insurer argued that the one contract claim rendered the entire lawsuit outside the coverage of the policy due to the broad definition of "claim" in the policy to include the entire lawsuit. The First Department characterized the carrier's interpretation of its policy as "an unduly rigid construction … in light of the realities of litigation, as well as 'a strained, implausible reading of the complaint that is linguistically conceivable but tortured and unreasonable.'"[3] The court unanimously affirmed the trial court's application of duty to defend principles in the context of a duty to reimburse policy by holding that "the fact that some of the causes of action in the [underlying] [c]omplaint might not be covered by the [p]olicy does not extinguish American International's obligation to provide a

***Thomas S. Novak** is a Partner of Sills Cummis & Gross P.C. Mr. Novak has concentrated his practice in insurance and reinsurance law for 25 years in the representation of both policyholders and carriers in coverage and bad faith disputes involving general liability, property, professional liability, directors' and officers' liability, and surety. When the firm was appointed as Special Counsel to the New Jersey Department of Banking and Insurance in connection with the liquidation of Integrity Insurance Company, Mr. Novak worked on the matter starting in 1987 and was lead partner from 1993 to 2006. Mr. Novak gratefully acknowledges the assistance of Summer Associate **Brian Biglin** in the preparation of this article.*

Please email the author at tnovak@sillscummis.com with questions about this article.

defense."[4]

In response to the insurer's contention that case law interpreting a carrier's broad defense obligation under "duty to defend" policies was irrelevant to a "duty to reimburse" D&O policy, the Court found the distinction "not dispositive."[5] The First Department relied on duty to defend cases interpreting general liability policies to reach the conclusion that notwithstanding the D&O policy's definition of claim to include all counts of a lawsuit, the "insurer has a *duty to defend* so long as there is any possibility of coverage under the policy, and here the possibility of coverage has not been eliminated."[6] The Court ordered AISIC to reimburse WestPoint for its defense expenses in the underlying litigation because AISIC could not show that *all* of the underlying allegations were entirely excluded. The Court held that the policy required reimbursement of all defense expenses "subject to recoupment of any amounts advanced for claims ultimately determined not to be covered."[7]

The recent *WestPoint* opinion squared with two other New York decisions: *Federal Insurance v. Kozlowski* and *The Trustees of Princeton University v. National Union Fire Insurance Company*. Both decisions rejected the insurers' contention that the presence of one or more excluded claims was fatal to coverage under their D&O policies and broadly interpreted the insurers' duty to advance defense expenses.

In *Kozlowski*,[8] the insured sought to recover expenses incurred in the defense of former Tyco Chief Executive Officer Dennis Kozlowski in three actions alleging claims covered by the policy, but also alleging claims for fraud, misappropriation of assets, and other conduct excluded under the policy. The insurer disclaimed any duty to advance defense expenses based on the policy's 'personal profit' exclusion (barring coverage for a claim arising from the insured obtaining a pecuniary benefit to which he was not legally entitled). The First Department affirmed the trial court's ruling that the insurer advance defense payments because "the duty to defend arises whenever the underlying complaint alleges facts that fall within the scope of coverage."[9] This principle, the court reasoned, covers a situation where "covered as well as noncovered claims…are intertwined."[10] The Court held that the carrier must pay for "all defense costs as incurred…subject to recoupment in the event it is ultimately determined no coverage was afforded [by the policy]."[11]

In *The Trustees of Princeton University v. National Union Fire Insurance Company*,[12] Princeton University sought coverage under a non-profit D&O policy for expenses incurred in defending a suit brought by dissident trustees alleging that the University had misappropriated trust funds. In an unpublished opinion that was later affirmed by the First Department, the trial court found that two of the twelve counts in the underlying action were barred from coverage by the 'insured v. insured' exclusion. The Court rejected the insurer's contention that the two non-covered claims rendered the entire lawsuit excluded from coverage under the policy. The Court held that the insurer's right to apportion covered and uncovered claims is not absolute: "the insurer is not entitled to apportion claims at the expense of the insured's defense of the underlying action, and if the insurer cannot allocate during the underlying action, it must pay all defense costs as incurred subject to recoupment."[13] Further, the Court approvingly cited the New Jersey Supreme Court's opinion in *SL Industries, Inc. v. American Motorists Insurance Company*, holding that if the carrier is ultimately unable to apportion defense expenses between covered and non-covered claims, it must reimburse the insured for all expenses.[14]

WestPoint joins a line of New York cases rebuffing D&O insurers' attempts to limit their coverage based on a hypertechnical construction of their policies.[15] Notwithstanding the policy definition of "claim" as encompassing the entire lawsuit, New York courts will not permit the presence of one or more excluded causes of action in a complaint to be fatal to coverage of the overall lawsuit. It is now clear that D&O policies providing for a duty to reimburse defense costs will be interpreted as having the same "heavy" defense burden as duty to defend policies.[16] As held most recently in *WestPoint*, the insurer must pay for all defense costs as those costs accrue and wait until resolution of the underlying suit to recoup payments that are ultimately determined to be outside of the policy's coverage. The proverbial dust must settle in the underlying litigation before the insurer (with the help of courts, if necessary) can determine which defense expenses are properly reimbursable and which are recoupable by the insurer. While New York courts will permit a carrier to recoup defense expenses attributable to the non-covered claims, the burden is on the carrier to establish which expenses pertain to the non-covered claims. If the carrier is unable to establish that certain expenses pertain solely to non-covered claims, the policyholder is entitled to full reimbursement of its defense expenses. Further, the carrier may not apportion expenses to the detriment of the insured and its defense in the common case where the insured is defending both covered and non-covered claims. Finally, by requiring the carriers to advance all defense expenses subject to recoupment at the end of the underlying litigation, the courts have shifted the risk of recouping non-covered fees from potentially bankrupt policyholders onto the carriers.

---

[1] *Most general liability policies are "duty to defend" policies where the carrier is obligated to defend a covered claim or litigation, it controls the defense of the litigation, and the cost of its defense obligation is in addition to the policy's limit of liability for indemnity. By contrast, D&O and professional errors and omissions policies are usually "duty to reimburse" policies where the insured controls the defense of the underlying litigation, the carrier reimburses or advances defense expenses as they are incurred, and the expenses reduce the remaining limit of liability of the policy.*

[2] *899 N.Y.S.2d 8 (App. Div. 2010).*

[3] Id. *at 9.*

[4] Id.

[5] Id.

[6] Id. *(emphasis added).*

[7] Id. *at 9-10.*

[8] Federal Insurance Company v. Kozlowski, *792 N.Y.S.2d 397 (App. Div. 2005).*

[9] Id. *at 402-3.*

[10] Id.

[11] Id. *at 403-4.*

[12] *NY Slip Op 50753U *1-2 (Sup. Ct. 2007),* aff'd Trustees of Princeton Univ. v. National Fire Insurance, *859 N.Y.S.2d 174 (App. Div. 1st 2008).*

[13] Id. *at *6.*

[14] Id.

[15] See In Re Worldcom, Inc. Securities Litigation, *354 F. Supp. 2d. 455, 462-63 (S.D.N.Y. 2005);* see also Burke v. Ulico Casualty, *165 Fed. Appx. 125, 128-9 (2d Cir. 2006) (approving the New York courts' broadened view of duties in D&O policies);* Sealed Air Corp. v. Royal Indem. Co., *404 N.J. Super. 363, 376-377 (App. Div. 2008) (conflating the obligation to reimburse under a D&O policy with the 'duty to defend').*

[16] McGinniss v. Employers Reinsurance Corp.