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Delaware Dole Ruling Will Guide Allocation In D&O Policies

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Directors and officers liability insurance policies often cover a settlement reached in the underlying litigation against directors and officers. Sometimes, the underlying litigation (be it shareholder class actions on breach of fiduciary duty or on violation of securities laws) is brought against defendants or upon matters that are both insured and uninsured under the D&O policies.

In such circumstances, the issue of allocation arises between covered and uncovered persons or matters, even when coverage is not disputed in general. Sometimes, the policy language will address allocation (such as requiring “best efforts” based on “relative legal and financial exposures”) and sometimes it will not.

One rule that has developed to address this allocation issue is the “larger settlement rule.” This rule was first illustrated by Judge Richard Posner in Harbor Insurance Co. v. Continental Bank Corp., where he held that to the extent the amount of a settlement was larger than it would have been but for the uninsured defendants or matters, the insurer is not obligated to pay for the larger amount.[1]

Recently, the Delaware Superior Court, in a case of first impression under Delaware law, interpreted an explicit allocation provision in a D&O policy and importantly held the larger settlement rule applicable despite the presence of a “best efforts” clause and a “relative legal and financial exposures” clause in the allocation provision.

Case Background and Parties’ Positions

In Arch Insurance Co. v. Murdock, certain excess insurers of a D&O policy sued the Dole Food Co. and one of Dole’s directors — David H. Murdock — for a declaratory judgment that two settlements in two underlying lawsuits were not covered by the policy, citing various coverage defenses.[2]

After the Delaware Court of Chancery issued an opinion finding the underlying defendants liable, Murdock reached a settlement in both underlying lawsuits and asked the excess insurers to reimburse the amount of the two settlements under the D&O policy after the primary layer of the insurance tower was exhausted.[3]

The excess insurers at the seventh and eighth layers refused to pay and filed a declaratory judgment action arguing, among other issues, that allocation should apply to the settlements based on the explicit allocation provision in the primary policy, and that the excess insurers were entitled to subrogation to any rights Murdock had against other underlying defendants who did not contribute to the settlements.[4] The parties filed cross summary judgment motions on these issues.[5]

On allocation, the insurers invoked the following allocation provision in the primary policy to argue that they were not obligated to reimburse the entire amount of the two settlements:

> If in any Claim, the Insureds who are afforded coverage for such Claim incur Loss jointly with others ... who are [uninsured], or incur an amount consisting of [both covered and uncovered Losses], *then the Insureds and the Insurer agree to use their best efforts to determine a fair and proper allocation of covered Loss. The Insurer's obligation shall relate only to those sums allocated to matters and Insureds which are afforded coverage. In making such determination, the parties shall take into account the relative legal and financial exposures of the Insureds in connection with the defense and/or settlement of the Claim.[6]*

The excess insurers argued that at least part of the settlements should be allocated to claims against Murdock in his capacity as controlling shareholder (an uninsured capacity, in contrast to his capacity as director) and against DFC (an uninsured underlying defendant who was held jointly and severally liable).[7] The insureds, on the other hand, argued that the larger settlement rule should apply, namely, allocation was only appropriate when the insurers could prove that "the settlement was increased by the presence of uninsured parties or non-covered claims."[8]

In addition, the insureds argued that the allocation provision was ambiguous because it did not "determine how to allocate settlement amounts when the parties [were] unable to agree."[9] And since allocation was in effect "a partial exclusion," this ambiguity should be interpreted in favor of coverage under contra proferentem.[10]

Court's Decision and Reasoning

Although the court ultimately decided that the larger settlement rule applied "under the facts and circumstances here," it did not adopt the insureds' argument in reaching the decision entirely.[11] Right off the bat, the court found the allocation provision unambiguous.[12] However, the court also found the allocation provision "unhelpful" because it did not "set out a specific formula to be applied in the event that parties fail to agree on allocation issues."[13]

Instead, the court looked to the "economic deal" underlying the insurance policy as the basis for its decision of first impression under Delaware law.[14] Specifically, "[t]he decision to apply the Larger Settlement Rule is to protect the economic expectations of the insured — i.e., prevent the deprivation of insurance coverage that was sought and bought."[15] The economic expectations of the insureds in this case must be interpreted through reading all relevant provisions in the policy as a whole, and "not on any single passage in isolation."[16]

One such relevant provision was the primary and excess policies' coverage of "all Loss that the Insured(s) become legally obligated to pay," without any qualification in the same provision.[17] As a result, any type of pro rata or relative exposure analysis seems to be contrary to the policy language.[18]

As to the "relative legal and financial exposures" language in the allocation provision, the court did not

view it as an explicit authorization of a pro rata allocation analysis, but instead interpreted it as supporting the "economic rationale" of the larger settlement rule: In the event of joint and several liability, the insured will be "legal[ly] and financial[ly] expos[ed]" to the entire amount of the settlement, and therefore, even under this relative exposure clause, the insureds should recover the entire settlement amount they were jointly and severally liable for.[19]

The court did not ignore the other end of the "economic deal" either, namely, the economic expectations of the insurer: The allocation provision must be interpreted together with the subrogation provision as well, and since the court already held the insurers had a right of subrogation to sue the other nonpaying underlying defendants, the insurers "could pay the full amount of the Claim here without pro rata allocation and still pursue [the other underlying defendants] through the Subrogation Provision."[20]

Aside from policy interpretation and legal analysis, the court commented several times that the "factual record [was] bereft of any fact that show that the Insurers and/or the Insureds engaged in any efforts to determine any allocation of covered loss"; "the parties did not even attempt to [do so]."[21]

The lack of negotiation and agreement on allocation here was not an accident — it was tied to some of the other key issues in the case, including the factual dispute of whether the insureds failed to cooperate with and obtain consent from the insurers regarding the underlying litigation and settlement, or whether the insurers set to deny coverage from the very beginning and refused to participate in the underlying lawsuits.

If the insureds' account of events was true, the insurers' lack of participation not only risked a claim of bad faith denial of coverage, but also had the (perhaps unintended) consequence of losing the allocation option if the jury found coverage was warranted.

The factual dispute will remain unresolved because the parties reached a settlement after the Delaware Superior Court's opinion on allocation and before trial. But the following rule articulated by the court will help guide future behaviors of insurers and insureds under D&O policies:

> The Larger Settlement Rule applies in those situations where (i) the settlement resolves, at least in part, insured claims; (ii) the parties cannot agree as to the allocation of covered and uncovered claims; and (iii) the allocation provision does not provide for a specific allocation method (e.g., pro rata or alike).[22]

Although the insureds prevailed on the issue of allocation in Arch Insurance, despite the explicit allocation policy provision with the "relative exposure" language, for policyholders, it is prudent to be cautious in negotiating on the issue of allocation with an insurer.

Though the failure to agree to any allocation was key here when the allocation provision in the D&O policy did not specify what to do if the parties did not reach an agreement on allocation, the lack of any allocation negotiation also worked in the policyholder's favor. It is also wise to keep in mind the impact a policy subrogation provision may have on allocation.

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[1] See 922 F.2d 357, 367 (7th Cir. 1990).

[2] No. N16C-01-104 EMD CCLD, at 6 (Del. Super. Ct. Jan. 17, 2020).

[3] Def. Murdock's Opening Br. ISO Mot. Summ. J. (Murdock Br.) at 6–7, Arch Insurance Co. v. Murdock, No. N16C-01-104 EMD CCLD (D.I. 636).

[4] See Arch Ins., No. N16C-01-104 EMD CCLD, at 6.

[5] Id. at 2.

[6] Pls. Excess Insurers' Opp.'n Br. to Defs. Mot. Summ. J. ("Excess Insurers Br.") at 60, Arch Ins., No. N16C-01-104 EMD CCLD (D.I. 665). (Emphasis in original.)

[7] See Murdock Br. at 30 & n.8.

[8] See, e.g., id. at 31.

[9] Id. at 34.

[10] Id.

[11] See Arch Ins., No. N16C-01-104 EMD CCLD, at 8.

[12] Id. at 12.

[13] Id.

[14] See id. at 14, 16.

[15] Id. at 13.

[16] Id. at 14 (internal quotation marks omitted).

[17] Id.

[18] Id.

[19] Id. at 15.

[20] Id. at 15–16.

[21] See id. at 5, 15.

[22] Id. at 13–14.