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Can D&O Insurers Contract Around Duty-To-Advance Costs?

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Take a close look at your directors and officers policy and chances are it includes an allocation provision that states the insurer will only advance defense costs for covered claims, instead of advancing defense costs for all claims. Although D&O insurers promise to advance defense costs prior to the conclusion of the underlying action, many D&O and management liability policies now include such an allocation provision, which insurers have inserted in an effort to limit their broad duty to advance defense costs.

In the absence of an allocation provision, courts correctly have held that the duty to advance defense costs is just as expansive as the duty to defend found in commercial general liability policies, which requires an insurer to defend an entire action so long as one of the underlying claims potentially is covered. Only a couple decisions have addressed how the inclusion of an allocation provision affects the insurer's duty to advance defense costs, and have held that the provisions are enforceable. These decisions, if followed, threaten to erode policyholders' valuable defense cost coverage.

The Duty to Advance Defense Costs: Different Method or Different Duty?

Insurance policies that provide defense coverage generally do so in one of two ways: (1) the insurer either has the duty to defend the policyholder or (2) the insurer has the duty to advance defense costs to facilitate the insured's provision of its own defense. The law on the former is well-settled — the duty to defend arises where there is a potential for coverage for even a single claim in an underlying action, and it extends to the entirety of the covered action. An often cited authority on this issue is Buss v. Superior Court, 16 Cal. 4th 35 (1997), in which the California Supreme Court held that so long as a claim is potentially covered under the policy, the duty to defend requires that the insurer defend the entire action. The duty to defend appears most often in CGL policies.

By contrast, most D&O policies do not provide the duty to defend, but instead provide that the insurer has the duty to advance defense costs prior to the conclusion of the underlying suit. Insurers have argued, without much success, that the duty to advance defense costs is a different type of duty that does not extend to uncovered claims. In Liberty Mut. Ins. Co. v. Pella Corp., 650 F.3d 1161 (8th Cir. 2011), the Eighth Circuit rejected this argument, holding that the duty to advance defense costs is

"congruent to the insurer's duty to defend" and, like that duty, arises "if the allegations in the complaint could, if proven, give rise to a duty to indemnify." Id. at 1170. Similarly, in Julio & Sons Co. v. Travelers Casualty & Surety Co., 591 F. Supp. 2d 651 (S.D.N.Y. 2008), the district court explained that the "whole purpose of advancing legal expenses rather than reimbursing them at the conclusion of the litigation is that insured organizations may not have the cash on hand to finance their own defense." 591 F. Supp. 2d at 660. The court correctly recognized that "there are no material differences between a duty to defend and a duty to advance defense costs." Id.

These and other decisions,[1] establish that the duty to advance defense costs has the same purpose as the duty to defend, and so logically should be governed by the same rules. Accordingly, a majority of courts have held that an insurer must advance defense costs for the entire action, just as an insurer with a duty to defend must defend the entire action rather than only the potentially covered claims. As the Ohio Court of Appeals explained, there is simply "no reason to make a distinction between duty to defend cases and duty to advance defense costs cases with respect to application of the one claim-all claims principle and pleadings test." Am Chem Soc. v. Leadscope, Inc., 2005 Ohio App. LEXIS 2428 (Ohio Ct. App. May 24, 2005).[2]

Allocation of Claims: Duty to Advance All Defense Costs or Only Costs for Potentially Covered Claims?

Likely in response to these holdings about the broad scope of the duty to advance defense costs, insurers have started adding allocation provisions into their policies, stating that advance defense costs must be allocated between covered and uncovered claims. The provisions typically provide something like the following:

If in any Claim the Insureds … incur an amount consisting of both Loss covered under this Policy and loss not covered by this Policy because the Claim includes both covered and uncovered matters, then the Insureds and the Insurer shall allocate such amount between covered Loss and uncovered loss based upon the relative legal exposures of the parties to covered and uncovered matters.

Some other variations of the allocation provision attempt to be more one-sided, providing that in the event the insurer and policyholder disagree over the proper allocation, the insurer will allocate according to its own view:

In the event that a determination as to the amount of Defense Costs to be advanced under this policy cannot be agreed to, then the Insurer shall advance Defense Costs excess of any applicable Retention which the Insurer states to be fair and proper until a different amount shall be agreed up or determined pursuant to the provisions of this policy and applicable law.

Only a couple cases have addressed the enforceability of these types of provisions, and have held the provisions enforceable. In Commercial Capital Bankcorp Inc. v. St. Paul Mercury Ins. Co., 419 F. Supp. 2d 1173, 1177 (C.D. Cal. 2006), the district court held that the insurer and policyholder were free to to contract around "the default rule of contemporaneous payment." Id. at 1181. It also rejected the insured's assertion that the provision was contrary to Buss, finding that "Buss is inapposite to the extent that it expresses any 'public policy' in favor of requiring an insurer under a 'duty to defend' policy prophylactically (sic) to defend all claims in a 'mixed' action," because "its rule is based entirely on the existence of a contractual duty to defend." Id. at 1181-82. In contrast, the insured in this case "paid (presumably lower) premiums for a lesser right." The court thus concluded that "[t]o require Defendant to advance all of Plaintiff's defense costs on a current basis despite [the allocation provision]'s clear

indication of the parties' contrary intent would give Plaintiff an unbargained-for windfall." Id.

The district court's reasoning in Capital Bankcorp is at odds with the logic of the previously discussed cases universally recognizing that "there are no material differences between a duty to defend and a duty to advance defense costs," Julio, 591 F. Supp. 2d at 660, and thus no logical reason for treating them differently. As the California Supreme Court explained in Buss, the "duty to defend a 'mixed' action in its entirety … does not arise out of the policy, but is imposed by law in support thereof." Buss, 16 Cal. 4th at 59. This duty is imposed by law specifically because without it, the duty to defend becomes meaningless. As the court explained, "[t]o defend meaningfully, [an insurer] must defend immediately. To defend immediately, it must defend entirely. It cannot parse the claims, dividing those are at least potentially covered from those that are not." Id.[3]

Thus, if the public policy in favor of providing a defense for all claims set forth in Buss prevents parties from contracting around that policy in duty-to-defend cases, that same public policy should trump allocation provisions regarding the duty to advance defense costs.

At a minimum, an insurer that completely denies coverage and refuses to advance any defense costs should not be allowed to rely on the allocation provision to attempt to justify its position. Policyholders purchase D&O policies and other liability policies to ensure they have the resources to mount a vigorous defense of the underlying action. Many policyholders cannot afford to wait until the end of a litigation to see if their insurers will cover the defense costs. If interpreted to trump the broad duty to advance defense costs, allocation provisions may inhibit policyholders from mounting that vigorous defense. Policyholders should carefully review their policies and understand the potential risks presented by these allocation provisions.

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[1] Acacia Research Corp. v. Nat'l Union Fire Ins. Co. of Pittsburgh, 2008 U.S. Dist. LEXIS 96955 (C.D. Cal. Feb 8, 2008); Hurley v. Columbia Cas. Co., 976 F. Supp. 268, 275 (D. Del. 1997); Am Chem Soc. v. Leadscope Inc., 2005 Ohio App. LEXIS 2428 (Ohio Ct. App. May 24, 2005).

[2] Accord, Westpoint Int'l Inc. v. Am. Int'l Sout Ins. Co., 899 N.Y.S.2d 8 (1st Dept. 2010).

[3] See also Dobson v. Twin City Fire Ins. Co., 2012 U.S. Dist. LEXIS 93823 (C.D. Cal. July 5, 2012) and Jeff Tracy v. U.S. Specialty Ins. Co., 636 F. Supp. 2d. 995, 1003-04 (C.D. Cal. 2009), both citing Capital Bankcorp to reach same result.
