

# WHAT WE'VE GOT HERE IS A FAILURE TO COMMUNICATE:

## THE COOPERATION CLAUSE AND D&O INSURANCE: ISSUES AND SOLUTIONS

By Joseph W. Bauer<sup>1</sup>

### **1. Background**

Most of the literature and case law discussing the cooperation clause in insurance contracts examines its use in general commercial liability policies and in personal lines coverage, such as auto and homeowners insurance.<sup>2</sup> But the clause is ubiquitous. A careful review will find some form of it in nearly any kind of policy. This includes executive and management liability insurance, commonly known as D&O insurance.<sup>3</sup>

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<sup>1</sup> The author is the principal of Bauer Advising LLC, an independent consulting firm he founded upon his retirement as the general counsel of a Fortune 500 publicly traded company for 20 years. Bauer Advising assists large companies and law firms in two areas: optimization of commercial insurance terms; and alternative legal fee arrangements, more fully explained at [www.baueradvising.com](http://www.baueradvising.com). This article was prepared for and published with materials distributed at the American Bar Association's meeting of its Insurance Litigation Section in Tucson, AZ in March 2011.

<sup>2</sup> For example, many cases involve so-called "examinations under oath" (EUOs) that now are commonly demanded in large auto accident claims and in homeowner's claims for theft and fire. In such cases the refusal of the policyholder to submit to such an examination has been held to breach the cooperation clause. Many other cases arise in the context of the policyholder's dissatisfaction with the defense strategy led by counsel appointed by the insurer pursuant to its duty to defend, especially where the insurer has not unequivocally acknowledged coverage of the claim. These cases often involve interaction between the cooperation clause, the duty to defend and the policyholder's position that it is entitled to counsel of its own choosing where the insurer has issued a "reservation of rights." Tension may well exist between the policy terms, including the cooperation clause, and counsel's ethical obligations in faithfully representing his client, the insured. As noted *infra*, because D&O policies do not impose a duty to defend on the insurer, such cases are not the focus of this article. For a thorough discussion of the ethical issues presented by such circumstances, see the submission of Paul A. Rose, "A Policyholder Perspective", submitted with the other papers of this panel.

D&O insurance, though, is not just any insurance. The stakes in D&O claims are often high, and the exposures for the named executives and directors are uncomfortably “close to the bone”. Personal and business reputations are in play. Large personal fortunes may become at risk almost overnight. So it is not surprising that claims under D&O policies, unlike many other liability problems, usually attract immediate and concerted attention in the c-suite, and often the notice also of shareholders and the SEC on account of (often) mandatory public disclosure by the company. When D&O suits are filed, tensions run high, in and around the boardroom.

Attention brings lawyers, often many of them.

Some directors, individually or as a group, may decide they need separate legal representation to protect their interests and distance them from the wrongdoing of others. If so, independent counsel will likely be retained. Some individual executives may feel that way too. Enter more lawyers. And separate from the legal rights of the individuals are the legal rights of the corporation, which must also be guarded by—you guessed it— still more lawyers. And if that were not enough, large companies invariably are insured for D&O liability by multiple insurance companies, often as many as six or more. In large claims, each insurer typically is represented by its own counsel.<sup>4</sup>

When so many lawyers bring so much advice, some of it is bound to conflict with the preferences and perceived contractual rights of the D&O insurer under the cooperation clause of the contract, and other closely related provisions<sup>5</sup>.

## **2. The Issues**

The issues that can arise are not small for either side. Consider the situation where counsel for a board committee—secure in the belief that the board was never told of egregious and concealed acts of the CEO—urges complete and open cooperation with law enforcement. He may even propose a voluntary waiver of attorney-client privilege to facilitate a rapid “clearing of the air” that will vindicate blameless defendants. Other defendants, especially those who perceive they have some, but limited, personal culpability may agree with this approach, hoping to obtain prosecutorial leniency on account of it. The D&O insurer, however, may well object to such a

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<sup>3</sup>A typical cooperation clause used by one prominent D&O carrier reads: "The Insurer shall have the right to effectively associate with each and every Organization and Insured Person in the defense and prosecution of any Claim that involves, or appears reasonably likely to involve, the Insurer, including, but not limited to, negotiating a settlement. Each and every Organization and Insured Person shall give the Insurer full cooperation and such information as it may reasonably require."

<sup>4</sup>The cooperation clause can be implicated also in relations between the insured and its various carriers, especially where the carriers jockey for position on responsibility for the claim, or themselves do not agree on a settlement strategy. In one recent Sixth Circuit case, Federal Insurance Co. (a unit of Chubb), refused to pay the defense costs of its policyholder on the ground that the policyholder had colluded with Nation Union Fire Insurance (a unit of AIG/Chartis) by amending its D&O policy with National Union so as to make it exclusively excess over, and not jointly primary with, the Federal Insurance policy. Over a spirited dissent, the court ruled that the insured's agreement with the other carrier had not breached the cooperation clause. The majority took the view that the cooperation called for by the clause related exclusively to claim management matters and did not restrict the insured's ability to make agreements with other insurers. *Abercrombie & Fitch Co. v. Federal Insurance Co.*, No. 09-3096 (6th Cir. March 11, 2010) (not recommended for full-text publication).

<sup>5</sup>Such as the “voluntary payments”, “consent to settlement” and “severability” clauses, each discussed *infra*.

strategy, worried that the disclosure of privileged information and documents will be seriously damaging and substantially elevate the settlement value of the case as a whole.<sup>6</sup>

The defendants who choose, over the objection of the insurer, to waive the privilege may face a challenge from the insurer that their actions breach the cooperation clause of the policy and therefore void their rights to recover under it. Even more concerning—depending on the severability provisions of the policy—the rights of *non-waiving* defendants or the corporation may also be impaired.<sup>7</sup>

Disagreement over defense strategy is not the only fertile ground for debate under the cooperation clause. There is large overlap between the cooperation clause and the provisions of the policy having to do with consent to settlement and other consent rights that most contracts afford to the insurer.

Unlike the usual general liability policy, D&O policies almost never include a “duty to defend” component. Technically speaking, the insureds select their own defense counsel and are reimbursed for the legal expenses incurred. This being the case, the “control of the defense”, normally reserved to the insurer in liability insurance (at least where coverage is acknowledged), technically remains with the insureds under a D&O contract. D&O defendants may perceive in themselves more control over their own destiny than they truly possess. In fact, their actual control is probably substantially limited by the cooperation clause working in tandem with the consent provisions of the policy. D&O policy forms commonly contain provisions precluding settlements without the express consent of the insurer and, for good measure, another one proscribing the making of voluntary payments without the prior consent of the insurer.<sup>8</sup>

The importance of this suite of provisions can hardly be overstated because settlement, in all of its dimensions<sup>9</sup>, is a principal driver in nearly every large D&O claim. There are situations in other kinds of commercial liability litigation, where the defendant may be indifferent to the

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<sup>6</sup> The Eighth Circuit, in the context of a professional liability policy involving a dentist, ruled recently that the insured's invocation of his Fifth Amendment rights and corresponding refusal to testify constituted a breach of the cooperation clause relieving the insurer of responsibility under the policy. *Medical Protective Co. v. Bubenik*, 2010 WL 547053 (8th Cir. Feb. 18, 2010). In view of the criminal enforcement undertones to many securities related D&O claims, the same issue could easily arise under a D&O contract. For a thoughtful discussion of the interplay between the Fifth Amendment and SEC enforcement practices, see "*Hot Topics in D&O Claims Handling and Coverage*", by James A. Skarzynski, Evan Shapiro and Cecilia Kaiser (BSWB 2006).

<sup>7</sup> “Severability” clauses appear in at least two sections of the typical D&O policy. It relates to the imputation of the knowledge, actions or culpability of one (or more) insured to other insureds, including the corporate entity. “Application severability” refers to statements and information considered part of the application for insurance. The misstatement or inaccuracy of one insured may be considered a misstatement by all, unless an appropriate provision limits its vicarious effect. “Exclusion severability” refers to conduct of one (or more) insured, or factual circumstances pertinent to one (or more) insured, that triggers a policy exclusion. The severability language of this clause will determine whether, or to what extent, the exclusion will be deemed applicable to other insureds, or to the corporation as an insured organization.

<sup>8</sup> A typical policy of one major D&O insurer provides: "The Insurer does not, however, under this policy, assume any duty to defend. The Insureds shall defend and contest any Claim made against them. The Insureds shall not admit or assume any liability, enter into any settlement agreement, stipulate to any judgment, or incur any Defense Costs without the prior written consent of the Insurer."

<sup>9</sup> Including its timing, amount, attendant publicity, and reputational impact.

timing of settlement, or may even see it in the interest of the company to extend the matter. It is surely not uncommon for a company to take a case to trial in order to vindicate a product line, or to discourage follow-on suits by new plaintiffs. But nearly one hundred percent of civil D&O suits that are not dismissed outright or on summary judgment are settled. And general counsels and experienced D&O defense lawyers will attest that, barring very unusual circumstances, the chairman of the board named in a substantial D&O claim has two closely related questions above all others: "When will this be over?" and "What are we doing to settle it?"

Despite ostensible control of their own defense under the policy, the cooperation clause, teamed with the consent to settlement, and voluntary payments clauses do not leave the answers to these questions to the discretion of the insureds—so long as they expect the costs of that settlement to be borne by the insurer.<sup>10</sup> A refusal to accept this proposition has proven a painful lesson for more than a few policyholders. Despite harsh outcomes, courts have regularly enforced the consent rights of insurance companies. See *Federal Insurance Co. v. Arthur Andersen LLP*, 522 F.3d 740 (7th Cir. 2008); *Vigilant Ins. Co. v. Bear Stearns Cos., Inc.*, 2008 NY Slip Op 2080 (N.Y. March 13, 2008).

### **3. Some Practical Solutions**

The hazards described above are avoidable. D&O policy terms, like the terms of any contract, are not "carved in stone" and unalterable. Most insurance companies, facing competitive offerings, are amenable to suggestion and negotiation. If they aren't, the client should be urged to look elsewhere. Nor are the terms of the policies that are broadly marketed by the major insurers all the same. Further, all "standard" terms are modifiable by negotiated endorsements. A diligent lawyer, invited into the process when coverage is purchased, can make a big difference in the policy as ultimately issued.<sup>11</sup> Such a lawyer would do well to focus on:

#### *Complete severability of all terms, including the cooperation clause*

There is no legal reason why the conduct, knowledge, or decisions of one insured (or more than one) should impair the contractual rights of others who do not participate in that conduct, have that knowledge, or join in those decisions. Severability should expressly extend to the cooperation clause and its sister provisions addressing consent to settlement and voluntary payments. An interpretive manuscript endorsement (or the text of the clause itself) should say so.

#### *Broaden the authority of the insured to settle within stated parameters*

D&O policies commonly provide that insureds may settle claims without insurer consent so long as the settlement is below self-insured or deductible levels, and that consent to settle above such

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<sup>10</sup> See *National Union Fire Ins. Co. of Pittsburgh, Pa. v. NVIDIA Corp.*, No. 09-02046, 2009 U.S. Dist. LEXIS 79759 (N.D. Cal. Aug. 18, 2009).

<sup>11</sup> Unfortunately, policyholders do not often seek legal assistance when insurance is purchased; in the usual instance, lawyers are not consulted until a claim is made--when it is too late to influence the terms of the contract. This too is a preventable circumstance. Most CEOs and members of senior-most management will support utilization of counsel in the procurement process when the fact of counsel's usual absence is brought to their attention.

levels will not be unreasonably withheld. Nothing prevents the negotiation of a higher threshold--perhaps half of policy limits--up to which the insured could settle as a matter of right without a challenge that either the cooperation clause or consent clause has been breached.

*Define and limit the settlement consent rights of the insurer*

There is no need for the policy to be silent on what constitutes a reasonable refusal by the insurer to consent to a settlement desired by the insured. But most are. The insured may have legitimate commercial motives to put the litigation behind it and get on with its business of serving the interests of shareholders. In practice, in such circumstances insurers, perceiving leverage, often require a substantial financial contribution to the proposed settlement by the policyholder as a condition of their consent, effectively imposing a funding obligation unsupported by the contract. Insureds often agree to so participate, seeing the financial contribution as preferable to protracted, distracting litigation and the possibility of personal exposure. Good lawyering up front could clarify and level this playing field by stipulating circumstances under which the insured could compel settlement<sup>12</sup> or by contractually providing a prompt mechanism--such as short-form binding arbitration--to be used when there is disagreement on the settlement of a covered claim.

*Clarify that the cooperation clause does not apply to an assertion of Fifth Amendment rights or attorney-client privilege.*

A compelling argument can be made that time honored traditional legal rights should not be compromised as a condition of insurance coverage. By endorsement (or manuscript terms) this intention could be certified.

#### **4. Conclusion**

Large D&O claims present almost the perfect legal storm. All of the elements needed for expensive disagreement are present: multiple, usually well-funded parties; high, even catastrophic, commercial and personal stakes; directly competing and equally legitimate contractual, commercial and even constitutional principles; and plenty of skillful lawyers to debate them all. But at the end of the day, businesses and executives need protection against these legal exposures, and strong insurance companies desire to produce and sell contracts of insurance to do that. Each needs the other. When vast sums are involved, the prospect of disagreement over what constitutes appropriate "cooperation" in matters of defense strategy and settlement will never be completely eliminated. But careful legal attention to the reach and wording of the cooperation clause and its related terms *when the policies are secured and negotiated* would reduce the likelihood of conflict when the large claim arrives.

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<sup>12</sup>Such as when the board, or a special committee thereof, determines by formal action that settlement of the claim is required to serve the best interests of the shareholders.