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ALLOCATION

The term "allocation" refers to the process of determining the amount of defense costs, settlements or judgments which is properly attributable or "allocated" to covered Claims against covered persons, on the one hand, and uninsured claims against uninsured persons, on the other. In essence, allocation simply refers to the process of determining the amount of insured loss when that loss is commingled with uninsured loss. The allocation process is one of the most troubling aspects of D&O insurance claims handling and can result in a contentious claims handling environment if the Insureds and Insurer are not adequately forewarned of the allocation issues or reasonable in their allocation expectations.

D&O policies frequently address allocation in two contexts: (i) predetermine the allocation percentage in the policy, or (ii) define the methodology which the parties must use to determine an appropriate allocation in each claim.

Predetermined Allocation. Some policies contain a provision which predetermines or fixes the allocation in certain Claims which otherwise requires an allocation, regardless of the facts of that Claim. The primary differences between available predetermined allocation provisions include the following:

Some provisions predetermine only the allocation between covered and non-covered parties, whereas other provisions also predetermine the allocation between covered and non-covered allegations or matters. The latter approach eliminates allocation disputes when a portion but not all of a Claim is subject to a coverage defense. Insurers are still entitled under such a provision to deny a claim in full.

Most predetermined provisions in D&O policies issued to public companies apply only with respect to Securities Claims since the range of potential allocation percentages in such Claims is relatively small in most cases and because Securities Claims usually create the most contentious allocation disputes. Allocation provisions in D&O policies issued to privately-held companies frequently apply to any type of Claim.

The predetermined percentage may apply only to defense costs, to both defense costs and indemnity, or may apply different percentages to defense costs and indemnity.

Instead of predetermining the allocation, the Policy may establish a minimum allocation percentage and allow the parties to negotiate a potentially higher allocation percentage.

If a predetermined allocation provision is included in the policy, it should be coordinated with any coinsurance provision, which similarly reduces the percentage of loss paid by the Insurer. Coinsurance is generally more protective to the Insurer and less desirable to Insureds than predetermined allocation because (i) coinsurance applies to all loss even if the loss is not otherwise subject to an allocation, and (ii) coinsurance applies to all types of claims, not just Securities Claims. However, Insureds realize a small benefit regarding the retention if coinsurance rather than predetermined allocation is used, since coinsurance typically applies only excess of the retention whereas predetermined allocation reduces the amount of loss that will deplete the retention.

Methodology. Instead of predetermining the allocation, some policies simply define how the allocation will be determined in a particular case. The alternative methodologies typically included within D&O policies include the following:

One approach is to provide that the parties will commit their best efforts to agree upon a fair and reasonable allocation under the circumstances of each claim. This approach leaves unresolved both what methodology should be used in determining the allocation as well as what the appropriate allocation is. In at least several jurisdictions, this approach will likely result in the pro-Insured "larger settlement rule" applying. That rule generally states that, under a D&O policy issued to a publicly-held company, a joint settlement of a Claim against both Insured D&Os and the uninsured company shall be entirely allocated to the Insured D&Os except and to the extent the settlement is larger as a result of the uninsured company being a defendant.[1] *However, this approach creates the greatest amount of uncertainty regarding allocation and thus will likely engender the most disputes between the Insureds and the Insurer under D&O policies issued to publicly-held companies.*

Another defined methodology is to allocate based upon the relative legal and financial exposures of and relative benefits to the parties. This methodology is generally viewed as most favorable to the Insurer and requires the parties to examine not only the factual and legal strengths and weaknesses of the case, but also the financial impact and collectability of the defendants and the benefits derived by each defendant from the settlement or defense. Several newer D&O policy forms are adopting this methodology.

As somewhat of a compromise methodology between the pro-Insured "larger settlement rule" and the pro-Insurer relative benefits methodology, some Insurers provide in the policy that the allocation will be based upon the "relative legal exposures" of the parties. This type of methodology excludes as irrelevant any consideration of the relative benefits and financial implications of the defense or settlement. Instead, the allocation analysis is based only on the strengths and weaknesses of the plaintiffs' legal claims and the defendants' legal defenses. Although D&O policies in the late 1990s frequently adopted this methodology, fewer policies adopt this methodology today.

[1] Based on the proportionate liability concept now applicable to Securities Claims by reason of the Private Securities Litigation Reform Act of 1995, it is doubtful the "larger settlement rule" applies to Securities Claims today.

About the Author:

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