STATE OF NEW YORK
INSURANCE DEPARTMENT
ONE COMMERCE PLAZA
ALBANY, NEW YORK 12257

David A. Paterson
Governor

Eric R. Dinallo
Superintendent

OGC Op. No. 08-10-07

The Office of General Counsel issued the following opinion on October 16, 2008, representing the position of the New York State Insurance Department.

Re: Duty to Defend – Directors' and Officers' Policies

Question Presented:

May a D&O liability policy include a provision that places the duty to defend upon the insured rather than the insurer?

Conclusion:

No, a D&O liability policy may not include a provision that places the duty to defend upon the insured, rather than the insurer.

Facts:

The inquirer reports that she represents ABC Insurance Company (ABC). The inquiry arises from the Department's denial of ABC's "Directors, Officers and Company Liability Insurance Program" filing on the ground that the policy filing specifically places the duty to defend upon the insured rather than the insurer. The relevant language of the policy filing is as follows:

Settlement and Defense

> A. It shall be the duty of the Insureds and not the duty of the Insurer to defend Claims . . . . The insurer shall have the right and shall be given the opportunity to effectively associate with the Insureds in the investigation, defense and settlement of any Claim that appears reasonably likely to be covered in whole or in part hereunder.
>
> B. The Insureds shall not settle any Claim, select any defense counsel, incur any Costs, Charges and Expenses, admit or assume any liability, stipulate to any judgment or otherwise assume any contractual obligation without the Insurer's prior written consent, which shall not be unreasonably withheld. The Insurer shall not be liable for any settlement, Costs, Charges and Expenses, assumed obligation, admission or stipulated judgment to which it has not consented or for which the Insureds are not legally obligated. The Insureds shall not knowingly take any action which increases the Insurer's exposure for Loss under this Policy. Notwithstanding any of the foregoing, if all Insureds are able to fully and finally dispose of, with prejudice, all Claims that are subject to one Retention for an amount not exceeding any applicable Retention, including Costs, Charges and Expenses, then the Insurer's consent shall not be required for such disposition.
>
> C. Subject to Clauses IV.C. and VII.C., the Insurer may pay on behalf of the Insureds, Costs, Charges and Expenses which the Insureds have incurred in connection with a Claim made against them, prior to the final disposition of such Claim. The Insurer shall pay Costs, Charges and Expenses no more than once every 90 days.
>
> The policy filing defines "Costs, Charges and Expenses" as
>
> "reasonable and necessary legal fees and expenses to which the Insurer consents and which are incurred by or on behalf of the Insureds in defending, settling, appealing or investigating any Claim and the cost of appeal, attachment or similar bonds, but shall not include :
>
> 1. salaries, regular or overtime wages, fees or benefit expenses associated with directors, officers or employees of the Company or the Company's overhead expenses; or . . . .

The policy also includes a provision that provides for allocation of defense costs between covered and uncovered loss. That provision reads as follows:

> If both Loss covered by this Policy and loss uncovered by this Policy are incurred, either because the Claim includes both covered and uncovered claims or because it includes both insured and uninsured parties, then the Insureds and the Insurer agree to fairly and reasonably allocate such amount between covered Loss and uncovered loss.

* * *

> Any negotiated, arbitrated or judicially determined allocation of Costs, Charges and Expenses on account of a Claim shall be applied retroactively to all Costs, Charges and Expenses on account of such Claim, notwithstanding any prior advancement to the contrary. Any allocation or advancement of Costs, Charges and Expenses on account of a Claim shall not apply to or create any presumption with respect to the allocation of other Loss on account of such Claim.

Analysis:

The term "duty to defend" is not defined in the New York Insurance Law. Rather, the term was coined by the courts to refer to an insurer's promise, as specified in the policy terms, to defend its insured against claims. See Mayor, Lane & Company v. Commercial Casualty Insurance Company, 169 A.D. 772 at 778 (1st Dep't 1915) (holding that the insurer had the duty to defend where the policy provided that "the Company will, at its own cost, defend such suit in the name and on behalf of the Assured."). See also James M. Fischer, Broadening the Insurer's Duty to Defend: How Gray v. Zurich Insurance Co. Transformed Liability Insurance into Litigation Insurance, 25 U.C. Davis L. Rev. 141, 146-7. Courts have construed policies that provide that the insurer will defend its insured as constituting litigation insurance for the defense of claims that are potentially within the policy's coverage. See, e.g., International Paper Co. v. Continental Casualty Co., 35 N.Y.2d 322, 326 (1974).

"The duty to defend arises whenever the allegations in a complaint against the insured fall within the scope of the risks undertaken by the insurer, regardless of how false or groundless those allegations might be." Seaboard Surety Co. v. Gillette Co., 64 N.Y.2d 304, 310 (1984). And, "[i]f any of the claims against the insured arguably arise from covered events, the insurer is required to defend the entire action." Frontier Insulation Contrs. v. Merchants Mut. Ins. Co., 91 N.Y.2d 169, 175 (1997).

The duty to defend is broader than just an insurer's obligation to pay defense costs. In In re WorldCom, Inc. Sec. Litig., 354 F. Supp. 2d 455 (S.D.N.Y 2005), the court noted that, "the duty to defend customarily includes an insurer's right to choose the attorney and to control the litigation strategy." See also Feliberty v. Damon, 72 N.Y.2d 112, 117 (1988) (noting that the duty to defend includes more than merely designating independent counsel to defend the insured). Indeed, the duty to defend typically includes the duty to investigate a claim and negotiate pretrial settlements. 22-136 Appleman on Insurance § 136.1 (LEXIS 2008).

No New York case has addressed the Superintendent's authority under the Insurance Law to require a D&O policy to place the duty to defend upon the insurer. Rather, the courts have simply interpreted particular policies to determine whether the policy states that an insurer has the duty to defend and whether a particular claim falls within that duty. See, e.g., Seaboard Surety Co. v. Gillette Co., 64 N.Y.2d 304 at 310.

The Superintendent's authority to approve policies, such as the ABC policy, derives from Insurance Law § 2307. That statute reads as follows:

> (b) Except as otherwise provided herein, no policy form shall be delivered or issued for delivery unless it has been filed with the superintendent and either he has approved it, or thirty days have elapsed and he has not disapproved it as misleading or violative of public policy. After notice and hearing to the insurer or rate service organization which submitted a policy form for approval, the superintendent may withdraw approval of such form on finding that the use of such form is contrary to the legal requirements applicable at the time of withdrawal. The effective date of the withdrawal of approval shall be prescribed by the superintendent but shall be not less than ninety days after notice of withdrawal. (Emphasis added.)

A D&O policy is a form of personal injury liability insurance that is authorized by Insurance Law § 1113(a)(13). Insurance Law § 1113(a)(13) defines "personal injury liability insurance" as "insurance against legal liability of the insured, and against loss, damage or expense incident to a claim of such liability . . . arising out of injury to the economic interests of any person, as the result of negligence in rendering expert, fiduciary or professional service . . . ."

It has long been the Department's view that the phrase "loss, damage or expense incident to a claim of such liability" in Insurance Law § 1113(a)(13) includes the cost of defending against a claim covered by the policy. See Opinion of Office of General Counsel ("OGC") No. 06-05-04 (May 9, 2006). By the plain terms of Insurance Law § 1113(a)(13), the conjunctive "and" links personal injury liability insurance to incidental losses, damages, or expenses. For this reason, the Department requires personal injury liability insurance coverage, including D&O insurance, to include coverage for legal defense costs associated with a covered claim. Defense-only coverage is not permissible as liability insurance, but is separately authorized as legal services insurance. See Insurance Law § 1116; see also OGC Opinion No. 06-05-04 (May 9, 2006).

Insurance Law § 3420, which sets forth provisions that an insurer must include in its liability insurance policies, also bolsters the Department's conclusion. Three of the required provisions evidence a New York public policy to protect a potential liability policy claimant from being denied compensation under the policy due to failings of the insured. Insurance Law § 3420(a)(1) requires a provision stating the insolvency or bankruptcy of the insured shall not release the insurer from its obligation to pay covered claims. Insurance Law § 3420(a)(2) requires a provision stating that an action may be maintained against the insurer for the payment, within policy limits, of a judgment for a covered claim that has not been satisfied within thirty days from the service of notice of entry of judgment upon the insured's attorney or both the insured and the insurer. Further, Insurance Law § 3420(a)(3) requires that notice by the claimant to any licensed agent of the insurer in this state shall constitute notice to the insurer. Thus, if an insured were to fail to satisfy its duty to defend to the satisfaction of the insurer or obtain all of the necessary approvals and the insurer were to try to disclaim liability under the policy, that result would run contrary to Insurance Law § 3420, which establishes that the insurer be directly responsible for paying claims on behalf of the insured.

N.Y. Comp. Codes R. & Regs. tit. 11, Part 71 (Regulation 107) also is relevant to the inquiry. That regulation demonstrates, with respect to personal injury liability insurance coverage, that the insurer bears the duty to defend and that the duty to defend entails more than simply paying defense costs. Specifically the regulation contemplates that the insurer "provide a proper defense." 11 NYCRR § 71.0(d)(1) states, in pertinent part, as follows:

> [T]he insurer generally has a duty to defend any liability suit coverage under the policy in which damages are sought. This duty to defend typically has been separate and apart from the obligation to pay damages under the policy and, accordingly, the insurer must provide a proper defense regardless of cost . . . .

Pursuant to 11 NYCRR § 71.2(a), a liability policy may not contain any provision that limits the availability of legal defense costs (except as otherwise provided for elsewhere in Part 71). That regulatory provision reads as follows:

> (a) No liability insurance policy, except as specified in this Part, shall be issued or renewed in this State containing a provision that:
>
> (1) reduces the limits of liability stated in the policy by legal defense costs;
>
> (2) permits legal defense costs to be applied against the deductible, if any; or
>
> (3)otherwise limits the availability of coverage for legal defense costs.

11 NYCRR § 71.1(a) defines "legal defense costs" as "allocated attorney and all other litigation expenses that can be separately identified as arising from the defense of a specific claim."

A policy that places the duty to defend upon an insured would run afoul of Regulation 107 because it would limit the availability of coverage for legal defense costs. By placing the duty upon the insured, the policy would condition defense cost coverage upon the insured taking charge of the defense. And, even where, as is the case with the proposed ABC policy, the policy provides coverage for attorneys' fees and other direct costs of litigation, the insurer transfers to the insured the insurer's duty to absorb the administrative costs of litigation, such as the cost of managing, controlling and otherwise overseeing the litigation. The ABC filing, in particular, excludes any coverage for compensation to directors, officers or employees of the insured, thereby negating any defense cost coverage for representation by the insured's in-house counsel.

Although the inquiry concerns the duty to defend, the Department notes that the ABC policy also limits the availability of coverage for legal defense costs by providing allocation of defense costs between covered and noncovered matters. As noted above, where the insurer has the duty to defend, in an action in which at least one claim may possibly fall within the coverage, the insurer has the duty to defend all claims in the action. Clearly, the cost allocation provision of the ABC policy affords less defense costs coverage to the insured than a policy under which the insurer bears the duty to defend. Moreover, Regulation 107 does not authorize any allocation of defense costs. Given these circumstances, the Department will not approve such a provision.

The inquirer cites 11 NYCRR § 71.3(c) to argue that Regulation 107 contemplates an insured having the duty to defend. That regulation requires that a policy that exceeds the 50% limitation specified in 11 NYCRR § 71.3(a) and (b) for application of defense costs against the limits of liability or deductible, respectively, vests in the insured certain rights to assist in the defense of a claim. These rights include the right of the insured to select the defense attorney or to consent to the insurer's choice of attorney; participate and assist in the direction of the defense of a claim; and consent to settlement. See 11 NYCRR § 71.3(c). But by specifying these rights, the regulation does not contemplate the duty to defend being placed upon the insured. Rather, the regulation's purpose is to protect an insured who might otherwise have little or no input over how legal defense costs were spent by an insurer with the duty to defend, but who may nevertheless bear a part of that expense. See 11 NYCRR § 71.0(d)(2).

The inquirer also asserts that sophisticated insureds prefer to bear the duty to defend as a means to control the litigation. However, Regulation 107 does not limit the extent to which a liability policy may afford participation rights to an insured, provided that the insurer retains the duty to defend. Thus, subject to the minimum requirements of Regulation 107, the Department conceivably would approve a policy filing under which the insured has an option to exercise some degree of control over or significant participation in the defense of a claim, provided that the insurer maintains the ultimate duty to defend. In any event, that the insured would have control over the litigation simply by virtue of having the duty to defend is negated by the terms of the ABC filing, which significantly limits an insured's actual control of the litigation by requiring that the insured obtain prior written permission from the insurer prior to taking such actions as settling a claim, selecting defense counsel, incurring any costs, charges and expenses, or admitting or assuming any liability.

Finally, contrary to the inquirer's assertion, the Department's view that a D&O insurer must bear the duty to defend is not "primarily based upon the [L]egislature's failure to pass legislation that would have addressed the defense obligation under directors' and officers' liability policies by exempting them from the requirement that the insurer have the duty to defend the insureds."[1] Rather, the Department's position springs from the reasons set forth above. Further, although the Department supported passage of such an amendment, the Department may not now enforce the Insurance Law as if the Legislature had passed it.

Nor, as the inquirer claims, has the Department had a longstanding position that an insurer may place the duty to defend upon the insured. Except for a short period of time many years ago during which the Department approved some policies that placed the duty to defend upon the insured pursuant to a draft regulation attached to Circular Letter No. 8 (1997), the Department maintained that liability insurers bear the duty to defend. Moreover, the Department withdrew that circular letter, effective October 11, 2002, after a full scale review of all of the Department's circular letters to identify any circular letters that were not consistent with Department policy and practice. See Department Circular Letter No. 1 (2001). And, the Department never promulgated the draft regulation attached to Circular Letter No 8 (1997). Indeed, the provision in the draft regulation that contemplated allowing an insurer to place the duty to defend upon its insured is, upon close inspection, inconsistent with the Insurance Law.

For further information you may contact Senior Attorney Brenda M. Gibbs at the Albany Office.

---

[1]The Department presumes that the inquirer refers to several bills that were introduced for the Department between 1995 and 1999 that

would have exempted D&O policies from the duty to defend requirement. See, e.g., S. 5431, 218th Sess. (N.Y. 1995).