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Dealing With Divergent Interests Among Defense Counsel, the Primary Insurer and Excess Insurers in Complex Litigation Involving Directors and Officers

by Joseph P. Monteleone

At least in theory, defense counsel and the various insurers in complex litigation involving directors and officers and the companies they serve should all align on the same side adverse to the plaintiffs in the case. While that oftentimes is initially the dynamic that takes place, interests frequently diverge as the litigation progresses.

In this article, we will explore various reasons why this divergence occurs, why it is in some sense understandable, and what excess insurers can do to protect their legitimate interests in achieving a fair and reasonable outcome.

At the outset of litigation, the defense perspective is typically the rosiest, and that usually includes the perspective of the insurers. That is not necessarily because defense counsel has an agenda to deceive or that insurers are inherently gullible. Rather, it is human nature to have an initially strong defense reaction and not readily perceive certain strengths in the plaintiff's case. Certainly there are cases with bad facts and unhelpful law that may warrant an attempt at an early settlement. Even in those cases, however, it is reasonable to try to extract a considerable discount from the plaintiffs in terms of settlement amount because they are buying certainty and saving much time, effort and expense on their side.

Putting those cases identified for early settlement aside, defense counsel and insurers will typically plan for a vigorous defense with the goal of an early win through a successful motion to dismiss or motion for summary judgment. Settlement is usually not considered until such motions have at least been filed, and settlement discussions then frequently take place under the auspices of a mediator. Unless the insurers have some coverage defense that they believe eliminates all defense coverage, as well as for judgment and settlement amounts, they will be part of this cohesive defense effort. Indeed, once a self-insured retention or deductible amount under the policy is fully exhausted, it is the insurers that will be funding the defense effort and any settlement as long as there are no coverage limitations.

When and how do these interests begin to diverge? Let's examine each of the constituents separately.

Defense Counsel and their Clients

Let us assume that all of the clients and their counsel have identical interests, although that is frequently not the case. For example, where an officer is under criminal investigation and facing a potential indictment, he or she is probably equally or even more concerned with personal liberty interests than with potential civil liability. Indeed, there have been situations where insurance is exhausted and the individual must bear criminal defense costs out-of-pocket and uninsured.

As a matter of legal ethics, there should never be differing interests between defense counsel and their clients. If there is such a potential, defense counsel must always subsume its interests to those of the client. That being said, here are some caveats to bear in mind:

- Defense counsel's goal should always be to successfully defend the litigation, even if a successful defense ultimately leads to a settlement.
- As virtually all D&O policies for publicly traded companies are *not* written with a duty to defend, defense counsel owes few, if any, formal duties to the insurer.
- Defense counsel needs to be cognizant of both the amount and scope of available insurance, including the fact that defense expenses typically erode the available limits of liability under a D&O policy.

- The D&O policy is not a blank check to be drawn as necessary to satisfy any and all legal expenses and settlement and judgment amounts.
  - Insurers are only liable under the policy and at law to pay legal fees and costs that are necessary, reasonable and covered under the policy. This protects not only the insurers' own legitimate interests, but also the interests of all insureds under the policy, particularly those that are striving to contain costs and preserving limits for a potential settlement or judgment.
  - Insurers only need to consent to a reasonable settlement that is well-supported by causation, liability and damages analyses, which should be undertaken by defense counsel and presented to the insurers before seeking their consent to settle.
- There is nothing *per se* objectionable in counsel attempting to extricate its clients from the litigation without any monetary exposure to them. This may mean pressuring the insurers to pay whatever is necessary to settle the case. Indeed, counsel probably has an ethical obligation to its clients to pursue this course, even though insurers may have valid objections to defense expenses and settlement amounts that are unreasonable.
- Defense counsel should never prolong litigation or incur unreasonable expenses that may ultimately be to the detriment of their client, particularly if the insurance limits may become exhausted due to protracted litigation and unreasonable defense expenditures.

Primary Insurer

In some situations, the primary will have the same interests as those of the excess insurers.

However, it frequently becomes apparent at some point in the litigation process that any combination of defense expenses and a settlement amount will exhaust the primary insurance. Indeed, it is not unusual in securities fraud class actions and other complex litigation for a primary policy with a limit of liability of $10M or even $25M to become exhausted by defense costs alone.

When exhaustion becomes an apparent inevitability, litigation dynamics can change drastically and a primary insurer may lose its incentive to vigorously contest certain coverage issues or to carefully scrutinize defense invoices for coverage, reasonableness and necessity before paying. Although a detailed discussion of potential remedies for excess insurers to protect themselves from abuse of the process is beyond the scope of this article, there is sometimes little in the way of practical leverage that can be exercised by an excess insurer to protect its interests from the primary insurer's conduct.

How can one tell when a primary insurer is simply "going through the motions"? The following may be some signs of this, although there may be other reasons for these actions:

- The insurer drops its outside coverage counsel and takes the matter completely in-house.
- The insurer and its outside counsel stop participating in insurer and defense counsel conference calls.
- The primary insurer declines to attend mediations or other sessions where it would typically want to be actively involved.

The best advice for excess insurers upon seeing a primary insurer simply "going through the motions" because it wants to quickly exhaust and put the matter behind them is to become proactive in the litigation from the outset by asking to see all defense invoices and objecting to any inappropriate items. The excess must also remain actively involved in all strategic and other periodic status discussions with defense counsel.

It is not only excess insurers, however, that should be rightfully aggrieved by this type of conduct by a primary insurer. Where there are multiple insured defendants represented by multiple counsel, each counsel must look beyond its own interests and appropriately object to unreasonable and unnecessary defense expenditures that reduce the available limits for all insureds.

In major litigation a few years ago, a somewhat novel approach was applied and worked well and fairly. Coverage counsel for the primary insurer reviewed all defense bills and made appropriate recommendations to the primary insurer for reductions. When it became apparent that the primary limits would exhaust no matter what, coverage counsel continued to vigorously review defense bills, but it tendered the invoices for its services to the first layer excess insurer because that was the layer that had the most to benefit from its services.

Excess Insurers

Frequently, excess insurers find themselves as the only parties with a real interest in vigorously defending the litigation and/or achieving a reasonable settlement. As discussed above, this occurs because the primary insurer has concluded that there is no scenario for it to save anything off its policy limits and defense counsel are focused solely on having the litigation settled with insurance company money. While these may each be legitimate interests, excess insurers can and should take steps to protect their own legitimate interests.

Perhaps the best way to undertake a vigorous defense and counter the plaintiff's theories of causation, liability and damages is to engage an independent expert to assist the defense.

Ideally, the expert will be retained through defense counsel and the insureds will become its clients. This will afford maximum protection to the expert's work product with privilege and confidentiality arguments.

However, where defense counsel resist the retention of such an expert, excess insurers have so retained and should consider retaining the expert solely on behalf of themselves. They will need to work out with defense counsel what information and documents can be provided to the expert, but having such an expert available to participate in mediations and otherwise in support of settlement negotiations can be invaluable in controlling settlement values.

Such experts can often play a very effective role in shareholder derivative and other litigation that is premised upon allegations of mismanagement, breach of fiduciary duty and/or business judgment rule defenses. This is certainly not to denigrate the role of such prominent experts as Cornerstone or NERA. Their expertise, however, lies more in the realm of securities class action litigation and assessing ranges of damages in those cases. Corporate governance is typically not directly at issue in those cases, but in cases where corporate governance issues are paramount, which is often the case in shareholder derivative or creditor litigation, it behooves the defendants and their insurers to have in place experts who can tell a story to rebut the allegations of the plaintiffs and any expert it may have on its behalf.

An interesting example of the work of such an expert was that of H.S. Grace & Company, Inc. in the well-known Walt Disney Shareholder Derivative Litigation (the hiring and the subsequent termination of Michael Ovitz), where they were a consulting expert retained by the primary D&O insurer and its outside counsel to review the record and advise on corporate governance issue with a view toward reducing the potential settlement value of the case. In denying the defendants' Motion to Dismiss, the Court delineated the task ahead for the defendants, their insurers and any consulting or testifying experts as follows:

> Stated briefly, plaintiffs' new allegations give rise to a cognizable question whether the defendant directors of the Walt Disney Company should be held personally liable to the corporation for a knowing or intentional lack of due care in the directors' decision-making process regarding Ovitz's employment and termination. It is rare when a court imposes liability on directors of a corporation for breach of the duty of care, and this Court is hesitant to second-guess the business judgment of a disinterested and independent board of directors. But the facts alleged in the new complaint do not implicate merely negligent or grossly negligent decision making by corporate directors. Quite the contrary; plaintiffs' new complaint suggests that the Disney directors failed to exercise any business judgment and failed to make any good faith attempt to fulfill their fiduciary duties to Disney and its stockholders. …In short, the new complaint alleges facts implying that the Disney directors failed to "act in good faith and meet minimal proceduralist standards of attention."

The work of the expert in Disney enabled the primary insurer to convince the defendants that they could reasonably argue that Disney had a well-accepted compensation culture that was adhered to in its hiring of Ovitz; that the negotiating team consisted of the Chair of Disney's Compensation Committee and a second committee member, both of whom were quite knowledgeable of Disney's compensation culture; and that over 50% of Ovitz's termination compensation arose from the 25% increase in Disney's stock price during Ovitz's 15 month tenure. The litigation ultimately proceeded to a trial on the merits and the Court entered judgment in favor of the Disney Defendants on all claims, pointing out that "what" they did was sufficient at the end of the day to carry the day, although "how" and "why" they did "what" they did left much to be desired.

The author previously used this same corporate governance expert on behalf of a primary insurer in a complex mediation, and recently had an opportunity to work together with them in a situation where creditors of a bankrupt company had made claims against the former directors and officers of that company alleging mismanagement that allegedly led to the demise of the company to the financial detriment of the creditors.[1]

In that most recent case, the insureds' defense counsel were anxious to conclude a settlement with the creditors that would have been funded entirely with insurance proceeds. The claim, however, was in its very early stages, and in fact no formal complaint had been filed in litigation. The creditors and the insureds simply proceeded directly into mediation with only a draft complaint articulating the claims of the creditors. The creditors' claims were arguably supported by the potential testimony of a restructuring company that was retained by the creditors shortly before the bankruptcy ensued. The chief restructuring officer interestingly was now running the company in bankruptcy, and his testimony would be largely self-serving in support of his recommendation that pursuit of additional financing was futile and that a bankruptcy petition was the only viable option.

The insureds' counsel balked at the suggestion of retaining an expert to counter the views of the restructuring officer, who had been allowed to attend a preliminary mediation session and make his views known to the mediator. Ultimately they acquiesced when the excess insurers, and in particular the insurer represented by the author, threatened to withhold consent to any settlement that took place premised solely on the demands of the plaintiff lawyers and the views of the restructuring officer. Although the consultant never was able to give formal testimony or make a formal presentation, the fact that there was a potential expert ready, willing and able to tell an alternative tale of management decision-making was likely instrumental in convincing the defense counsel of the resolve of the excess insurers and getting the ultimate settlement value reduced by about 40%.

In conclusion, more of the actions discussed in this article need to be done to counter the upward spiral in settlement values and defense costs, especially in the area of shareholder derivative actions and creditor claims. Ideally, insurers will convince the insured defendants and their counsel to directly retain the corporate governance expert on a consulting or testifying witness basis. If not, as discussed above, there can still be much value gained by the insurers in independently retaining the expert.

Endnote

1 Just as this article is not meant to denigrate pre-eminent damages and settlement valuation experts such as NERA and Cornerstone, it is also not intended to be an advertisement for H.S. Grace & Company, Inc. The author merely uses their work as illustrative examples of what a corporate governance expert can do because they are the experts with which he is most and directly familiar.

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