When does an insured forfeit coverage under a professional liability, fiduciary liability, or Directors and Officers Liability ("D&O") insurance policy by settling a lawsuit without first obtaining its insurers' consent? Three 2008 appellate cases examined this question. The three cases reached differing results in terms of coverage, but those results are easily harmonized. Together, the three cases teach lessons valuable for both policyholders and insurers.

SOME GENERAL PRINCIPLES

Typical D&O, business professional liability, and fiduciary liability insurance policies do not impose on the insurer a duty to defend claims against the insured. The policies usually require only that the insurer indemnify the insured for loss incurred, including defense costs, with most policies today requiring the insurer to advance defense costs. Some policies may provide the insurer with the right, but not the obligation, to assume the defense.

Most policies contain a provision requiring the insurer's consent to settlements, and therefore policyholders risk losing coverage if they do not seek their insurers' consent to a proposed settlement. On the other hand, insurers do not have veto power over reasonable deals that they consider too rich. Policyholders that cooperate meaningfully with their insurers may enter reasonable settlements over insurers' objections, as shown in the one 2008 appellate case in which consent was sought and refused. A policyholder does not automatically forfeit coverage if, in the exercise of its judgment, it accepts a settlement over its insurers' objection, especially when insurers hinder the policyholder's legitimate settlement efforts prior to and during a trial in which the policyholder faces significant liability. Also, where an insurer has fully denied coverage, insureds in many states may settle claims without that insurer's consent.

Several recent decisions deal with these issues.

THE *BEAR STEARNS* CASE

In *Vigilant Ins. Co. v. The Bear Stearns Cos.*, 10 N.Y.3d 170 (2008), the Court of Appeals of New York (New York's highest court) held that Bear Stearns lost coverage by failing to comply with a consent-to-settle provision. Vigilant issued Bear Stearns a primary professional liability policy that attached above a $10 million self-insured retention. Federal and Gulf issued follow-form excess policies providing additional coverage.

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by Bernard P. Bell

Bear Stearns had sought coverage for underlying claims involving SEC, NASD, and NYSE investigations into the practices of research analysts. Bear Stearns signed a settlement in principle and later a consent agreement agreeing to pay $80 million to settle the claims. Bear Stearns did not request consent from its insurers until three days *after* executing the consent agreement.

The policies provided that:

> The Insured agrees not to settle any Claim, incur any Defense Costs or otherwise assume any contractual obligation or admit any liability with respect to any Claim in excess of a settlement authority threshold of $5,000,000 without the Insurer's consent, which shall not be unreasonably withheld … . The insurer shall not be liable for any settlement, Defense Costs, assumed obligation or admission to which it has not consented.

The court held that Bear Stearns forfeited its coverage by not informing the carriers of the settlement until after the fact. The court reasoned:

> As a sophisticated business entity, Bear Stearns expressly agreed that the insurers would "not be liable" for any settlement in excess of $5 million entered into without their consent. Aware of this contingency in the policies, Bear Stearns nevertheless elected to finalize all outstanding settlement issues and executed a consent agreement before informing its carriers of the terms of the settlement. Bear Stearns therefore may not recover the settlement proceeds from the insurers.

The court of appeals rejected Bear Stearns' argument that the consent agreement was not a settlement within the meaning of the policy because it was still subject to court approval. Having signed the consent agreement, Bear Stearns was not free to walk away.

THE *ARTHUR ANDERSEN* CASE

In a second case, the Seventh Circuit Court of Appeals also held that a policyholder's failure to consent precluded coverage. In *Federal Ins. Co. v. Arthur Andersen LLP*, 522 F.3d 740 (7th Cir. 2008), a number of retired Andersen partners sued Andersen after it discontinued its practice of disbursing lump sums from its pension plan on request. Andersen notified its primary fiduciary liability insurer, Federal, that Andersen had been sued and had hired defense counsel. Federal reserved its rights and requested further information, which Andersen provided. Andersen proposed a $75 million payout to retirees and *then* asked Federal to contribute its $25 million in limits. Federal refused to contribute, and Andersen settled as it had proposed.

A clause in the policy committed Andersen not to settle any claim for more than $250,000 without Federal's "written consent, which shall not be unreasonably withheld." The Seventh Circuit found that Federal did not owe Andersen coverage for the settlement, for several reasons, including that Andersen lacked the consent of its insurers. "Arthur Andersen didn't ask for the consent or even the comments of its insurers; it presented the deal to them as a *fait accompli.* By cutting Federal Insurance out of the process, Arthur Andersen gave up any claim to indemnity."

Andersen argued that Federal's failure to take action during the pendency of the claim estopped Federal from relying on the consent clause as a defense. The court rejected this argument, holding that estoppel would not apply in cases in which the insured indicates that it does not want the insurer's assistance or is unresponsive to or uncooperative with the insurer's legitimate requests for information.

THE *BERNARD SCHWARTZ (GLOBALSTAR)* CASE

The policyholder fared better in *Schwartz v. Liberty Mut. Ins. Co.*, 539 F.3d 135 (2d Cir. 2008). The Second Circuit Court of Appeals there found that the policyholder had not forfeited his right to coverage by requesting, at 10:00 p.m. on a Sunday night, consent to settle a trial that was set to resume at 9:00 a.m. on Monday morning. This description makes *Schwartz* sound very similar to *Bear Stearns* and *Andersen*, but the differences in the policyholders' behavior and the nature of the insurers' involvement in these cases are revealing and important.

Schwartz was CEO of Globalstar, a company in the satellite telephone business. Globalstar's technology fizzled, and Globalstar and Schwartz soon became defendants in a securities class action, of which Globalstar timely notified its D&O insurers before filing for bankruptcy. The $10 million primary layer of D&O insurance was written by Twin City, and several excess carriers provided $5 million layers above that.

The insurance contracts required the insureds to obtain the insurers' consent before entering into a settlement.

Globalstar's insurers took an active role in the securities litigation—monitoring the claims, evaluating settlement possibilities, participating in settlement negotiations, and watching the trial. These insurers participated in three mediation sessions between Schwartz and the plaintiffs. Schwartz and the excess carriers thought a settlement of $12 million to $13 million was reasonable, but the primary carrier, Twin City, would not agree. The insurers collectively pressured Schwartz to move for summary judgment even though the settlement value of the case would increase if he lost. After Schwartz filed the summary judgment motion, the plaintiffs offered to settle for $15 million but said the settlement value would rise if the court denied the motion or the case went to trial. Schwartz sought the insurers' consent to a $15 million settlement, but the insurers refused to fund it. Twin City never authorized Schwartz to offer more than $5 million of its $10 million limit toward settlement.

Trial began, and the plaintiffs were presenting evidence in support of a damage award of $600 million to $800 million. In a settlement conference during trial, the trial judge advised the insurers that the case would go to the jury and that a plaintiffs' verdict could be eight or nine figures.

After two weeks of trial, Schwartz was scheduled to testify on Monday, July 18, 2005. On Saturday, July 16, 2005, defense counsel learned, and notified the insurers, that the plaintiffs would accept $20 million to settle. At 10:04 p.m. on Sunday evening, defense counsel sought the insurers' consent to settle at that figure. Defense counsel offered to discuss the settlement with the insurers that night or before 9:00 a.m. the next morning. None of the implicated insurers consented to the settlement. Nonetheless, Schwartz settled the case on Monday morning for $20 million, which he paid by personal check.

The insurers contended that the settlement was not covered because it was unreasonable, because they had not consented to it, and (in respect of the excess carriers) because the underlying primary carrier had not paid its limits.

Schwartz then sued the insurers. The jury awarded Schwartz full coverage and found that his failure to obtain the insurers' consent did not bar coverage for the settlement because the insurers breached their duties of good faith and fair dealing. The jury imposed a bad faith judgment against the primary carrier, holding it liable for its $10 million limit, plus the difference between the $15 million settlement offer and the $20 million settlement. But the court dismissed the bad faith claims after post-trial briefing.

The Second Circuit (applying California law) upheld the jury verdict in favor of Schwartz, holding that: (1) the insurers had an adequate opportunity to consider and evaluate settlement opportunities; (2) the $20 million settlement was reasonable; and (3) the insurers unreasonably withheld their consent. The insurers argued that the court should have focused the jury's attention exclusively on the 11 hours, starting at 10:04 p.m. on Sunday night, that defense counsel gave the insurers to consent to the settlement. But the Second Circuit held that the insurers' opportunity to consider settlement extended "over a prolonged course of consultation, monitoring and negotiation, so that the settlement was in the nature of anticlimax rather than surprise."

The *Schwartz* outcome may have been influenced by the fact that Schwartz paid the $20 million settlement with a personal check. Obviously, Schwartz accepted defense counsel's view that the settlement was reasonable. The jury's verdict also reflected a view that the primary insurer and not the excess carriers should have borne the consequences of failing to settle at $15 million. The primary carrier escaped without extracontractual liability, but only because of a complex choice-of-law ruling by the Second Circuit.

A FEW LESSONS

The obvious lesson from *Bear Stearns* and *Andersen* is that, absent exigent circumstances or very favorable or manuscripted policy language as to consent, policyholders jeopardize their coverage if they do not attempt to obtain their insurers' advance consent to a proposed settlement.

But a corollary lesson, underscored by the *Schwartz* case, is that insurers do not have veto power over reasonable settlements and that they act at their own peril when they frustrate legitimate settlement negotiations by taking unreasonable positions or asserting objections that in retrospect appear unjustified or contrary to the insured's interests. The holding in *Schwartz* shows the wisdom for policyholders

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in maintaining regular communication with insurers and responding timely to legitimate information requests.

Even after *Bear Stearns*, *Andersen*, and *Schwartz*, there remains no reported decision upholding as reasonable an insurer's refusal, under a D&O or similar fiduciary or management liability policy, to consent to settlement of a covered claim merely because the insurer believes the deal is too rich. The *Schwartz* opinion is the latest in a body of authority establishing that insurers that reserve their rights do not have the unilateral power to reject a reasonable settlement of underlying litigation. When insurers reserve rights, insureds are "allowed to take reasonable measures to defend themselves, including settlement." *Sun-Times Media Group, Inc. v. Royal & SunAlliance Ins. Co. of Canada*, C.A. No. 06C-11-108 RRC, 2007 WL 1811265 (Del. Super. June 20, 2007) (citation omitted).

Finally, *Schwartz* illustrates how risky it is for excess carriers to hide behind the intransigence of a primary carrier. In retrospect, the excess carriers in *Schwartz* may have been better served by helping the policyholder fund a $15 million settlement than by withholding their consent merely because the primary carrier refused to pay its limits. Courts will not interpret policies "to permit an excess insurer to hover in the background of critical settlement negotiations and thereafter resist all responsibility on the basis of lack of consent." *Fuller-Austin Insulation Co. v. Highlands Ins. Co.*, 135 Cal. App. 4th 958, 38 Cal. Rptr. 3d 716 (Ct. App. 2d Dist.), *cert. denied*, 549 U.S. 946 (2006). ■

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