

**A GRAND JURY INVESTIGATION AS
A CLAIM UNDER A DIRECTORS &
OFFICERS POLICY
AND
THE ALLOCATION OF DEFENSE COSTS
UNDER A DIRECTORS & OFFICERS
POLICY WHEN AN OFFICER IS THE
TARGET OF A GRAND JURY
INVESTIGATION**

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I. INTRODUCTION

Officers and directors, as representatives of the corporate entity, often find themselves as defendants in a lawsuit, or sometimes even the target of a criminal investigation. To entice qualified persons to assume such corporate roles, officers and directors are indemnified for the defense costs of actions which arise simply because of their activities as officers and directors. To finance this indemnification and to indemnify directors and officers for losses for which they are not indemnified by their corporations, corporations often purchase a directors and officers insurance policy ("D & O Policy").

Simply purchasing a D & O Policy, however, does not solve all liability problems for a corporation. In fact, the very nature of a D & O Policy can create multiple coverage and allocation issues since these policies do not insure the corporation itself against its own liabilities or defense costs. The following fact scenario will illustrate some of the problems faced by a corporation and its insurer in allocating defense costs when a corporate officer is the subject of a grand jury investigation.

II. FACT SCENARIO

Bullets 'n Stuff, Inc., a subsidiary of the food giant Red Hot Chili Pepper Sauce Incorporated, designed and marketed a new bullet, the BloodMaster Special, as part of a Department of Defense competition. The competition's goal was to develop the deadliest bullet in the world. The fierce competition among the major ammunition manufacturers was spurred not only by the promise

of a lucrative Department of Defense contract, but the lure of an untapped civilian market for explosive bullets.

The BloodMaster Special project was headed by a young Vice-President, Connie Cannon, hell-bent on making a name for herself in the Bullets 'n Stuff organization. Bullets 'n Stuff promised young Cannon a \$10,000 bonus and promotion to Executive Vice-President if the company entry won the competition. While the project got off to a quick start, Cannon and her development team encountered a serious set-back -- the explosive chosen for the bullet's explosive tip was unstable. With the competition deadline drawing near, Cannon decided to deviate from the standard test result format so as to conceal the bullet's unstable characteristics.

Bullets 'n Stuff and the other competitors submitted their test results before the live fire demonstration. At the carefully controlled live fire demonstration, the BloodMaster Special performed flawlessly and was named winner on the spot. An order for 50 million rounds of the BloodMaster Special was inked within days.

After 10 million rounds had been produced, the Department of Defense realized that the bullets were too unstable for military use. Chemical analysis soon revealed that the instability of the bullet was caused by the explosive used -- Louisiana Hot Sauce. While it had been rumored that this dangerous concoction had once been used by the East Germans, it had been banned from the arsenals of most developed countries.

The authorities quickly obtained by subpoena all test results from the offices of Bullets 'n Stuff. Within days, Connie Cannon became the subject of a grand jury investigation. Even though no formal charges or claims had been asserted against Bullets 'n Stuff or Cannon, the company hired a law firm to protect the interests of the company and Cannon. The company agreed to advance Cannon's attorney fees upon her agreement to repay the company for the law firm's fees if she ended up being convicted of criminal wrongdoing. The law firm began its representation of the company and Cannon by thoroughly investigating the test reporting procedures of Bullets 'n Stuff. A written report of its findings was issued to the Board of Directors.

Inexplicably, the grand jury did not recommend bringing criminal charges against Cannon. While Bullets 'n Stuff had notified their D&O insurer of Cannon's actions and resultant legal problems, no demand for payment under the D&O Policy was made until after it became clear that no charges would be brought against Cannon. Eventually, Bullets 'n Stuff demanded payment of all the charges incurred by the law firm (including fees for preparing the report). The insurer denied any payment of the law firm's bills on two grounds: (1) the defense of the grand jury investigation and potential criminal charges was not a "claim" under the policy and (2) some of the work done by the law firm appeared to benefit the corporation more than the officer.

III. ANALYSIS

A. "Claim" in a D&O Policy

The first issue is to determine whether a grand jury investigation constitutes a "claim" under the D & O Policy. The term "claim" is rarely defined in an insurance policy. There are very few cases on what constitutes a "claim", however the intent of this paper is to substantiate the argument in favor of coverage on behalf of Cannon and Bullets 'n Stuff. Generally what constitutes a "claim" is ascertained from the wording of the policy and the actual facts involved. The lead case which would afford coverage under the D&O policy is Polychron v. Crumb & Forster Insurance Co., 916 F.2d 461 (8th Cir. 1990). In Polychron, the Eighth Circuit held that under Arkansas law, legal fees incurred by a bank officer during a grand jury investigation of the officer's activities was covered by the bank's D&O policy. Additionally, a grand jury subpoena and resulting investigations were "claims" under the D&O policy and the legal fees incurred therefrom constituted a covered "loss." The insurer in Polychron argued that defense of a criminal matter is not a covered loss since that policy excluded "fines or penalties imposed by law". However, the court rejected this argument, and concluded that attorneys' fees incurred in defense of a criminal matter, at least where the insured was acquitted, was a covered loss. Polychron, 916 F.2d at 464.

Additionally, the Polychron court specifically held that, under Arkansas law, the term "claim" encompassed a grand jury investigation of a bank director. The Court further stated that

since the function of a subpoena is to command a party to produce certain documents, the subpoena therefore constitutes a "claim" against a party. The Court held that even though the subpoena was directed to the Bank, the documents demanded related to the director's conduct as a bank official.

B. Allocation of Defense Costs

After establishing a "claim" on the strength of Polychron, Bullets 'n Stuff now must hurdle the insurer's argument pertaining to the allocation of defense costs.

There is very little dispute that while an insurer under a D&O Policy is required to pay directors' and officers' defense costs, the insurer may not be required to pay that portion of costs attributable solely to the corporation's defense. See, PepsiCo, Inc. v. Continental Casualty Company, 640 F.Supp. 656, 666 (1986); Health-Chem Corporation v. National Union Fire Insurance Co., 559 N.Y.S.2d 435 (1990). The battle lines are drawn, however, when determining which costs are attributable to the corporation's defense and which are attributable to the director's and officer's defense. The allocation of defense costs is rarely subject to a motion for summary judgment. See, eq., Reliance Group Holdings, Inc. v. National Union Fire Insurance Co., 594 N.Y.S.2d 20 (A.D. Dept. 1 1993).

The most common method of allocating defense costs between covered and non-covered claims and parties is the "reasonable relation" test. See, Burlington Drug Co. v. Royal Globe Insurance Co., 616 F.Supp. 481 (D.C. Vt. 1985); Potomac

Electric Power Co. v. California Union Insurance Co., 777 F.Supp. 980 (E.D.C. 1991); Budd Co. v. Travelers Indemnity Co., 820 F.2d 787 (6th Cir. 1987). The "reasonably related" test can be traced to Continental Casualty Company v. Board of Education, 489 A.2d 536 (Md. 1985). In Continental Casualty, certain claims against officers and directors were found to have been covered under the D&O Policy, and other claims against the same persons were found to be non-covered. In determining the standard for apportioning costs and expenses, the Maryland Court of Appeals stated:

The [insured] is entitled to be put in as good a position as it would have occupied had [the insurer] performed the contract. Counsel defending the . . . suit could probably have billed [the insurer] for all services and expenses reasonably related to the defense of [covered counts]. Legal services and expenses are reasonably related to a covered count if they would have been rendered by reasonably competent counsel engaged to defend a suit against the [insured] arising out of the same factual background as did the [subject lawsuit] but which alleged only the matters complained of in [the covered counts] of the . . . complaint.

Continental Casualty, 489 A.2d at 537 (emphasis added).

The Maryland Court of Appeals clearly stated that an insurance company is not entitled to the apportionment of costs when legal services benefited the defense of both covered and non-covered claims.

To phrase our meaning of "reasonably related" in another way, we do not believe that the [the insurer] is entitled to an apportionment between tort and contract counts based simply on the fact that an item of legal service or expense would also be of use to counsel in defending a [non-covered] count . . . in

addition to its use in defending a [covered] count. Having purchased this form of litigation insurance, the [insured] is entitled to the full benefit of its bargain. So long as an item of service or expense is reasonably related to defense of a covered claim, it may be apportioned wholly to the covered claim.

Id. (emphasis added).

Continental Casualty, however, also held that the insured had the burden of establishing that a given item of legal service or expense was reasonably related to the defense of a covered claim. Note, however, that this view of the imposition of the burden of proof is not universally accepted. See, Health-Chem, supra, where the burden of showing that all or specific portion of defense costs were incurred in defense of an uncovered parties or claim was on insurer. See, also, Crist v. Insurance Co. of North America, 529 F.Supp. 601 (D. Utah 1982).¹

Prior to the Continental Casualty decision, the Sixth Circuit Court of Appeals developed a similar test. In Insurance Co. of North America v. Forty-Eight Insulations, Inc., 633 F.2d 1212 (6th Cir. 1980), the court held that if defense costs can be apportioned, they should be. However, the court also held that if

¹ As an aside, the relative exposure between covered and uncovered claims and parties is irrelevant with respect to the issue of apportioning costs and expenses. See, e.g., Federal Realty Investment Trust v. Pacific Insurance Co., 760 F.Supp. 533 (D. Md. 1991). The insurer can, however, use the excessive disproportionality between services and risk of liability to challenge the reasonableness of the amount of defense fees charged. Id.

the costs cannot be apportioned, then the insurer must bear the entire cost.

An insurer must bear the entire cost of defense when "there is no reasonable means of prorating the costs of a defense between the covered and the not-covered items." Thus, in the typical situation, suit will be brought as the result of a single accident, but only some of the damage sought will be covered under the insurance policy. In such cases, apportioning defense costs between the insured claim and the uninsured claim is very difficult. As a result, courts impose the full costs of defense on the insurer.

Forty-Eight Insulations, 633 F.2d at 1224 (citations omitted, emphasis added). Note that this case, however, did not involve a D&O Policy. See, also, E.E.O.C. v. Southern Publishing Co., 894 F.2d 785 (5th Cir. 1990) (insurer is liable for defense costs only where there is no reasonable means of prorating costs of defense between covered and non-covered claims).

C. Should Defense Costs Be Submitted As They Become Due?

Finally, the issue of whether Bullets 'n Stuff should have submitted the defense costs as they became due deserves some discussion. While this issue turns on the specific policy language in question, generally, the insurer has the duty to pay defense fees as they are incurred but can reserve right to repayment if claim was ultimately uncovered. See, Gon v. First Date Insurance Co., 871 F.2d 863 (9th Cir. 1989) (insurer required to pay all legal expenses of underlying litigation as incurred, even though insurer was entitled to apportioned expenses between covered and uncovered claims and persons. However, where apportionment was

impractical before judgment, defense fees must be paid as incurred so as not to deny the insureds the benefit of the protection they purchased.); Okada v. MGIC Indemnity Corp., 823 F.2d 276 (9th Cir. 1987) (insurer has the duty to pay defense costs as they come due); Pepsico, Inc. v. Continental Casualty Company, 640 F.Supp. 656, 666 (1986); FDIC v. Booth, 824 F.Supp. 76 (M.D. La. 1993).

This conclusion was also reached by the federal court for the Southern District of Florida, in National Union and Fire Insurance Co. v. Brown, 787 F.Supp. 1424 (S.D. Fla. 1991) aff'd 963 F.2d 385, where the timing of an insurer's obligation to fund defense costs under a D&O policy was at issue. The District Court, analyzing many of the cases cited in this paper, concluded that the insurer was required to pay defense costs as they were incurred by insureds, rather than foregoing payment until the underlying suit was adjudicated or settled. Note, however, that a recent bankruptcy opinion disagreed with Brown. Matter of Celotex Corp., 152 B.R. 661, 666 (Bkrctcy. M.D. Fla. Tampa Div. 1993) citing National Union Fire Ins. Co. v. Goldman, 548 So.2d 790 (Fla. Dist. 2 DCA 1989); Zaborac v. American Casualty Co. of Reading, PA., 663 F.Supp. 330 (C.D. Ill. 1987); Luther v. Fidelity and Deposit Co. of Maryland, 679 F.Supp. 1092 (S.D. Fla. 1986).

IV. CONCLUSION

While there may be resistance to consider attorney's fees incurred to represent a corporate officer or director in a grand jury investigation as a "claim" within a D&O Policy, the Polychron opinion provides authority for this position. Also if the

corporation retained one law firm to protect the interests of both the corporation and the officer or director, the insurer and insured will have to allocate the defense costs to covered and uncovered claims or parties. If the defense costs cannot be allocated using the reasonable relation test, the insurer will be required to pay for all the defense costs.

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