

CHOICE OF LAW PROVISIONS: THE VALUE OF CERTAINTY AND CONSISTENCY

The scope of coverage afforded under D&O and other types of policies is determined based not only on the terms and conditions of the policy, but also on the law applicable to the policy. Brokers and insureds correctly devote a lot of time and effort into negotiating the most desirable policy terms, but too often fail to similarly address the important question of what law will apply when interpreting and enforcing the policy.

The discussion below addresses the importance of state law to an insurance policy, how D&O policies have historically treated choice-of-law issues, what the benefits of an express choice-of-law provision in the policy are, and alternative approaches to the choice-of-law issue in today's complex D&O insurance program structure.

A. IMPORTANCE OF STATE INSURANCE LAW

All states have a body of statutes and case law addressing numerous insurance coverage issues. For example, state laws frequently address how policies are to be interpreted, what an insurer must prove to rescind the policy based on Application misrepresentations or to deny coverage for a claim based on late notice of the claim to the insurer, the meaning of various policy terms and provisions, and the expected behavior of insurers and insureds in a claim situation. Many times there are significant differences among the laws of various states on these issues, so the selection of which state law applies to a particular claim can be critical when determining the rights and obligations of both insureds and insurers.

The question of which state's insurance laws apply to a claim is important not only in defining what coverage ultimately exists for the claim, but also in creating coverage expectations and in influencing the parties' behavior throughout the claim. For example, insureds may approach their defense strategy in the underlying claim, and insurers may become more or less involved in the underlying claim, depending on their certainty as to the applicable insurance rules. Therefore, the ability to determine with certainty at the beginning of a claim what body of law will apply to insurance issues relating to that claim can benefit both insureds and insurers.

B. HISTORICAL APPROACH TO CHOICE-OF-LAW ISSUES

D&O insurers in the United States historically have not included within their policy forms a provision which defines what state law applies to the interpretation and enforcement of the policy. The most likely reason for that silence has been the desire by insureds and insurers to maintain flexibility on this issue so that in a particular claim each can argue that the law most favorable to their position applies to that claim.

Frequently, but not always, silence results in the law of the state where the insured company is located applying, which many insureds view as a conceptually acceptable result since the insureds are presumably most familiar with that law. But such silence does not necessarily mean a court interpreting or enforcing the policy will apply the law of the state where the insured company is located. Each state has developed a rather elaborate set of rules to determine which state's laws should apply to a dispute involving parties in multiple jurisdictions if the policy does not select a jurisdiction for that purpose. These rules are called "conflict of law" rules (i.e., the rules define which among various conflicting laws will apply). The court in which the coverage litigation is filed will apply its state's "conflict of law" rules to determine whether the insurance law of that state or some other state will apply to that policy.

These "conflict of law" rules, which apply when the policy does not contain a choice-of-law provision, vary among states and frequently are complex and unpredictable to apply. For example, depending on the state, relevant factors for a court to consider when selecting the applicable state law includes the principal place of business of the insured company and the insurer, where the policy was negotiated and purchased, where the conduct being covered occurred, and where the coverage proceeding is pending.

To compound the uncertainty of this process, a separate "conflict of law" analysis is required for each policy within the D&O insurance program since some of the relevant factors change for each insurer. As a result, if multiple policies within a D&O insurance program are silent regarding the choice of law, the laws of different states may apply to different layers within the insurance program, thereby creating the risk of inconsistent coverage determinations within the insurance program for a single claim. The fact that the excess policies afford follow-form coverage may not mitigate this risk. A follow-form excess policy usually states that it follows the *terms and conditions* of the underlying followed policy, and therefore may not follow or adopt the laws applicable to the silent followed policy unless such laws independently are applicable to the excess policy.

An express choice-of-law provision in the insurance policy should eliminate this risk of uncertainty and can create consistency regarding the applicable state law throughout the insurance program. However, having a choice-of-law provision only in one of the excess policies may or may not create consistency with the other policies within the program. In a somewhat surprising ruling, a Delaware trial court ruled in 2008 that a choice-of-law provision in an excess policy applied to other follow-form policies higher in the insurance tower even though those higher policies did not expressly follow the terms of the lower excess policy. The court further ruled that policies lower in the insurance tower also adopted the higher layer's choice-of-law provision. In explaining these conclusions, the court noted that the parties conceded that the law of a single state should apply to the entire insurance tower. Since one policy in the insurance tower contained a choice-of-law provision, the court found that all other policies above and below that policy in the tower should be subject to that choice-of-law provision in order to create the consistency which both the insurers and the insureds admittedly desired. *AT&T vs. Clarendon Amer. Ins. Co.*, 2008 Del. Super. LEXIS 220 (Del. Super. Ct. June 25, 2008). It is far from certain whether other courts will reach the same conclusion,

particularly if all parties do not concede that consistency throughout the program is intended or desired. Therefore, incorporating appropriate choice-of-law provisions into the program rather than relying on a court to decide the issue is much more likely to yield the intended result.

In recent years, most D&O insurers have included a limited type of choice-of-law provision in their policy forms, which addresses what law will apply to determine whether punitive or multiple damages are insurable under the policy. These provisions usually adopt a “most favorable jurisdiction” approach by saying the punitive or multiple damages will be insurable under the policy if such damages are insurable under any jurisdiction which has a substantial relationship to the parties, the policy or the claim. However, the policy is otherwise silent on the applicable law for all other purposes under the policy.

Unlike D&O insurers in the U.S., insurers located in Bermuda have traditionally not remained silent, but have included a broad choice-of-law provision in their D&O policies. An example of such provision is as follows:

This Policy, and any dispute, controversy or claim arising out of or relating to this Policy, shall be governed by and construed and enforced in accordance with the internal laws of the State of New York, except insofar as such laws: (i) may prohibit payment hereunder in respect of punitive, exemplary or multiple damages; or (ii) . . . are inconsistent with any provisions of this Policy.

The reason Bermuda insurers use such a provision relates to their off-shore status and policy sales practices. For a variety of business reasons, Bermuda D&O insurers typically require their D&O policies to be negotiated, purchased and issued in Bermuda. Therefore, under the “conflict of law” rules of most states, the laws of Bermuda/United Kingdom would probably apply to those Bermuda D&O policies if the policies were silent with respect to the applicable laws. Because few U.S. insureds are sufficiently knowledgeable about Bermuda/United Kingdom insurance law, few U.S. insureds are willing to purchase a D&O policy which is likely to be subject to such foreign law. As a result, Bermuda D&O insurers have historically selected within the policy form the law of a designated state in the U.S. for purposes of interpreting and enforcing their policies.

Most such provisions in Bermuda policies select New York law primarily because New York insurance law is very well developed and is reasonably predictable due to the large number of insurance cases which have been litigated in that state.

As a result of these historical practices, many D&O insurance towers have significant inconsistencies among the different policies within the tower regarding applicable law. Many of the policies in the tower are silent regarding a choice of law, thereby requiring a separate analysis under each such policy based on the unique facts of that layer. Some policies may adopt the law of a specific state, particularly if the policy is issued by a Bermuda insurer. Very few D&O insurance towers have the same law applying to all policies within the tower.

C. BENEFITS OF CHOICE-OF-LAW PROVISION

There are two primary benefits to including a choice-of-law provision in D&O policies: certainty and consistency. Policies which remain silent on the applicable law lose both of these benefits and significantly complicate the resolution of insurance issues in many claims.

As explained above, the process for determining the applicable law when the policy is silent can be complicated, time consuming and expensive. The parties must first research the insurance law of all of the potentially applicable jurisdictions to determine if there is a material difference among those state laws regarding the insurance issue in question. If there is (which is frequently the case), then the “conflict of law” rules of the state in which the coverage litigation is pending must be researched and the relevant factors under those rules must be examined. Often, this analysis is performed under the “conflict of law” rules of several states before the coverage litigation is filed in order to select the preferred state in which to litigate the coverage issues.

After the parties complete this analysis, there is frequently a disagreement between the parties as to what is the applicable law, so that disagreement must be submitted to the court for resolution before the underlying coverage issues can be resolved by the court.

All of this is obviously time consuming and expensive, and the ultimate result is far from predictable. None of that is desirable for either the insureds or the insurer. At a time when the insureds are incurring large losses in the underlying claim, no one is benefitted by a prolonged and expensive choice-of-law disagreement which must be resolved before the substantive coverage issues can be resolved. The uncertainty and delay created by the policy being silent on the choice-of-law issue are exactly what the parties should avoid during the claims process.

A choice-of-law provision in the policy obviously eliminates this distraction, delay, expense and uncertainty. When a claim is made, the parties immediately know what state law applies to the policy and can quickly research that law for guidance on any coverage issues relating to the claim. This certainty benefits both the insureds and insurer and can help maintain a cooperative relationship between the parties during a potentially contentious time.

Likewise, a choice-of-law provision in all of the policies within a D&O insurance program can create consistency within the program as to the applicable state law. As explained above, silence within the policies can result in different policies within the tower applying different state laws, which could lead to coverage under some policies and no coverage under other policies, even though all of the excess policies are “follow form.” This inconsistency can not only create unexpected gaps in insurance coverage and disappointment by the insureds, but can also jeopardize the attachment of other excess layers since many excess policies state their coverage is no broader than the narrowest coverage below them.

The consistency created by a choice-of-law provision can also simplify any coverage litigation since the parties in that litigation would be briefing and debating the insurance laws of only one state. If different insurers within the same coverage litigation have different state

laws applying to their policies, the insureds and the court will be forced to address the insurance laws of multiple states, thereby further complicating the coverage litigation.

For policies with their own unique arbitration or alternative dispute resolution provision, this choice-of-law consistency with other policies is somewhat less important because other insurers probably will not be participants in the arbitration or ADR proceeding. Likewise, choice-of-law consistency between the “ABC” policies, on the one hand, and the Side A policies, on the other hand, within a D&O insurance program is less important because those two sets of policies have materially different terms and conditions, and the Side A policies are designed to afford coverage inconsistent with the underlying “ABC” policies. However, at a minimum there are sound benefits for creating choice-of-law consistency within all “ABC” policies and within all Side A policies, subject to unique arbitration and ADR provisions.

D. ALTERNATIVE SOLUTIONS

The following describes several approaches for including a choice-of-law provision throughout a D&O insurance program.

1. Provision in Primary Policy. If the primary policy includes a choice-of-law provision, all excess follow-form policies should be subject to that provision, thereby providing consistency throughout all follow-form policies without the need to include separate choice-of-law provisions in each excess policy. However, because Side A DIC policies do not generally follow the terms of the primary policy, a choice-of-law provision should also be included in the lead Side A policy.
2. Most Favorable Jurisdiction Provision. Instead of selecting one specific state in the choice-of-law provision, a broader ‘most favorable jurisdiction’ provision could be used (similar to the “most favorable jurisdiction” provision commonly used in D&O policies with respect to the insurability of punitive damages). Such a provision could list several alternative states as potentially applicable and could state that the law of whichever one of those listed states which would provide the broadest coverage for the insureds in a particular claim will apply to that claim. For this purpose, the listing of several specific states seems more appropriate than the more open-ended approach commonly used for punitive damages (i.e., any state with a substantial relation to the parties, the policy or the claim) because the open-ended approach can lead to uncertainty and disagreement as to which states satisfy the “substantially related” criteria.
3. Separate Provision for Arbitration Policies. Those policies within the insurance program which have an arbitration clause could select a state different than the one selected in policies with no arbitration provision. The most important goal in creating consistency within the insurance program regarding choice-of-law is to eliminate the need for the court and the parties to apply in one coverage proceeding different state laws to different policies within the program. That

result can be achieved even if the policies with an arbitration provision select a different state law since coverage disputes under those arbitration policies will be resolved in a different proceeding.

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In summary, the selection of which state law to apply when interpreting and enforcing D&O policies can be a very important issue, yet too many insureds, brokers and insurers ignore that issue until a claim is made. A more prudent approach is to address the issue in the policies, thereby creating certainty and consistency within the insurance program before the claim is made and thus avoiding potentially costly and time consuming disagreements on this issue after the claim is made.

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