

Fordham Urban Law Journal

Volume 16, Number 3

1987

Article 4

Disbursement Of Insurance Money Covering An Insured's Legal Expenses As Incurred

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Disbursement Of Insurance Money Covering An Insured's Legal Expenses As Incurred

Arthur P. Xanthos

Abstract

In the Southern District of New York, *Pepsico, Inc. v. Continental Casualty Co.* held that the D & O insurance carrier was obligated to pay the insured's costs as they accrue, subject to reimbursement should adjudication show that there were no grounds for coverage. This Note proposes that the Pepsico rule favoring the insured is the more judicious view regarding interim payments. This Note discusses the differing interpretations of D & O policy defense cost clauses, and then analyzes the Pepsico rule from the standpoints of reasonable expectations, contract interpretation and unconscionability. After comparing D & O insurance with standard liability insurance, this Note recommends adoption of the Pepsico rule in other jurisdictions.

KEYWORDS: liability, insurance, director, officer, fiduciary

DISBURSEMENT OF INSURANCE MONEY COVERING AN INSURED'S LEGAL EXPENSES AS INCURRED

I. Introduction

Directors' and officers' liability insurance (D & O insurance) provides coverage for costs incurred by a director or officer in defending a third-party claim.¹ Because directors and officers² stand in a fiduciary relationship³ to their corporation and its shareholders,⁴ they may be held personally liable if they fail to perform their duties with due care and financial damage to the corporation results.⁵ Moreover, litigation costs can be enormous⁶ and lawsuits can last

1. See Goldstein & Gordon, *Directors' and Officers' Liability Insurance*, FOR THE DEF. 2 (Aug. 1987) [hereinafter Goldstein & Gordon]; Johnston, *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 1993, 2013, 2015-16 (1978) [hereinafter Johnston]; Oettle & Howard, *D & O Insurance: Judicially Transforming a "Duty to Pay" Policy into a "Duty to Defend" Policy*, 22 TORT AND INS. L.J. 337, 337 (1987) [hereinafter Oettle & Howard]; Comment, *Practical Aspects of Directors' and Officers' Liability Insurance—Allocating and Advancing Legal Fees and the Duty to Defend*, 32 UCLA L. REV. 690, 690 (1985) [hereinafter *Practical Aspects*].

2. For the purposes of this Note, the term director(s) is used to mean director(s) or officer(s) or both.

3. "Fiduciary relationship" has been defined in the following manner: One is said to act in a "fiduciary capacity" . . . when the business which he transacts, or the money or property which he handles, is not his own or for his own benefit, but for the benefit of another person, as to whom he stands in a relation implying and necessitating great confidence and trust on the one part and a high degree of good faith on the other part. BLACK'S LAW DICTIONARY 564 (5th ed. 1979).

4. "The relation of an officer of a corporation to it is fiduciary, and he must at all times act in good faith and unselfishly toward the corporation." Jacobson v. Brooklyn Lumber Co., 184 N.Y. 152, 162, 76 N.E. 1075, 1078 (1906); see also Alpert v. 28 Williams St. Corp., 63 N.Y.2d 557, 568, 473 N.E.2d 19, 25, 483 N.Y.S.2d 667, 673 (1984); Fe Bland v. Two Trees Mgmt. Co., 125 Misc. 2d 111, 116, 479 N.Y.S.2d 123, 127, *aff'd*, 109 A.D.2d 1110, 487 N.Y.S.2d 159 (1st Dep't 1985).

5. See Goldstein & Gordon, *supra* note 1, at 2.

6. See *id.*; Johnston, *supra* note 1, at 1993; *Practical Aspects*, *supra* note 1, at 709.

for indeterminate periods of time.⁷ An institution will, therefore, often purchase D & O insurance⁸ to alleviate the financial risk of crippling defense costs to its directors⁹ in instances where they may not be indemnified by the institution.¹⁰

D & O insurance is a relatively new form of liability coverage.¹¹ Although D & O policies were first marketed in the 1950's, they received scant attention from commentators until the mid-1960's.¹² Lloyd's of London, the well known British insurance giant,¹³ dominated the D & O insurance market until the late 1960's.¹⁴ Today, several American companies in addition to Lloyd's offer D & O insurance coverage,¹⁵ although the number of insurers willing to offer it has decreased in recent years.¹⁶

Unlike most other liability insurance, D & O insurance does not require the insurer to assume the insured's defense;¹⁷ rather, it imposes upon the insurer a duty to pay the insured's defense costs.¹⁸ Although

7. See *Little v. MGIC Indem. Corp.*, 649 F. Supp. 1460, 1468 (W.D. Pa. 1986), *aff'd*, 836 F.2d 789 (3d Cir. 1987); *Practical Aspects*, *supra* note 1, at 694.

8. A corporation may itself indemnify its directors for some forms of liability, but state statutes strictly regulate areas of allowable coverage. See N.Y. BUS. CORP. LAW § 726 (McKinney & West Supp. 1987). The corporation may, therefore, opt to purchase insurance from outside sources. Then when a director seeks to finance his legal defense, he either approaches his corporation (for "advances") or its insurance carrier (for "interim payments"). See *Practical Aspects*, *supra* note 1, at 709.

9. See *Little*, 649 F. Supp. at 1461.

10. See Johnston, *supra* note 1, at 2004. New York Business Corporation Law § 726 empowers corporations to purchase D & O insurance for several purposes: (1) to indemnify the corporation for its obligation to indemnify directors and officers; (2) to indemnify directors and officers where the corporation permits their indemnification; and (3) to indemnify directors and officers in instances where the corporation fails to indemnify them. N.Y. BUS. CORP. LAW § 726 (McKinney & West Supp. 1987). This Note concerns D & O insurance under categories 2 and 3.

11. See Johnston, *supra* note 1, at 2012.

12. See *id.*; Note, *Liability Insurance for Corporate Executives*, 80 HARV. L. REV. 648, 648 (1967) [hereinafter *Corporate Executives*].

13. F. WORSLEY & G. GRIFFITH, *THE ROMANCE OF LLOYD'S* 13-14 (1932).

14. See Johnston, *supra* note 1, at 2012.

15. See *id.* (citing Brockmeier, *Status of D & O Liability Coverage*, RISK MGMT. MAG. 20 (Jan. 1977)); see also *Continental Casualty Co. v. Board of Education*, 302 Md. 516, 529, 489 A.2d 536, 542 (1985).

16. See Goldstein & Gordon, *supra* note 1, at 2.

17. See *id.*; Johnston, *supra* note 1, at 2023; Oettle & Howard, *supra* note 1, at 339.

18. See Goldstein & Gordon, *supra* note 1, at 2; Johnston, *supra* note 1, at 2023; Oettle & Howard, *supra* note 1, at 339; D. DEY & S. RAY, *ANNOTATED COMPREHENSIVE GENERAL LIABILITY INSURANCE POLICY* 53 (Defense Research Institute, Inc. 1984) [hereinafter *LIABILITY INSURANCE*]. In the typical D & O policy

most D & O insurance provisions are standardized,¹⁹ courts differ as to when the insurer must disburse these payments.²⁰ Specifically, there is a dispute concerning whether the standard D & O insurance policy²¹ requires the insurer to pay the insured's defense costs as they accrue²² despite policy language providing that this duty does not arise until final adjudication of the underlying claims against the insured.²³ This timing issue arises because attorneys' fees and expenses usually come due before final adjudication,²⁴ and because one cannot immediately determine whether the cost of the defense will ultimately fall within policy coverage.²⁵

While some jurisdictions have held that the standard D & O policy requires the insurer to reimburse defense costs²⁶ as they accrue,²⁷

insuring clause, the insurer agrees to pay on behalf of each director or officer any loss (as the term is defined in the policy) arising from claims made against them by reason of any wrongful act (as the term is defined in the policy) committed in their respective capacities of directors or officers. See Johnston, *supra* note 1, at 2015.

19. See J. KEETON, INSURANCE LAW 72 (1971) [hereinafter KEETON]. These provisions include such clauses as the "option" clause, the "no action" clause and the "consent to costs" clause. See generally Oettle & Howard, *supra* note 1, at 339-40.

20. The dilemma arises because the D & O insuring clause seems to indicate that payments will be made as losses are incurred, while the option clause seems to require disbursement only after adjudication. For a lucid description of the dilemma, see Little v. MGIC Indem. Corp., 649 F. Supp. 1460, 1462 (W.D. Pa. 1986), *aff'd*, 836 F.2d 789 (3d Cir. 1987).

21. For an analysis of the components of the typical D & O insurance policy, see Oettle & Howard, *supra* note 1, at 337-40. Lloyd's D & O policy is the one most widely used. See *Practical Aspects*, *supra* note 1, at 699 n.83; *Corporate Executives*, *supra* note 12, at 649-50.

22. In this Note, the phrase "as they accrue" is synonymous with "as incurred" when describing the payment of legal expenses.

23. See Goldstein & Gordon, *supra* note 1, at 2; Johnston, *supra* note 1, at 2023; Oettle & Howard, *supra* note 1, at 337.

24. See *Pepsico, Inc. v. Continental Casualty Co.*, 640 F. Supp. 656, 659 (S.D.N.Y. 1986) (citing *Okada v. MGIC Indem. Corp.*, 608 F. Supp. 383, 385 (D. Haw. 1985), *aff'd in part, rev'd in part*, 795 F.2d 1450 (9th Cir. 1986)).

25. See Oettle & Howard, *supra* note 1, at 338. The typical D & O policy contains several important statutory exclusions and some "non-standard" exclusions, added to the policy by the insurers, which limit coverage. See Johnston, *supra* note 1, at 2017. One particularly popular exclusion, the "dishonesty exclusion," excludes liability "with respect to claims brought about or contributed to by the dishonesty of the insureds . . ." *Id.* at 2019. Usually, however, a claimant's dishonesty is not established until adjudication. Consequently, insurers prefer to cover defense costs after a final adjudication and not on an "as incurred" basis.

26. "Defense costs" is not entirely synonymous with "legal expenses." For purposes of this Note, however, the terms are used interchangeably.

27. See *Okada v. MGIC Indem. Corp.*, 608 F. Supp. 383, 385 (D. Haw. 1985), *aff'd in part, rev'd in part*, 795 F.2d 1450 (9th Cir. 1986); *Pepsico, Inc. v.*

others have held that the insurer has the right to await a final adjudication.²⁸ Each view has widely divergent consequences. The former redounds to the detriment of insurers,²⁹ while the latter works against insureds and the institutions they represent.³⁰ In resolving such a contractual dilemma, courts examine the plain meaning of the policy language,³¹ rules of contract interpretation³² and principles of unconscionability.³³

In the Southern District of New York, a recent case, *Pepsico, Inc. v. Continental Casualty Co.*,³⁴ held that the D & O insurance carrier was obligated to pay the insured's costs as they accrue,³⁵ subject to reimbursement should adjudication show that there were no grounds for coverage.³⁶

This Note proposes that the *Pepsico* rule favoring the insured is the more judicious view regarding interim payments. Part II discusses

Continental Casualty Co., 640 F. Supp. 656, 659-60 (S.D.N.Y. 1986); *Little v. MGIC Indem. Corp.*, 649 F. Supp. 1460, 1465 (W.D. Pa. 1986), *aff'd*, 836 F.2d 789 (3d Cir. 1987).

28. See *Clandening v. MGIC Indem. Corp.*, No. CV 83-2432 (C.D. Cal. May 24, 1983); *California Chiropractic Ass'n v. CNA Ins. Co.*, No. C-579-326 (Sup. Ct. Los Angeles County June 26, 1986); *Enzweiler v. Fidelity & Deposit Co.*, No. 85-99 (E.D. Ky. May 13, 1986); *Luther v. Fidelity & Deposit Co.*, No. 85-2762-Civ.-JWK (S.D. Fla. Aug. 15, 1986); *First Fed. Sav. and Loan Ass'n v. MGIC Indem. Corp.*, No. 32-2121 (D.N.J. Sept. 3, 1982); *Citizens State Bank v. MGIC Indem. Corp.*, No. L-050357-84 (N.J. Super. Ct. Law Div. June 28, 1985); *Bank of Commerce & Trust Co. v. National Union Fire Ins. Co.*, 651 F. Supp. 474, 476-77 (N.D. Okla. 1986).

29. For a discussion of the woes confronting insurers in the face of the former view, see *Practical Aspects*, *supra* note 1, at 714 n.163 (given time value of money insurer would rather pay later than sooner; also, insurer risks loss if he advances defense costs to non-covered director).

30. The detrimental impact on insureds of defense cost reimbursement at the conclusion of trial is noted in *Johnston*, *supra* note 1, at 1993-94.

31. See *Omaha Indem. Co. v. Johnson & Towers, Inc.*, 599 F. Supp. 215 (D.C.N.Y. 1984); *Libra Bank Ltd. v. Banco Nacional De Costa Rica, S.A.*, 570 F. Supp. 870 (D.C.N.Y. 1983); *In re Estate of Olson*, 447 Pa. 483, 488, 291 A.2d 95, 98 (1972) (quoting *Orner v. T. W. Phillips Gas & Oil Co.*, 401 Pa. 195, 199, 163 A.2d 880, 883 (1960)); *Pennsylvania Mfrs.' Ass'n Ins. Co. v. Aetna Casualty & Surety Ins. Co.*, 426 Pa. 453, 457, 233 A.2d 548, 551 (1967).

32. See *Okada*, 795 F.2d at 1453-55; *Little*, 649 F. Supp. at 1463; *Pepsico*, 640 F. Supp. at 659-60; *Mohn v. American Casualty Co.*, 458 Pa. 576, 586, 326 A.2d 346, 351 (1974).

33. See *Standard Venetian Blind Co. v. American Empire Ins.*, 503 Pa. 300, 307, 469 A.2d 563, 567 (1983); *Witmer v. Exxon Corp.*, 495 Pa. 540, 551, 434 A.2d 1222, 1228 (1981) (quoting *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 449 (D.C. Cir. 1965)).

34. 640 F. Supp. 656 (S.D.N.Y. 1986).

35. *Id.* at 659-60.

36. *Id.* at 660.

the differing interpretations of D & O policy defense cost clauses. Part III puts forth the *Pepsico* rule, a view in support of the insured. Part IV analyzes the *Pepsico* rule from the standpoints of reasonable expectations, contract interpretation and unconscionability, and, after comparing D & O insurance with standard liability insurance, recommends adoption of the *Pepsico* rule in other jurisdictions.

II. Differing Interpretations of Defense Cost Clauses

Case law on the timing of insurance disbursement falls along two lines: that which obligates the insurer to pay the defense costs as incurred (the pro-insured argument), and that which grants the insurer the right to await a final adjudication (the pro-insurer argument).³⁷

A. The Pro-Insured Argument

In *Okada v. MGIC Indemnity Corp.*,³⁸ the defendant, an insurance company, issued a D & O liability insurance policy to the plaintiffs, insured directors and officers of First Savings and Loan.³⁹ The plaintiffs, defendants in two underlying cases⁴⁰ wherein they were alleged to have caused First Savings and Loan to become insolvent,⁴¹ sought a declaratory judgment to construe the terms of the D & O policy.⁴² At issue was whether MGIC Indemnity Corporation (MGIC) had to pay the attorneys' fees of the plaintiffs as incurred.⁴³ MGIC's primary argument was that the option clause of the D & O insurance policy relieved it of the duty to advance legal expenses.⁴⁴ This provision reserved for the insurer the option to advance defense costs to the insured.⁴⁵ The District Court of Hawaii held that the

37. "The pro-insured argument" and "the pro-insurer argument" are terms created for this Note.

38. 608 F. Supp. 383 (D. Haw. 1985), *aff'd in part, rev'd in part*, 795 F.2d 1450 (9th Cir. 1986).

39. *Id.* at 385.

40. The two underlying suits were *FLSIC v. Alexander*, 590 F. Supp. 834 (D. Haw. 1984), and *First Hawaiian Bank v. Alexander*, 558 F. Supp. 1128 (D. Haw. 1983). *Okada*, 608 F. Supp. at 385.

41. *Id.*

42. *Id.* A party seeks declaratory relief to obtain a declaration of rights so that he understands what he can and cannot legally do. See D. DOBBS, *REMEDIES* 26 (West 1973).

43. See *Okada*, 608 F. Supp. at 385.

44. See *id.* at 386.

45. Section 5(c) of the policy contained the following provision:

The insurer may *at its option* and upon request, advance on behalf of the [d]irectors and [o]fficers, or any of them, expenses which they have

option clause was inconsistent with the definition of loss in the policy,⁴⁶ thus creating an ambiguity which, under Hawaii law, was to be construed against the drafter/insurer.⁴⁷ The court added that a D & O insurance policy like the one described by MGIC would be virtually impossible to vend to reasonable directors and officers⁴⁸ and that an insurance policy "should be construed according to the reasonable expectations of the insured."⁴⁹ On appeal, the Ninth Circuit affirmed the district court's holding that MGIC was obligated to pay plaintiff's defense costs as they came due.⁵⁰

In *Little v. MGIC Indemnity Corp.*,⁵¹ the United States District Court for the Western District of Pennsylvania ruled against the defendant insurance company using a similar rationale. Union National Bank of Pittsburgh (UNB) purchased a D & O policy for the benefit of its directors and officers.⁵² The policy was issued by MGIC Indemnity Corporation (MGIC).⁵³ Beginning in 1983, UNB was named as a defendant in several lawsuits brought by five other institutions.⁵⁴ James P. Little (Little), vice-president of UNB's commercial loan department, was named as a third-party defendant in each of the lawsuits.⁵⁵ MGIC refused to advance defense costs to

incurred in connection with claims made against them, prior to disposition of such claims, provided always that in the event it is finally established the [i]nsurer has no liability hereunder, such [d]irectors and [o]fficers agree to repay to the [i]nsurer, upon demand, all monies advanced by virtue of this provision.

Id. (emphasis added).

46. *Id.* Section 1(d) of the policy defines "loss" as follows:

The term "[l]oss" shall mean any amount which the [d]irectors and [o]fficers are legally obligated to pay or for which the [a]ssociation is required to indemnify the [d]irectors or [o]fficers . . . for a claim or claims made against the [d]irectors and [o]fficers for [w]rongful [a]cts and shall include but not be limited to damages, judgments, settlements, costs . . . and defense of legal actions

Id. at 385.

The court noted an additional ambiguity in the policy—between § 5(c), *supra* note 45, and § 5(a). Section 5(a) provides in pertinent part: "No costs, charges and expenses shall be incurred or settlements made without the [i]nsurer's consent" *Okada*, 608 F. Supp. at 386.

47. *See id.*

48. *See id.* at 387.

49. *Id.* (citing *Sturla, Inc. v. Fireman's Fund Ins. Co.*, 67 Haw. 203, 210, 684 P.2d 960, 964 (1984)).

50. *See Okada v. MGIC Indem. Corp.*, 795 F.2d 1450, 1454 (9th Cir. 1986).

51. 649 F. Supp. 1460 (W.D. Pa. 1986), *aff'd*, 836 F.2d 789 (3d Cir. 1987).

52. *Id.* at 1461.

53. *Id.*

54. *Id.* at 1462. For a list of the underlying suits, see *id.* at 1462 n.1.

55. *Little v. MGIC Indem. Corp.*, 649 F. Supp. 1460, 1461-62 (W.D. Pa. 1986), *aff'd*, 836 F.2d 789 (3d Cir. 1987).

Little, arguing that the D & O policy provided the insurer the option to advance such costs at its discretion.⁵⁶ Little, consequently, sought a declaratory judgment ordering MGIC to pay the defense costs associated with the other lawsuits.⁵⁷ The court held that because the language of the D & O policy was ambiguous⁵⁸ MGIC was obligated to pay Little's defense costs in the underlying suits as those costs were incurred.⁵⁹ Under Pennsylvania law, ambiguities are resolved against the insurer.⁶⁰ The court, therefore, held for the plaintiff.⁶¹ The court further proffered that even if the language of the D & O policy unambiguously granted the insurer an absolute option to withhold defense costs until a final adjudication, such a provision would be unconscionable under Pennsylvania law.⁶² This is because "it leaves the insured no meaningful choice in the matter . . . he has no real alternative even though the cost of defense may bankrupt him,"⁶³ and "it is unreasonably favorable to the insurers, who may blithely disclaim responsibility for the insured's enormous financial burdens while the insured must fight on."⁶⁴

B. The Pro-Insurer Argument

Other jurisdictions hold that the standard D & O policy does not obligate the insurer to pay defense costs as incurred.⁶⁵ In *Luther v.*

56. *Id.* at 1462.

57. *Id.*

58. *See id.* at 1469.

59. The court noted the following ambiguities:

There are two ambiguous parts to the D & O policy . . . [s]ubsection 5(C) creates confusion by seeming to absolve the insurer from its duty to pay reasonable defense costs contained in [s]ubsection 5(A) Another ambiguity is apparent when [s]ection 3(A)(5) is read in conjunction with [s]ection 5.

Id. at 1465.

60. *See Mohn v. American Casualty Co.*, 458 Pa. 576, 586, 326 A.2d 346, 351 (1974).

61. *Little v. MGIC Indem. Corp.*, 649 F. Supp. 1460, 1466, 1469 (W.D. Pa. 1986), *aff'd*, 836 F.2d 789 (3d Cir. 1987).

62. *See id.* at 1468.

63. *Id.* There are three reasons why the insured has no choice but to accept the coverage offered him. First, the exposure to tremendous liability generates an urgent need for some kind of D & O coverage. *See infra* notes 121-27 and accompanying text. Second, the small market for D & O insurance limits opportunity to shop for bargains. *See supra* note 16 and accompanying text. Third, standardization of D & O policy provisions renders the existence of alternative insurers moot. *See infra* notes 154-66 and accompanying text.

64. *Little*, 649 F. Supp. at 1648.

65. *See supra* note 28 and accompanying text.

Fidelity & Deposit Co.,⁶⁶ for example, the court refused to force an insurance carrier to pay insured directors and officers interim payments⁶⁷ for their defense costs.⁶⁸ The United States District Court for the Southern District of Florida found that the policy's option clause, the crux of the dispute, was plain and unambiguous on its face.⁶⁹ It undeniably granted the insurer an *option* to advance payments to the insured.⁷⁰ Consequently, the policy required no special construction or interpretation.⁷¹

In *Continental Casualty Co. v. Board of Education*,⁷² insured members of the Charles County Board of Education sought construction of a D & O insurance policy issued by Continental Casualty Company (CCC).⁷³ Although the issues before the court did not specifically include the "as incurred" question,⁷⁴ the court did discuss the validity of the policy's option clause.⁷⁵ After a detailed analysis of the D & O policy,⁷⁶ the majority noted that the clause's language gave CCC "the option, *but not the obligation*" to disburse payments for legal costs as incurred.⁷⁷ The court found support for its position in the plain meaning of the option clause language⁷⁸ and one com-

66. No. 85-2762-Civ.-JWK (S.D. Fla. Aug. 15, 1986).

67. See *supra* note 8.

68. *Luther v. Fidelity & Deposit Co.*, No. 85-2762-Civ.-JWK (S.D. Fla. Aug. 15, 1986); see also *Clandening v. MGIC Indem. Corp.*, No. CV 83-2432 (C.D. Cal. May 24, 1983).

69. "The language contained therein clearly reflects that [the insurer], if it so chooses, *may* advance expenses . . . [but] is not obligated to do so" *Luther v. Fidelity & Deposit Co.*, No. 85-2762-Civ.-JWK (S.D. Fla. Aug. 15, 1986) (emphasis added).

70. See *id.*

71. See *id.*

72. 302 Md. 516, 489 A.2d 536 (1985).

73. *Id.* at 520, 489 A.2d at 538.

74. The court of appeals considered five certified questions, none of which specifically concerned whether the insurer must disburse D & O insurance payments on an "as incurred" basis. See *id.* at 531-37, 489 A.2d at 543-47.

75. The policy contained the typical option clause language. *Id.* at 522, 489 A.2d at 539. See *infra* note 78 for the pertinent text of the option clause. For further discussion of option clauses in general, see Oettle & Howard, *supra* note 1, at 339-40.

76. See *Continental*, 302 Md. at 520-22, 489 A.2d at 538-39.

77. *Id.* at 530, 489 A.2d at 543 (emphasis added).

78. The option clause contained the following provision:

(b) The [i]nsurer may at its option and upon request, advance on behalf of an [a]ssured . . . fees, costs and expenses which have been incurred in connection with claims made against an [a]ssured, prior to disposition of such claims, provided always that, in the event it is finally established the [i]nsurer has no liability hereunder, each agrees to repay to the [i]nsurer, upon demand, all monies advanced on their behalf pursuant

mentator's description of D & O insurance: "Under D & O policies the insured must provide its defense, although the insurer may participate at its [own] option" ⁷⁹

In *Bank of Commerce and Trust Co. v. National Union Fire Insurance Co.*,⁸⁰ the insureds sought declaratory relief concerning a D & O insurance policy.⁸¹ The United States District Court of Oklahoma denied both parties' motion for summary judgment, holding that there were "genuine issues of material fact to be resolved."⁸² Although the court did not decide the "as incurred" issue explicitly,⁸³ it did observe that a final adjudication in the underlying suit could show that the directors and officers were disqualified from coverage.⁸⁴ Accordingly, this case stands for the proposition that coverage for defense costs is a function of underlying claims.⁸⁵ Because coverage cannot be established absolutely until a final adjudication of the underlying claims,⁸⁶ it would appear, under the view espoused in *Bank of Commerce*, that an insurer has no obligation to reimburse the insured's defense costs as incurred.⁸⁷

In *Enzweiler v. Fidelity & Deposit Co.*,⁸⁸ the District Court of Kentucky was more explicit. In *Enzweiler*, Fidelity & Deposit Company of Maryland (Fidelity) issued a D & O policy to Ervin Enzweiler (Enzweiler), president of Northern Kentucky Bank & Trust (Northern).⁸⁹ Enzweiler became involved in a number of suits arising out of his conduct as president of Northern, and sought a declaratory judgment as to whether Fidelity was required to make payments under the D & O policy.⁹⁰ The court held that the insurance company could elect to await the outcome of the underlying claims against

to this provision.

Id. at 522, 489 A.2d at 539 (emphasis added).

79. *Id.* at 530, 489 A.2d at 543 (citing W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS ch. 20 (3d ed. 1978)).

80. 651 F. Supp. 474 (N.D. Okla. 1986).

81. *Id.* at 475. For an explanation of declaratory relief, see *supra* note 42.

82. *Bank of Commerce*, 651 F. Supp. at 476.

83. The court noted that the "as incurred" issue remained moot until it was determined whether the insured's alleged actions fell within the policy's coverage. *Id.* at 476-77.

84. See *id.* at 476.

85. See *id.*; see also Oettle & Howard, *supra* note 1, at 343.

86. See Oettle & Howard, *supra* note 1, at 344.

87. It is impossible to permit the insurer to await a final adjudication on the one hand, and obligate him to pay costs as incurred on the other.

88. Civ. No. 85-99 (E.D. Ky. 1986).

89. *Id.*

90. *Id.*

Enzweiler before advancing any payments.⁹¹ While placing emphasis on the plain meaning of the option clause provision in the D & O policy,⁹² the court also reasoned that the judgment in the underlying actions "may be such that there is no coverage."⁹³

III. The *Pepsico* Rule

In *Pepsico, Inc. v. Continental Casualty Co.*, the Southern District of New York adopted a position similar to that of the "pro-insured" jurisdictions. The decision obligates insurers to pay an insured's defense costs as incurred,⁹⁴ but stipulates, however, that such payments are made subject to reimbursement⁹⁵ should final adjudication show that there were no grounds for coverage.⁹⁶

In *Pepsico*, plaintiff Pepsico, Inc. (Pepsico) purchased a D & O insurance policy from Continental Casualty Company (Continental).⁹⁷ Pepsico sought to recover from Continental money paid in litigation involving Pepsico's directors and officers.⁹⁸ Pepsico argued that Continental had a duty to pay the defense costs to the directors and officers on an "as incurred" basis.⁹⁹ Continental countered that it was not liable to pay the legal fees until final adjudication because there remained the possibility that a final adjudication would reveal that the directors and officers had disqualified themselves from coverage.¹⁰⁰ Consequently, Continental moved to dismiss the complaint.¹⁰¹

91. *Id.*

92. *See id.* at 1.

93. *Id.*

94. *See Pepsico, Inc. v. Continental Casualty Co.*, 640 F. Supp. 656 (S.D.N.Y. 1986). For a discussion of the pro-insured argument, see *supra* notes 38-64 and accompanying text. There are relatively few decided cases on point, but *Pepsico* clearly and concisely sets out the rule.

95. *See Pepsico*, 640 F. Supp. at 659.

96. Insurers frequently raise the possibility that the recipients of the insurance payments are not covered by the policy. *See Little v. MGIC Indem. Corp.*, 649 F. Supp. 1460, 1466 (W.D. Pa. 1986), *aff'd*, 836 F.2d 789 (3d Cir. 1987). This argument is referred to as the "no-coverage objection."

97. *Pepsico*, 640 F. Supp. at 657.

98. *Id.*

99. *Id.* at 658.

100. Paragraph IVb(5) of the D & O policy excluded coverage for payments "brought about or contributed to by the dishonesty of the [d]irectors or [o]fficers." *Id.* at 659.

101. *Id.* at 657.

The court held that the D & O policy language did not excuse Continental from its obligation to pay the defense costs as incurred.¹⁰² The court looked primarily to the plain meaning of the terms of the D & O policy,¹⁰³ which contained, *inter alia*, a dishonesty exclusion clause.¹⁰⁴ Nowhere in the policy, the court observed, was entry of final judgment made a prerequisite to payment of defense costs.¹⁰⁵ Furthermore, according to the D & O policy definition of loss¹⁰⁶ the insurer's duty to pay all defense costs attached once the directors and officers were legally obligated to pay them.¹⁰⁷ It then became incumbent upon Continental to confine its duty to pay,¹⁰⁸ which it could do "only if it could establish as a matter of law that there was no possible factual basis on which it might be obligated to indemnify the directors and officers."¹⁰⁹ Since Pepsico's directors were "legally obligated to pay" their legal expenses "as incurred," Continental was required to cover this loss on an "as incurred" basis.¹¹⁰

IV. Courts Should Adopt the *Pepsico* Rule

The *Pepsico* rule is justified on the grounds of reasonable expectations, rules of contract interpretation and principles of unconscionability.¹¹¹ Further, alternative support for the rule is found by analogizing D & O insurance to standard liability insurance.¹¹²

A. The Parties' Reasonable Expectations

Where possible, the words of an insurance policy are to be given their plain, ordinary meaning.¹¹³ This rule, derived from the linguistic

102. *Id.* at 659. The court also noted that Continental would be entitled to reimbursement should final adjudication show that no coverage existed in the first place. *Id.*

103. *See id.* at 660-61.

104. "The policy excludes coverage for any payments 'brought about or contributed to by the dishonesty of the [d]irectors or [o]fficers.'" *Id.* at 659.

105. *Id.*

106. "Loss shall mean any amount which the [d]irectors and [o]fficers are legally obligated to pay . . . [including] amounts incurred in the defense of legal actions, claims or proceedings and appeals therefrom" *Id.*

107. *See id.*

108. *See id.* at 660.

109. *Id.* (citing *Villa Charlotte Bronte, Inc. v. Commercial Union*, 64 N.Y.2d 846, 848, 476 N.E.2d 640, 642, 487 N.Y.S.2d 314, 316 (1985)).

110. The *Okada* court made the same point. *See Okada v. MGIC Indem. Corp.*, 608 F. Supp. 383, 386 (D. Haw. 1985), *aff'd in part, rev'd in part*, 795 F.2d 1450 (9th Cir. 1986).

111. *See supra* notes 31-33 and accompanying text.

112. *See infra* notes 172-93 and accompanying text.

113. *See C. Raymond Davis & Sons, Inc. v. Liberty Mutual Ins. Co.*, 467 F.

formalism of the old British courts,¹¹⁴ is concisely summed up by Professor Wigmore: "You cannot disturb a plain meaning."¹¹⁵

From judicial regulation of adhesion contracts,¹¹⁶ however, emerges one broad principle: "The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored *even though painstaking study of the policy provisions would have negated those expectations.*"¹¹⁷ This doctrine puts forth an objective method of achieving equity between insurer and insured.¹¹⁸ It signifies that the standard for policy interpretation is that of the layman, not the sophisticated underwriter.¹¹⁹ The crucial question to be resolved, therefore, is whether a D & O policyholder could reasonably expect defense costs to be underwritten as incurred.¹²⁰

A director's legal costs can be enormous,¹²¹ and his legal battles can last for years.¹²² Directors are exposed to the possibility of defense costs "far in excess of anything that has been experienced historically."¹²³ According to a 1982 Wyatt Company D & O insurance survey,¹²⁴ for example, the average total cost per policy claim amounted to \$365,000.¹²⁵ Even claims that were eventually dropped

Supp. 17, 20 (E.D. Pa. 1979) (citing *Easton v. Washington County Ins. Co.*, 391 Pa. 28, 137 A.2d 332 (1958)).

114. See 9 J. WIGMORE, EVIDENCE § 2461, at 197 (1983).

115. *Id.*

116. An adhesion contract is a standardized contract form offered to consumers without affording the consumer a realistic opportunity to bargain. BLACK'S LAW DICTIONARY 38 (5th ed. 1979). For the origin of the term see Patterson, *The Delivery of a Life-Insurance Policy*, 33 HARV. L. REV. 198, 222 (1919).

117. KEETON, *supra* note 19, at 351 (emphasis added).

118. *Id.*

119. See *id.*; see also *Steven v. Fidelity & Casualty Co.*, 58 Cal. 2d 862, 869-70, 377 P.2d 284, 288-89, 27 Cal. Rptr. 172, 176-77 (1962).

120. See *Little v. MGIC Indem. Corp.*, 649 F. Supp. 1460, 1465-66, *aff'd*, 836 F.2d 789 (3d Cir. 1987).

121. See *supra* note 6 and accompanying text; see, e.g., *Little*, 649 F. Supp. at 1468; J. BISHOP, THE LAW OF CORPORATE OFFICERS AND DIRECTORS: INDEMNIFICATION AND INSURANCE ¶ 1.01 (1981).

122. See *supra* note 7 and accompanying text. *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156 (1974), a D & O liability suit that exemplifies the indeterminate amount of time during which a director may be forced to cover his defense costs, generated six years of legal fees. See Knepper, *An Overview of D & O Liability for Insurance Company Directors and Officers*, 45 INS. COUNS. J. 63 (1978).

123. Johnston, *supra* note 1, at 1993.

124. The Wyatt Company is a consulting firm specializing in pension plans, actuarial evaluations, risk management, employee benefits and executive compensation. See *Practical Aspects*, *supra* note 1, at 692.

125. See *id.* at 694 (citing THE WYATT COMPANY, 1982 COMPREHENSIVE REPORT: DIRECTORS AND OFFICERS LIABILITY/ FIDUCIARY LIABILITY 14 (1982)).

cost directors an average of \$70,000 in legal expenses.¹²⁶ Clearly, the threat of potentially crippling legal costs is the primary reason directors obtain D & O liability insurance.¹²⁷

In fact, the only notice a policyholder might have that he may be forced to underwrite his entire defense is the language of the option clause in the D & O policy,¹²⁸ a clause often cited in opinions for its ambiguity and vagueness.¹²⁹ Certainly, the split of authority on the clarity of the clause is some indication that the option clause language is less than clear.¹³⁰

A D & O policyholder, therefore, would reasonably expect defense costs to be underwritten as incurred.¹³¹ Indeed, a D & O policy that provided otherwise "would not truly protect the individual from financial harm."¹³² It would leave the insured in an extremely vulnerable position,¹³³ as few directors are likely to possess the resources to sustain such costs.¹³⁴ Consequently, a reasonable director or officer would almost never purchase a D & O policy that did not cover legal costs as incurred.¹³⁵

B. Rules of Contract Interpretation

Ordinary rules of contract interpretation also demonstrate the validity of the *Pepsico* rule.¹³⁶ Most insurance policy provisions are drafted by the insurer.¹³⁷ If a provision in an insurance contract is ambiguous, or inconsistent with another provision, it is construed in favor of the insured and against the insurer.¹³⁸ The primary

126. See *Practical Aspects*, *supra* note 1, at 694.

127. See Goldstein & Gordon, *supra* note 1, at 2.

128. See *supra* note 45 for the typical option clause language.

129. See, e.g., *Little v. MGIC Indem. Corp.*, 649 F. Supp. 1460, 1465, *aff'd*, 836 F.2d 789 (3d Cir. 1987); *Okada v. MGIC Indem. Corp.*, 608 F. Supp. 383, 387 (D. Haw. 1985), *aff'd in part, rev'd in part*, 795 F.2d 1450 (9th Cir. 1986); *Okada*, 795 F.2d at 1453-54.

130. See *Little*, 649 F. Supp. at 1466.

131. See *supra* notes 48-49 and accompanying text.

132. *Okada*, 608 F. Supp. at 387.

133. See *id.*; *Little*, 649 F. Supp. at 1468-69; *Practical Aspects*, *supra* note 1, at 691 ("uneasy lies the corporate head unprotected by a solid D & O policy").

134. See *Johnston*, *supra* note 1, at 1993.

135. See *Little*, 649 F. Supp. at 1466; *Okada*, 608 F. Supp. at 387.

136. See *supra* note 32 and accompanying text.

137. See KEETON, *supra* note 19, at 350.

138. See *Westchester Resco Co., L.P. v. New England Reinsurance Corp.*, 818 F.2d 2 (2d Cir. 1987); *Stern v. Satra Corp.*, 539 F.2d 1305 (2d Cir. 1976); *Van Ekris & Stoett, Inc. v. S.S. Rio Paraguay*, 573 F. Supp. 1475 (D.C.N.Y. 1983),

rationale is that purchasers of insurance generally possess a less than complete mastery of the nuances of their policy¹³⁹ and therefore should be protected from "the fine print" of long and complicated forms.¹⁴⁰

This is no less true in the case of purchasers of D & O insurance. D & O policies granting the insurer an option to withhold defense costs until adjudication, *i.e.*, policies with the typical option clause, are often found to contain ambiguous or conflicting clauses.¹⁴¹ This is due to the problematic nature of a policy construction favoring the insurer—*i.e.*, finding that an insured's accruing defense costs are not "losses" under the policy¹⁴²—and a perceptible attempt by the courts to "do equity" by straining to find ambiguities in D & O policies.¹⁴³

Insurers contend, however, that directors are sufficiently intelligent to recognize policy ambiguities on their face.¹⁴⁴ Purchasers of D & O insurance, insurers argue, are more sophisticated than the average consumer in bargaining for insurance coverage.¹⁴⁵ At least one court has found, however, that directors require the same judicial protection from policy ambiguities as ordinary consumers.¹⁴⁶ Indeed, the doctrine of construing ambiguities against the drafter is "*more* rigorously applied in insurance than in other contracts, in recognition

aff'd, 738 F.2d 419 (2d Cir. 1984); *see also* *Okada v. MGIC Indem. Corp.*, 608 F. Supp. 383, 386 (D. Haw. 1985), *aff'd in part, rev'd in part*, 795 F.2d 1450 (9th Cir. 1986); *Pacific Indem. Co. v. Linn*, 766 F.2d 754, 761 (3d Cir. 1985); *Allen Spooner & Son, Inc. v. Connecticut Fire Ins. Co.*, 314 F.2d 753, 755 (2d Cir.), *cert. denied*, 375 U.S. 819 (1963); *Mohn v. American Cas. Co.*, 458 Pa. 576, 586, 326 A.2d 346, 351 (1974); *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 269, 419 P.2d 168, 171, 54 Cal. Rptr. 104, 107 (1966). This is known as the doctrine of *contra proferentem*. *See* W. YOUNG & E. HOLMES, *INSURANCE* 56-65 (2d ed. 1985).

139. *See* KEETON, *supra* note 19, at 351-52.

140. *See id.*

141. *See supra* notes 128-30 and accompanying text.

142. One commentator illustrates this problem in a discussion of the *Okada* court's reasoning:

[Loss] is defined to include "any amount which the [d]irectors and [o]fficers are legally obligated to pay" The court reasoned that the insured is "legally obligated to pay" defense costs as they come due (in the sense that the insured's counsel has submitted a bill). Thus, the court concluded, a "loss" covered by the policy is sustained at the time defense costs are incurred.

Oettle & Howard, *supra* note 1, at 347.

143. *See* 11 G. COUCH, *COUCH ON INSURANCE* § 44:6 (rev. ed. 1982); KEETON, *supra* note 19, at 356.

144. *See* *Little v. MGIC Indem. Corp.*, 649 F. Supp. 1460, 1469 (W.D. Pa. 1986), *aff'd*, 836 F.2d 789 (3d Cir. 1987).

145. *See id.*

146. *See id.*

of the difference between the parties in their acquaintance with the subject matter.”¹⁴⁷

C. Unconscionability

Can an insurer escape the noose of the *Pepsico* rule by including in its D & O policy an unambiguous, clear provision disclaiming obligation to pay on an “as incurred” basis? If the D & O policy is unambiguous the court must give effect to that language.¹⁴⁸ Therefore, justification for deviating from unambiguous D & O policy language lies only in principles of unconscionability,¹⁴⁹ which ensure that an insurer will not be permitted an unconscionable advantage in an insurance transaction despite fully informed consent on the part of the insured.¹⁵⁰ The crucial question, then, is whether it would be unconscionable to force policyholders to underwrite their own legal defense costs for an indeterminate period of time.¹⁵¹

The basic test of unconscionability is whether the clauses involved in the D & O policy are so one-sided as to oppress or unfairly surprise the other party.¹⁵² That is, does the standard D & O policy include: (1) an absence of meaningful choice on the part of one of the parties; and (2) terms which are unreasonably favorable to the other party?¹⁵³

D & O policies are contracts of adhesion.¹⁵⁴ An insurer generally offers a limited range of insurance forms¹⁵⁵ and the purchaser must

147. *Gaunt v. John Hancock Mutual Life Ins. Co.*, 160 F.2d 599, 602 (2d Cir.) (emphasis added), *cert. denied*, 331 U.S. 849 (1947).

148. *See New York v. Home Indem. Co.*, 106 A.D.2d 124, 483 N.Y.S.2d 834 (3d Dep’t), *aff’d*, 66 N.Y.2d 669, 486 N.E.2d 827, 495 N.Y.S.2d 969 (1985); *Jewish Bd. of Family and Children’s Servs., Inc. v. City of New York*, 66 N.Y.2d 710, 487 N.E.2d 283, 496 N.Y.S.2d 426 (1985). *See generally* 4 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 602A, at 325-34 (3d ed. 1961).

149. *See Standard Venetian Blind Co. v. American Empire Ins.*, 503 Pa. 300, 307, 469 A.2d 563, 567 (1983) (citing 13 PA. CONST. STAT. § 2302) (court may refuse enforcement of contract or particular clause if unconscionable at time of drafting); *Oettle & Howard*, *supra* note 1, at 348.

150. *See KEETON*, *supra* note 19, at 348.

151. *See Little*, 649 F. Supp. at 1468.

152. J. CALAMARI & J. PERILLO, *CONTRACTS* 406 (2d ed. 1986) [hereinafter *CALAMARI & PERILLO*]. The concept of unconscionability has entered the general law of contracts. *Id.* at 403.

153. *Id.* at 407.

154. *See KEETON*, *supra* note 19, at 350. “There has been increasing recognition . . . that the bargaining process has become more limited in modern society [The consumer faced with an adhesion contract] has no real choice. He must take that form or leave it.” *CALAMARI & PERILLO*, *supra* note 152, at 6.

155. *See KEETON*, *supra* note 19, at 73.

accept one if he desires coverage.¹⁵⁶ The major advantage this offers the insurer is economy of operations.¹⁵⁷ By drafting standardized insurance policies insurers avoid the cost of negotiating insurance on a policy-by-policy basis.¹⁵⁸ Insurers contend that the public also benefits from standardization.¹⁵⁹ The standardized policy is developed from experience, they argue, and is therefore a fair approximation of a policyholder's needs.¹⁶⁰

An insured, nonetheless, has "little choice beyond electing among standardized provisions offered to him."¹⁶¹ Standardized provisions, though, limit the "scope of choice" of the insurance purchaser.¹⁶² Essentially, there exists an inequality in bargaining power between vendors and purchasers of insurance policies.¹⁶³ Purchasers of D & O insurance "have no more leverage than the ordinary person who deals with insurance companies"¹⁶⁴ because they also cannot bargain for the terms of the policy.¹⁶⁵ The insured, therefore, faces an absence of meaningful choice when purchasing D & O liability insurance.¹⁶⁶

Furthermore, a D & O policy that grants the insurer an absolute option to withhold defense costs is unreasonably favorable to the insurer.¹⁶⁷ The insurer could defer all payments until adjudication;¹⁶⁸ this is usually for an indeterminate amount of time.¹⁶⁹ Moreover, the D & O policy would allow the insurer the luxury of deferring payments in virtually every case.¹⁷⁰ Finally, the policy would prove quite unfavorable to the insured, as it would leave him in a financially

156. *See id.*

157. *See id.* at 69.

158. *See id.*

159. *See id.*

160. *See id.*

161. *Id.* at 350. The bargaining process with regard to adhesion contracts "is not one of haggle or cooperative process but rather of a fly and flypaper." CALAMARI & PERILLO, *supra* note 152, at 6 (quoting Leff, *Contract as Thing*, 19 AM. U.L. REV. 131, 143 (1970)).

162. *See* KEETON, *supra* note 19, at 69.

163. *See id.* at 348; *see also* Standard Venetian Blind Co. v. American Empire Ins., 503 Pa. 300, 304, 469 A.2d 563, 567 (1983).

164. *Little v. MGIC Indem. Corp.*, 649 F. Supp. 1460, 1469 (W.D. Pa. 1986), *aff'd*, 836 F.2d 789 (3d Cir. 1987).

165. *See id.*; *see also* KEETON, *supra* note 19, at 72-73.

166. The small number of insurers willing to carry D & O insurance exacerbates the absence of meaningful choice. *See supra* note 16 and accompanying text.

167. *See supra* note 64 and accompanying text; *see also Practical Aspects*, *supra* note 1, at 714 n.163.

168. *See Little*, 649 F. Supp. at 1468; Goldstein & Gordon, *supra* note 1, at 2; Johnston, *supra* note 1, at 2023; Oettle & Howard, *supra* note 1, at 340.

169. *See supra* note 122 and accompanying text.

170. *See Little*, 649 F. Supp. at 1468-69.

vulnerable position.¹⁷¹ Considerations of unconscionability dictate, therefore, that an insurer should be required to cover legal expenses as incurred.

D. Analogy to Standard Liability Policies

Pepsico serves as a valid basis for requiring insurers to cover an insured's defense costs as incurred. Given the reluctance of some courts to utilize reasonable expectations,¹⁷² *contra proferentem*¹⁷³ and unconscionability¹⁷⁴ to establish a pro-insured holding,¹⁷⁵ however, further, alternative support can be found by analogy to standard liability policies.¹⁷⁶

Standard liability policies differ from D & O insurance policies in that they impose a duty upon the insurer to defend its insureds.¹⁷⁷ D & O policies, by contrast, are indemnification policies. They impose upon the insurer a duty to pay the costs of the defense of the insured.¹⁷⁸ Accordingly, standard liability policies do not generate the "as incurred" problem standard D & O policies do.¹⁷⁹ More interestingly, however, the insured under a standard liability policy enjoys the benefits of an insurer-provided defense despite the possibility of an ultimate determination that coverage under the policy never existed.¹⁸⁰

Despite the fact D & O policies have been traditionally regarded as indemnification policies,¹⁸¹ jurisdictions today should construe

171. See *supra* note 63 and accompanying text. The insured's travails are compounded by the fact corporate defense lawyers do not work under contingency arrangements, whereas counsel for stockholder plaintiffs usually do. See *Practical Aspects*, *supra* note 1, at 691.

172. See *supra* notes 113-35 and accompanying text.

173. See *supra* notes 136-47 and accompanying text.

174. See *supra* notes 148-71 and accompanying text.

175. A pro-insured holding is one requiring insurers to disburse payments for an insured's legal expenses as these are incurred. See *supra* notes 26-30 and accompanying text.

176. For an overview of the different components of a standard liability policy, see generally *LIABILITY INSURANCE*, *supra* note 18.

177. See Goldstein & Gordon, *supra* note 1, at 2. This is commonly referred to as the duty to defend. See generally Oettle & Howard, *supra* note 1, at 342-43.

178. See Goldstein & Gordon, *supra* note 1, at 2.

179. See *id.* This is because where there are no payments made to the insured there is no timing issue concerning such payments. See also *supra* notes 20-25 and accompanying text.

180. See Oettle & Howard, *supra* note 1, at 343. For an explanation of the no-coverage objection, see *supra* note 96 and accompanying text.

181. See *Corporate Executives*, *supra* note 12 (the D & O insuring clause suggests that the policy provides indemnity rather than liability coverage).

them as liability policies, imposing a duty to defend upon D & O insurers.

Logically, there is little substantive difference between a defense provided by the insurer (a liability policy construction) and one financed by payments disbursed by the insurer (an indemnification policy construction). In both instances the net result is that the insured is not forced to sustain the potentially enormous costs of financing a defense.¹⁸² Furthermore, in both instances it is the insurer that provides the defense; only the *method* of provision differs.¹⁸³ In fact, the only real difference between an insured's defense under a liability policy and one under a D & O policy is that under the D & O policy the insurer can, in effect, *deny any defense to the insured*, even where the plaintiff's complaint reveals that the insured may have coverage.¹⁸⁴ This would be clearly impermissible if D & O policies were construed as liability policies.

Indeed, there is a judicial tendency toward reading such indemnity policies as standard liability policies.¹⁸⁵ According to one commentator, even Lloyd's D & O policy,¹⁸⁶ with its clear language to provide indemnity coverage only, "would probably be construed as liability rather than indemnity insurance."¹⁸⁷ This is because of the "selfish" nature of indemnity contracts, as well as the insurer's obligation to pay "losses" incurred by the insured:

In the first place, the definition of "loss" includes "judgments" as well as "payments." . . . It is well established that a covenant to pay "judgments" rendered against an insured signifies that *the policy is intended to provide liability rather than indemnity coverage*.¹⁸⁸

182. See *supra* notes 6, 121-27 and accompanying text.

183. It is the different *method* of providing a defense in D & O policies that generates the "as incurred" problem. See *supra* notes 177-79 and accompanying text.

184. By utilizing the no-coverage objection, see *supra* note 96, an insurer can disclaim payment on an "as incurred" basis. If there is then an adjudication that precludes an insured from coverage, the insurer can refuse to pay the costs of the defense. The net result is that the insurer has denied the insured a defense.

185. See *Knickerbocker Ins. Co. v. Faison*, 22 N.Y.2d 554, 240 N.E.2d 34, 293 N.Y.S.2d 538 (1968), *cert. denied*, 393 U.S. 1055 (1969); *Corporate Executives*, *supra* note 12, at 651-53. Such a reading, if valid, would impose the duty to defend, ordinarily found in standard liability policies, on D & O insurers. See generally *supra* notes 17-18 and accompanying text.

186. See *supra* notes 13-14, 21 and accompanying text.

187. *Corporate Executives*, *supra* note 12, at 652.

188. *Id.* (emphasis added).

If D & O policies are read as liability policies, as they should be,¹⁸⁹ D & O insurers necessarily have a duty to defend. In insurance law, a duty to defend arises when the allegations in the plaintiff's complaint even arguably reveal that the insured might have coverage.¹⁹⁰ Under such a construction, then, the "as incurred" problem disappears, as a D & O insurer could not be permitted to await a final adjudication without breaching its duty. The D & O insurer would have to pay its insured's defense costs as incurred.

The similarity between an insurer-provided defense and one financed by the insurer, as well as the tendency toward reading D & O policies as standard liability policies,¹⁹¹ leads to the conclusion that D & O insurers have a "duty to defend"¹⁹² their insureds. The practical implication of this duty is that D & O insurers cannot be permitted to deny their insureds a defense, which is precisely what they do when disclaiming a duty to pay an insured's legal costs on an "as incurred" basis.¹⁹³ The weight of the analogy dictates, therefore, that D & O insurers have a duty to pay an insured's legal costs on an "as incurred" basis.

V. Conclusion

Jurisdictions differ in the interpretation of D & O policy defense cost clauses. The *Pepsico* rule requires an insurance carrier to disburse insurance money to cover an insured's legal expenses as they accrue, subject to reimbursement should adjudication show that there were no grounds for coverage. Such a rule comports with the reasonable expectations of the insured and is consistent with rules of contract interpretation and principles of unconscionability. The rule also finds support by analogizing D & O policies to standard liability policies. Courts should therefore adopt the *Pepsico* standard requiring D & O insurers to disburse payments as legal costs are incurred by directors and officers.

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189. See *supra* notes 181-88 and accompanying text; *Corporate Executives*, *supra* note 12.

190. See *Westchester Resco Co., L.P. v. New England Reinsurance Corp.*, 818 F.2d 2 (2d Cir. 1987); *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 419 P.2d 168, 54 Cal. Rptr. 104 (1966).

191. See *supra* note 185 and accompanying text.

192. See *id.*

193. See *supra* note 184 and accompanying text.

