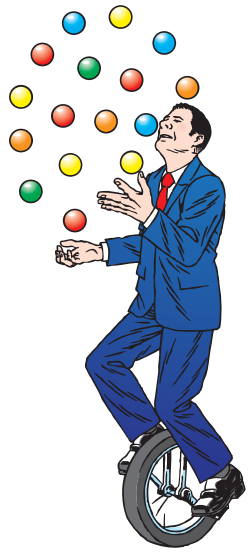
Interim Funding Agreements

Enabling Resolution in the Face of Coverage Issues

BY DON MCGARVEY AND TARA ARGENT



Actions against directors and officers usually involve complex, high stakes claims, which result in protracted and expensive litigation. It is also common for coverage issues to arise in such circumstances. For example, if there is no applicable entity coverage, problems can arise where the underlying action is against the directors and officers and the corporation and policy does not provide for an allocation provision in respect of covered and uncovered claims.

Furthermore, the underlying claim may be settled early on in the proceedings as a business decision in order to avoid the possibility of an even larger trial verdict. This is notwithstanding coverage issues that may be present. These circumstances can create friction between the insurer and the directors and officers, not to mention defence counsel.

Whether an insurer must advance defence costs in the face of a coverage dispute prior to the resolution of the underlying action can be a contentious issue. Some jurisprudence supports the notion that payment of defence costs under a D&O policy is only required upon resolution of the underlying action. Other jurisprudence suggests that defence costs are payable even prior to resolution of the underlying action, notwithstanding the coverage dispute.

Alternatives to lawsuit juggling

When faced with an underlying action, many directors and officers are loath to then sue their insurance carriers and make public the coverage issues that may be at play. There are alternatives, however, to juggling two lawsuits in these circumstances. One avenue is the use of a interim funding agreement (IFA). An IFA is a separate agreement between the insureds and the insurer. The parties can agree that defence costs and/or indemnity payments can be advanced by the insurer allowing the coverage issues to be determined at a later date. Both the insurer and the insureds reserve their rights as to the coverage issues.

An IFA can facilitate efficient and cost effective resolution of the underlying claim. An IFA enables the parties to reach a resolution of the underlying claim at an earlier stage. It may also serve to eliminate the need for costly litigation with respect to determining the allocation of costs or settlement funds in respect of losses covered and uncovered. Often, when the underlying claim has been settled, the insurer and the insureds will have a better mutual understanding of the circumstances. This allows for an easier resolution of the coverage issues than might otherwise have been the case.

Once settlement of the underlying action has been reached, the insurer and the insureds can, under the terms of the IFA, proceed to determine the covered issues through mediation or arbitration, rather than through the court system.

Jurisprudence in Canada

There is a paucity of Canadian jurisprudence with respect to allocation of settlement funds and contribution to settlements of the underlying action. However, the issue was addressed in *Coronation Insurance Co. v. Clearly Canadian Beverage Corp.* In *Clearly Canadian*, the insurer and the insured agreed to contribute to the settlement of the underlying action without prejudice to their ability to have allocation issues determined by the courts at a later date. The insurer then brought an action for allocation of the settlement funds. It argued that its portion of the settlement funds should be reduced to account for the fact that it should not have to pay for the corporation's share of the settlement. This is because, according to the insurer, the policy only provided coverage to the insured directors and officers.

The Court considered two schools of the thought from the American jurisprudence: (1) the larger settlement rule and (2) the "Knepper and Bailey" factors. Under the larger settlement rule, an insurer must pay the entire settlement costs concerning claims against the directors and officers and the corporation if the settlement was not made larger by the corporation's involvement. The "Knepper and Bailey" factors were put forth in an American text on director and officer liability. They suggest that settlement costs should be allocated based on a number of factors, such as the identity of each individual, the risks and hazards to each beneficiary of settlement and the burden of litigation on each party, to

Illustration by Glenn McEvoy

name only a few. Ultimately, the Court in *Clearly Canadian* concluded in the absence of specific policy wording, the large settlement rule applied.

Allocation of defence costs

As with allocation of settlement funds, similar allocation issues arise with defence costs. Some parts of a claim may be covered by a D&O policy while others may be excluded. Allocation of defence costs can become a significant issue as there is only a duty to reimburse covered defence costs. The leading Canadian case on this issue is *Continental Insurance Co. v. Dia Met Minerals Ltd.*, wherein only some of the claims against the directors and officers were covered under the D&O policy. The directors retained their own defence counsel and the claim was ultimately settled. At issue was whether the insurer was responsible to pay for the defence costs related to the uncovered, as well as covered, claims.

The Court concluded that defence costs should be allocated based on the evidence at the end of the underlying case (whether through judgment or settlement):

> *In my view, the Court's suggestion that unlike the duty to defend, the obligation to indemnify in respect of defence costs should be "assessed retrospectively" offers the solution to the almost insurmountable difficulty of apportioning defence costs, on the basis of pleadings alone, before or even after trial. No reason in principle has been offered to us as to why the pleadings alone should govern and in my view there are strong reasons why they should not. It seems both illogical and inequitable to require an insurer who has not sought to shirk its obligations, to bear the entire cost of defending a mixed claim in the face of clear terms that require it to pay the cost of defending only claims relating to the insureds' offices as directors and officers of Dia Met, and that exclude losses arising from dishonest acts or the making of personal profits. If the Court were to require ENCON to pay the entire defence costs of the insured, it would provide them with a windfall merely because one or more allegations that were covered by the Policy were advanced among several that are not covered. The only cases cited to us that would support such a result were cases in which insurers refused to honour their obligation to defend and were held liable for the full costs of defending as a measure of damages for their breach of contract. Clearly this is not such a case.*

Ultimately, an IFA can be effective in reaching an earlier resolution of the underlying action as well as deterring further costly litigation between directors and officers and their insurers. An IFA can be customized to suit the parties desires, whether it be to agree on payment of defence costs and/or settlement funds. Agreeing to fund now (under the appropriate reservation of rights), usually saves a lot later.

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