

SETTLEMENT 101: A Policyholder's Perspective

By: Jeannine Chanes¹

There are two rules for policyholders settling with insurance companies.

First, draft the settlement agreement yourself. Unfortunately, settlement agreements drafted by insurance companies (and their counsel) may not accurately reflect the deal that the policyholder thought it negotiated. This is true even where both parties are well intentioned, because the party writing the agreement will naturally resolve any open or unsettled issues in its favor. The party that drafts the settlement agreement always has the advantage.

Second, never take anything at face value. Every provision of a settlement agreement must be looked at in the context of the agreement as a whole. A provision that looks suspicious on its face may be perfectly acceptable when cross-referenced with the definitions of the terms used, or in light of the other terms and conditions of the agreement, or under the law governing the liabilities being settled. Likewise, overly expansive definitions, or the omission of critical issues, may turn a provision that appears to be perfectly straightforward into something far beyond anything the policyholder had ever contemplated. As a result, policyholders and their counsel should not evaluate any part of a settlement agreement by itself.

The following provisions contain the most common traps for the unwary.

¹ Jeannine Chanes is a partner at the New York office of Fried & Epstein, LLP, which regularly represents policyholders in insurance coverage disputes. She is a frequent speaker and author on the subject of insurance coverage, particularly on issues of allocation and settlement. Information concerning Fried & Epstein's Insurance Coverage Practice Group may be obtained by visiting the firm's website at www.fried-epstein.com. The opinions expressed in this article are solely those of the author and do not necessarily reflect the views of Fried & Epstein, LLP or its clients. Copyright Jeannine Chanes 2001.

I. Definitions

The breadth of any settlement agreement is determined by its seemingly innocuous “Definitions” section. Definitions are tricky because they interlock. Generally, policyholders want to limit the scope of a settlement agreement by keeping definitions as narrow and specific as possible. Insurance companies, on the other hand, want the widest, most comprehensive release they can get for their settlement dollars, which means that they want to use definitions that contain broad, general language.

These competing interests do not mean that the only way a policyholder can get a satisfactory settlement is by insisting that every policy term be defined narrowly. Remember that settlement is always about compromise – on both sides. Fortunately, a definition that on its face looks overly broad may in fact be sharply limited by other defined terms. As shown below, the importance of the breadth of one definition in a settlement agreement often diminishes in direct proportion to the narrowness of the other definitions.

A. The Parties

A policyholder typically wants to release only its own rights as to the specific insurance company or companies it is settling with. Insurance companies prefer a release that includes the policyholder’s parents, subsidiaries, affiliates, predecessors-in-interest, principals and agents – both known and unknown. This definition is generally not good for the policyholder. Given the increasing frequency of mergers, acquisitions and spin-offs, a release using a definition this broad can be a trap, particularly if the settlement agreement contains an equally broad definition of the claims being released. A policyholder should think long and hard

before releasing the rights of any other entities, first considering whether or not it has the right to sign such a release, and then deciding whether it is prudent to do so under the circumstances.

Likewise, insurance companies use equally expansive definitions of themselves, including parents and “sister” companies. This definition is not good for the policyholder either, because many insurance companies are parts of consolidated groups or “fleets,” and have parents or sister companies that are not specifically named in the settlement agreement. These unnamed entities could nonetheless be included in the settlement agreement merely because the settling insurance company was broadly defined. Again, a policyholder should think about which – if any – entities other than the named insurance company it is willing to release under a settlement agreement.

B. The Policies

A policyholder wants to settle claims under a specific set of policies. Again, the insurance company prefers to settle any and all policies of all types, known and unknown (and preferably including the policies issued by its parent and sister companies as well).

A broad definition of the policies released creates two problems for the policyholder. The chief problem is that, unless the policyholder has a simple corporate history with no mergers, acquisitions, spin-offs, predecessors in interest, or parent or sister companies, the policyholder may inadvertently release unknown policies that provide coverage for other members of its corporate “family.” When that happens, the policyholder is generally on the hook for the coverage it has released (the amount that the policyholder is on the hook for is determined by the settlement agreement’s “Indemnification” section). The other problem is that the value of “unknown” policies has not been factored into the settlement amount and, in fact,

cannot be quantified. If the policies being released are broadly defined, the policyholder is potentially accepting substantial exposure to future liabilities for which it is not being compensated.

C. The Claims

The definition of “claims” in the settlement agreement is perhaps the most critical of all definitions. As noted above, a policyholder can comfortably accept broad definitions of the settling parties and the policies released, as long as the definition of the claims released is narrow. However, a settlement agreement with a broad definition of the claims released very often proves unworkable for the policyholder unless the definitions of the settling parties and the policies released are limited.

Claims released in a settlement agreement are like ripples in a pool – they can be defined to include an ever-expanding area of liability. For instance, the hierarchy of environmental claim releases (from most restrictive to most expansive) is:

Litigation settlement: only those environmental claims at issue in pending litigation;

Known claims: all known environmental claims (including any claims relating to sites not at issue in pending litigation);

Known sites: all environmental claims (known or unknown) at all known sites;

Complete environmental buy-back: all environmental claims (known or unknown) at all sites (known or unknown); and

Complete policy buy-back: all claims (known or unknown) of any kind under the policy.

The hierarchy of releases for products liability and mass tort settlements (again, from most restrictive to most expansive), is similar:

Litigation settlement: only those products/mass tort claims currently at issue in pending litigation;

Known claims: all known products/mass tort claims (including any claims not at issue in pending litigation);

Complete products/toxic tort buy-back: all claims (known and unknown) that would impact the products/mass tort coverage; and

Complete policy buy-back: all claims (known or unknown) of any kind under the policy.

In any settlement, a definition of claims that is limited to the claims in the litigation, or to known claims, is fairly safe for the policyholder (although the settling insurance company may try to define “known” to include a mere suspicion on the part of any of the policyholder’s employees). The policyholder must carefully evaluate – and value – all its potential liabilities before agreeing to a more expansive definition of claims, particularly where the definition would result in a complete buy-back of a particular coverage line, or of the policy itself.

In addition, specific claims can almost always be excluded, or “carved out,” of the settlement agreement. For instance, environmental settlement agreements commonly carve out bodily injury claims (defined to include mental injury), employee claims (of any type), asbestos-related claims, product liability claims and Natural Resource Damage (“NRDA”) claims (if possible). Likewise, product liability and toxic tort settlements may carve out environmental, employee and asbestos claims, as well as certain other products or tort liabilities (for instance, those not at issue in the pending litigation). Finally, a policyholder should explicitly carve out any potential claims that were not valued as part of the settlement demand or paid for by the settling insurance company as part of the settlement amount.

II. The Settlement Amount

A. The Settlement Amount is Net

In all settlement negotiations, make sure that the insurance company understands that the initial demand and the final settlement amount are net, and have factored in any applicable deductibles, self-insured retentions and retrospective premiums. Failure to clarify this from the beginning of settlement discussions could result in the policyholder receiving a settlement check substantially lower than the amount it settled for or, worse, a check for the full amount – and a bill for the full amount plus the retrospective premium (say, an additional 30%).

The best way to address these problems is to include a clause in the settlement agreement that specifically states there will be no reduction in the settlement amount for deductibles or SIRs, and/or no charge back to the policyholder (or its parents, etc.) under any potentially-applicable retrospective premium agreement. Further, if the policy has an aggregate deductible or a maximum retrospective premium, make sure the settlement agreement explicitly provides for erosion of the deductible or retro, as appropriate, for all amounts not included in the settlement amount because they were within the deductible or retro.

B. Timing

Once a settlement has been reached, the natural tendency is for policyholders to want to be paid immediately. Because settlement agreements are generally executed separately by the parties, however, settlement monies (whether in the form of checks or wire transfers) rarely reach the policyholder on the day it signs the settlement agreement. Every settlement agreement must specify when the settlement check will be delivered to the policyholder. From a policyholder's perspective, ten days after both parties have executed the agreement is a

reasonable period, although settlement agreements (and insurance company bureaucracy) frequently set a longer period such as twenty or thirty days.

When negotiating settlement agreements, timing is an area where the parties can be somewhat creative. For instance, timing can be tweaked to provide for an expedited (or delayed) payment with an eye on the impact of the payments on the party's profit or loss for a particular year, or even a particular fiscal quarter. Similarly, a settlement structured so that payment of the settlement amount is made over an extended period, rather than in one lump sum, may be advantageous for both parties.

C. Allocation

Another issue that should be addressed is how (and whether) the settlement amount will be allocated. Depending on the characterization of the liabilities being settled, the policy terms, and the current status of the limits (i.e., erosion), the way the settlement amount will be allocated between defense and indemnity costs, or to specific policies, may be of great importance to one or both of the parties.

Some insurance companies want a provision in the settlement agreement giving them the sole discretion on allocation. Even where the policyholder does not care what the allocation is, the settlement agreement should require that any such allocation must be disclosed by the insurance company. Ideally, this disclosure would be made prior to execution of the settlement agreement, although some settlement agreements merely require disclosure of any allocation within ten or twenty days of execution of the agreement.

As with all things in settlement, each side prefers that any allocation be done in the way that is most favorable to it. Generally, insurance companies want to "use up" the

policies that provide the best coverage, which are generally the earliest policies that it has on the risk. (Although in some cases the insurance company may want to assign the settlement to policies backed by the best reinsurance.) Policyholders, on the other hand, want to “use up” the policies that provide the worst coverage, such as those with high deductibles or retros, or those with the most exclusions.

D. Other Issues

Not all policies have aggregate limits, particularly for the premises and operations coverage that is applicable to most environmental claims. The existence (or non-existence) of aggregate limits in comprehensive or commercial general liability policies is hotly contested among coverage counsel, insurance companies and policyholders. As a result, any reference to “aggregate limits” in a settlement agreement should raise a red flag of caution for policyholders. Clauses stating that the settlement amount will be charged against aggregate limits, or will exhaust aggregate limits, may be treated as an admission that the policies do, in fact, have aggregate limits. This admission may be used against the policyholder. By merely inserting the phrase “any applicable” before any reference to the policy’s aggregate limits, a policyholder can protect itself from making such an admission and inadvertently surrendering coverage for future claims.

III. The Release

The scope of the release, as established by the definitions of the parties, the policies and the claims being released, is the heart of the settlement agreement and demands a great deal of attention and focus by the policyholder. As discussed above, most of the hidden dangers in a release come from the scope of the definitions being used.

However, where the settlement is broader than a release of claims under specific policies, the policyholder should add a clause that retains its rights to sue the settling insurance company for coverage on behalf of any entity the policyholder acquires in the future under that newly-acquired entity's policies. Likewise, the agreement should clearly state that the policyholder retains its right to pursue coverage under any policies sold by any other insurance company that the settling insurance company acquires in the future under that newly-acquired entity's policies. An easy way to retain these rights would be to define the policyholder and the insurance company to include only those affiliated entities (such as parents, subsidiaries, etc.) as of the date of the execution of the settlement agreement.

IV. Confidentiality

Confidentiality provisions are part of every boilerplate settlement agreement, and will be included whether it was discussed or not. To protect itself, every policyholder should make sure it has the right to disclose the agreement's terms to its auditors and as required by law. Policyholders should preserve some flexibility here, in the event their securities lawyers decide that the settlement is material in connection with the disclosure of the company's environmental or other liabilities. Further, a policyholder should consider whether it wants to reserve its right to disclose certain terms of the settlement agreement to its other insurance companies in the context of confidential settlement discussions.

Often the insurance company has a greater interest in non-disclosure than the policyholder. In that case, the burden of opposing subpoenas or other requests for disclosure should be placed on the insurance company. Where the policyholder wants to keep terms of the settlement agreement confidential but the insurance company needs to disclose them to its reinsurers, the policyholder may want to include a provision requiring that the insurance

company obtain a signed confidentiality agreement from the reinsurer before any such disclosure.

V. Indemnification

Unfortunately for the policyholder, typical settlement agreements contain provisions requiring the policyholder to defend and indemnify the insurance company for any claim against the insurance company arising from a released claim or liability. This indemnification provisions cover cross-claims for contribution from other insurance companies, third party claims under direct action statutes and, if the scope of release in the agreement is expansive, claims by other entities with rights under the policies for the claims or coverage released. (The latter becomes an issue where the policyholder is settling an entire line of coverage – such as an environmental buy-back – or agreeing to a full policy buy-back.)

Policyholders are understandably reluctant to agree to defend and indemnify their insurance companies, because agreeing to do so puts the policyholder in the position of acting like the insurance company for its insurance company. The insurance company, on the other hand, could not reasonably be expected to pay the policyholder the settlement amount without transferring at least some of the risk of subsequently being found liable for that amount, or more, if sued by another party with rights to the settled coverage.

Although defense and indemnification clauses can be crafted many different ways, the following summaries of the most common approaches will help policyholders work out the best provisions for their particular circumstances.

A. No Indemnification or Defense

A policyholder's refusal to provide defense and indemnity in a settlement is generally a deal-breaker for any settlement. This position is useful as an opening in any negotiations, but it is unrealistic and impractical for any policyholder seriously interested in settling.

B. Capped Indemnity, No Defense

A good compromise position for the policyholder is to agree to indemnify the settling insurance company up to a fixed amount, but not to agree to provide any defense. Generally, the indemnification cap is set at the settlement amount, although it could be set higher or lower depending on the circumstances of an individual settlement.

This approach has two main advantages. First, the policyholder has no obligation for any of the insurance company's defense costs or for any indemnity costs until the litigation is resolved either through settlement or judgment. Second, even if the policyholder is eventually required to indemnify the insurance company, any such indemnification is capped. The policyholder can obtain further protection if the agreement contains language that allows the policyholder to control settlement of any such claims to the extent that they fall within the policyholder's indemnity obligation.

C. Capped Indemnity and Some Defense (Shared, Capped or Uncapped)

Like many policyholders, many insurance companies place as high a value on the defense of any actions against them as they do on the actual indemnity. Depending on the insurance company it is settling with, a policyholder may get the insurance company to agree to share this defense obligation, generally on a fifty-fifty basis. Where that is not possible, most

insurance companies will agree to put the defense obligation within the same cap as the indemnity obligation.

Another, riskier, alternative, is for the policyholder to give the insurance company a capped indemnity with an uncapped defense. Where an uncapped defense is necessary, the policyholder can protect itself using a number of provisions, such as: (i) the indemnified insurance company shares in the defense costs (generally in return for some control over the defense); (ii) the policyholder is informed in advance of any disbursements above a fixed amount (say, \$10,000); (iii) the policyholder has the unilateral right to settle within its indemnity obligation; and (iv) the defense obligation ends once the indemnity cap is reached.

In every case where the policyholder agrees to assume some or all of the defense costs (whether or not they are capped), the policyholder should retain some control over the selection of counsel and the handling of the defense. Generally, one of the parties has the right to select counsel, subject to the approval by the other party (such approval not to be unreasonably withheld).

D. Uncapped Indemnity, With or Without Defense

Like the policyholder's quest for a settlement agreement with no indemnification provision, every insurance company wants a settlement agreement with an uncapped indemnification. Fortunately, most are willing to settle for less. The obvious danger for a policyholder is that an uncapped indemnification agreement (with or without defense provisions) puts it at risk for more than it received in settlement. Under the circumstances, policyholders must insist on control of the defense and settlement of all indemnified claims.

The risk of giving such a complete indemnification is most likely to materialize where the coverage litigation goes to trial and the policyholder wins a joint and several judgment against its non-settling insurance companies. There is also a danger to settling policyholders in states which allow direct actions against insurance companies, although direct actions rarely arise where the policyholder is a solvent corporation. Finally, an uncapped indemnification may cause problems for policyholders who have released other parties' rights to the policies (such as the rights of sister companies or spun-off entities), particularly when the policies released have no aggregate limits for the claims at issue. Policyholders need to have a thorough understanding of their corporate history and their insurance portfolio before agreeing to an uncapped indemnity.

Having said that, however, there are some circumstances where policyholders may prudently agree to uncapped indemnity and defense provisions. First, where the policyholder has agreed to a "buy-back" or commutation of an insurance policy (or a particular line of coverage under the policy), the policyholder has effectively given a complete indemnification of that policy (or of those claims). In the event that the settling insurance company is sued, it would almost certainly tender the settlement agreement to the court and the claimant, which would undoubtedly result in the insurance company's dismissal from the action. Thus, giving an uncapped indemnity and defense in this context does not increase the policyholder's risk. (Obviously, however, policyholders should think twice and consult coverage counsel before agreeing to a policy commutation or any type of coverage buy-back.)

Giving an uncapped indemnification and defense is also less risky where the policies being released are high-level excess and the law governing the action would be likely to preclude coverage entirely (based on policy exclusions) or allocate the indemnification and defense obligations in such a fashion that the policies would never be pierced.

Finally, the risk of uncapped indemnification diminishes as an increasing number of the policyholder's insurance companies settle (assuming that each settlement agreement contains a waiver of cross-claims for contribution by the settling insurance company, as discussed below). The closer the policyholder comes to resolving its coverage dispute with all of its insurance companies, the less anxiety it should feel about giving broader indemnification and defense provisions.

V. Waiver of Cross-Claims

Another provision that is becoming increasingly standard in settlement agreements is the requirement that the settling insurance company waive its rights to cross-claim for contribution against any of the policyholder's other insurance companies for the liabilities being settled. (The risk, of course, is that a settled insurance company would sue another settled insurance company for contribution, thus triggering the policyholder's indemnification and defense duty under the settlement agreement.) In order for both parties to be fully protected, the policyholder needs to agree to use its best efforts to obtain similar waivers from all of the other insurance companies it settles with.

VI. Choice of Law

Some insurance companies insert a choice of law provision into settlement agreements that specifies which state's law will govern any agreements under the dispute. In general, a policyholder that is unfamiliar with the law in the potentially applicable jurisdictions should take the choice of law provision out. However, if the policyholder is clearly associated with one state (for instance, where it is incorporated, has its principal place of business and the settlement was executed in the same state and that state has a reasonable connection with the liabilities being settled), the choice of law provision may not be worth fighting over.

VII. A Word About Coverage-in-Place Agreements

One of the frequent roadblocks to settlement occurs when a policyholder's future liability cannot be quantified, often because it is contingent upon some event beyond the control of either the policyholder or the insurance company (for instance, where a pending lawsuit could increase the policyholder's liability by millions of dollars). In these cases, the parties may agree to a "coverage-in-place" agreement to resolve their dispute and avoid litigation costs. Typically, coverage-in-place agreements include a lump sum payment by the insurance company for past costs, and provisions for payment of future defense and/or indemnity costs under a specified formula.

Unfortunately, not every insurance company that enters into a coverage-in-place agreement is willing or able to live up to its end of the bargain. Before even considering a coverage-in-place agreement, a policyholder should check the insurance company's current solvency status and its rating in A.M. Best's. In addition, the policyholder should also find out whether, in fact, the insurance company it is negotiating with has actually paid out under previous coverage-in-place agreements or whether it has a history of renegeing on such deals. Only by completing this due diligence can a policyholder enter into a coverage-in-place agreement with any degree of confidence that the disputed claims have, in fact, been resolved.

Conclusion

Every settlement agreement is unique. Therefore, there can be no "absolute" rules of settlement for policyholders, only guidelines to help craft the best possible settlement agreement given the particular facts, circumstances, claims and policies being settled. Further, settlement is like diplomacy in that the end result is the compromise that both parties feel they can live with.

Hopefully, the issues discussed above have shed some light on the areas that most often trap the unwary policyholder. As for those issues policyholders may face that were not discussed, the guidelines are simple: stop, think, consider all the implications of the language or terms being proposed, and then consider every possible negative impact of the proposed terms and the likelihood that those events will come about. If the risk is worth the settlement amount, a policyholder can reasonably agree to assume it. If not, keep negotiating.