Tapping Insurance Proceeds In Class Actions Creates Strange Bedfellows and Many Opponents

Settling complex class action lawsuits frequently requires the consensus not just of corporate directors and officers, but also their primary and excess insurers, as standard directors and officers (D&O) policies prohibit the insured from admitting or assuming any liability without the prior written consent of the insurer.

This provision, intended to reduce the moral hazard of an insured shopping for his or her release with a blank check, thereby protecting insurers from expedient but unreasonable settlements, generally results not only in the insurer’s sign-off privileges, but an active seat at the table during settlement negotiations and mediation. But what happens when the insurer disclaims coverage and refuses to enter the fray? In this situation, individual defendants are often left to fend for themselves, but they are not without options. An arguably covered defendant may extract some value without first litigating against the insurer, but doing so requires threading the needle of optimal settlement drafting, court approval, and third-party objections.

The most common method to utilize the untapped potential of a coverage action as settlement consideration is for the insured to settle with the class, securing his or her release by consenting to a confession of judgment in the amount of the settlement, accompanied by an agreement not to execute except against the applicable insurance policy, the rights under which are assigned to the plaintiff class. This arrangement is attractive both for the individual defendant, who often lacks the resources to personally satisfy a significant judgment or litigate against the insurer, as well as the plaintiff class, which avoids the costs of proceeding against a judgment-proof defendant. A mere assignment, as opposed to a declaratory ruling on coverage, is also attractive from the court’s perspective as it avoids prejudicing the insurer. If the claim was indeed excluded by the policy, the insurer continues to pay nothing, and the plaintiff class obtains no recovery against that defendant. If coverage was in fact wrongly denied, the insured remains free from payment, and the insurer must cover the settlement as it otherwise would.

The first stumbling block when attempting to craft such a settlement is often the language of the D&O policy itself. Most policies define covered loss as amounts that the insured becomes “legally obligated to pay” on account of a covered claim. Therefore, many insurers argue that a defendant who consents to a judgment but is protected by a covenant not to execute is not legally obligated to pay plaintiffs, and therefore has suffered no loss. A minority of courts have barred such agreements under this logic, concluding that a confession of judgment in which the insured would never expect to pay out of his or her own resources nullifies the possibility of coverage. These courts caution that to hold otherwise would invite collusion between the settling parties. Most courts, however have concluded that a liability insurer cannot have its cake and eat it too, disclaiming coverage whilst simultaneously complaining that a settlement and accompanying covenant not to execute eliminates the insured’s obligation to pay. One court went so far as to bless a judgment 13 times in excess of the insurer’s policy limits where the insurer accidentally neglected to defend the insured. To resolve the policy language, these courts have reasoned that a covenant not to execute except against the insurance policy does not affect the insured’s underlying liability, but is rather “an agreement to seek recovery only from a specific asset—the proceeds of the insurance policy and the rights owed by the insurer to the insured.”

In New York, the Second Department has taken the majority view, holding that a covenant not to execute is not tantamount to a release of liability in the underlying action sufficient to relieve the insurer of its duty to pay the insured’s “legally obligated” damages. This approach has been accepted and applied by the Second Circuit as well. Within the permissive New York framework, the critical judicial analysis in approving an insured’s settlement is therefore whether the amount of the judgment is reasonable in light of the risks of litigation, and non-collusive. In New York, “[i]n order to recover the settlement amount from the insurer, the insured need not show actual liability to the party with whom it has settled so long as a potential liability on the facts known to the insured is shown to exist, culminating in a settlement in an amount reasonable in view of the size of possible recovery and degree of probability of claimant’s success against the insured.” Accordingly, the settling parties should have the judgment entered for a specified amount—otherwise the plaintiff or a subsequent assignee may be barred from filing a direct action, particularly if the insurer is an excess carrier with no duty to defend.

Current case law suggests several steps to maximize the value of the assignment. First, while some degree of coordination between counsel for the settling individual and plaintiffs is unavoidable once the settlement is signed, the parties should consider utilizing an arms’ length mediator to first determine the settlement’s
economics and immunize the judgment amount from ex post claims of collusion. Second, for the same reason, the parties may seek expert analysis to assess reasonable damage calculations. Third, best practices also dictate that the judgment be limited to a claim not excluded by the relevant policy language, such as negligence or breach of the duty of care. Otherwise, a policy’s intentional wrongful conduct exclusion language may be triggered by the court entering a final judgment, frustrating the plaintiff class’ ability to assert their claims as assignees. Fourth, the settlement’s release and proposed dismissal order should exclude the claim or claims on which the consent judgment is based.11

Unfortunately, no amount of advance planning can ensure an unimpeded settlement approval where third-party stakeholders are vying for the same pool of insurance proceeds. This can become an acute issue in large bankruptcies, where separate and often competing plaintiffs and creditors are seeking recovery from defendants covered by the same policies, and thus a limited set of resources. One recent example of an assignment-based settlement that successfully navigated these waters comes from the long-running commodities class action captioned In re Platinum and Palladium Commodities Litigation.12

Originally filed in April 2010, the action consolidated separate sub-classes of plaintiffs representing purchasers of platinum and palladium futures and bullion. These plaintiffs brought antitrust, RICO, and common law claims against a hedge fund, future commission merchant MF Global, and several individuals, including a former MF trader, for allegedly manipulating these precious metals markets. While the claim against MF Global was stayed after the firm filed for Chapter 11 protection in November 2011, the remaining claims, including those against the former trader, continued unabated.13 Class plaintiffs sought hundreds of millions of dollars in damages from the entity defendants, but the MF trader lacked resources to even entertain a settlement.14

Therefore in conjunction with other defendants’ monetary settlements, and in lieu of any cash consideration, the MF trader consented to entry of judgments totaling $42 million, solely as to a state law negligence claim, assigning his rights to a 2011 D&O liability policy for which the primary and excess insurers had denied coverage. The terms of the settlements barred the assignee plaintiffs from enforcing the judgment against the trader personally. None of MF Global’s primary or excess insurers objected to the settlement or the amount of the judgment against the trader. The district court ultimately approved the settlement as to all defendants, including the trader, entering the consent judgment in November 2011, the remaining claims, and actions brought by the MF Global Litigation Trustee and affirming the covenant not to execute judgments.15 Moreover, even assuming that the insurance policies were properly at issue, the Customer Reps’ interest was deemed too speculative given the early stages of their own lawsuit; they would need to obtain a judgment and also prove coverage in order to have colorable claims to the insurance proceeds.16

Paulay likewise denied permissive intervention for the Customer Reps, and ultimately granted final approval to the class settlements.17 In the end, the settling parties’ limited but potent use of the court proved to be an effective recipe for the plaintiffs. As part of a larger settlement with MF Global Plan Administrator and Litigation Trustee objected to the settlement and filed an adversary proceeding seeking to enjoin its final approval. In objecting, the Administrator and Trustee argued that $25 million in senior D&O coverage otherwise available to satisfy claims against MF Global’s independent directors would be irreversibly lost if the claims now proposed to be settled are paid off in piecemeal fashion.18 At the time of writing, these issues were scheduled to be heard prior to publication, and may have been resolved.

Within the permissive New York framework, the critical judicial analysis in approving an insured’s settlement is therefore whether the amount of the judgment is reasonable in light of the risks of litigation, and non-colusive. 19

The MF Global SIFA trustee, they were able to monetize the consent judgments by assigning them to the MF estate in exchange for $1 million.20 While this outcome should give comfort to parties seeking approval of insurance-assessment settlements, it also illuminates the fact that the first-to-settle plaintiff is often the victor in insurance-driven settlements. In the MF Global bankruptcy, Bankruptcy Judge Martin Glenn has frequently mediated various parties’ disputes over the proper source for payment of defense costs, picking between D&O and errors and omissions (E&O) policies but setting soft caps on fee advances.21 Perhaps predictably, these fees have multiplied as a result of competing class actions, opt-outs, regulatory proceedings and actions brought by the MF Global Litigation Trustee. Indeed, counsel for certain individual insureds in the multi-district litigation recently described the need to lift the existing soft cap as “urgent,” citing the almost 100 depositions described the need to lift the existing soft cap as “urgent,” citing the almost 100 depositions


2. See, e.g., Fowser v. Schmidt Real Estate & Ins., 755 F.2d 135, 139 (9th Cir. 1985).


7. See, e.g., Pinto v. Allstate Ins. Co., 221 F.3d 394, 403 (2d Cir. 2000).


10. We do not address here those factors to be considered in the context of a motion to approve a class action settlement, which the Second Circuit enumerated in City of Detroit v. Grinnell, 495 F.2d 448, 463 (2d Cir. 1974).

11. It is notable, however that the Second and D.C. Circuits have allowed bad faith claims to proceed against the insurer where the assignment was accompanied not by a restrictive covenant, but by a settlement release that arguably eliminated the insured’s liability in the underlying action altogether. See Pinto, 221 F.3d at 404. (“[a]lthough the parties may not have chosen their form to execute their intention, New York courts have ignored the formal distinction between a release and a covenant not to sue or execute in order to avoid an unjust result.”); Gray, 684 F. Supp. at 1113, 1116 (D.D.C. 1988) (similar); but see Deangelis v. Allstate Ins. Co., 252 A.D.2d 877, 879 (2d Dep’t 1998) (“A release discharging an insurer from all liability effectively relieves an insurer from indemnifying under a contract of insurance.”).


13. Id. at *1-2.


17. Id. at *6.

18. Id. at *7.

19. Id. Perhaps tellingly, in the same order denying intervention, Pauley noted that the case was “now on its sixth amended complaint,” having been “litigated vigorously for more than four years.” Id. at *1.


