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Guest Post: No Choice of Law in Delaware Coverage Disputes?

By Kevin LaCroix on September 10, 2019 POSTED IN INSURANCE COVERAGE

In the following guest post, Jeremy Salzman and Kylie Tomas of Sompo International and Ommid Farashahi and Jonathan Cipriani of BatesCarey LLP discuss a recent series of Delaware court decisions in which the courts applied Delaware law in addressing insurance coverage disputes. In their article, the authors question Delaware law appropriately should have been the law applied in those cases. I would like to thank the authors for allowing me to publish their article as a guest post on this site. I welcome guest post submissions from responsible authors on topics of interest to this blog's readers. Please contact me directly if you would like to submit a guest post. Here is the authors' article.

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It is no secret that Delaware courts exert significant influence on the American corporate law landscape. With more large companies incorporated in Delaware than any other state, Delaware boasts a bench that is extremely well-versed in corporate law issues.

A disturbing trend has developed recently, however, with Delaware courts expanding their influence even further, into the area of insurance law. In a spate of recent decisions, Delaware courts have applied Delaware law to insurance coverage disputes, essentially by default in the absence of a choice of law provision, where the policyholder is incorporated in Delaware. Delaware courts have given little to no regard to, for example, the state where the policy was issued, the state where the policyholder is headquartered, or state amendatory endorsements, attached to the policy, reflecting the intent of the parties to be subject to the law of certain state (other than Delaware).

This unfortunate trend has significant consequences for insurance carriers issuing policies to Delaware-incorporated insureds. These include the increase in the number of coverage actions filed by policyholders against insurers in Delaware, as well as the application of Delaware insurance law, which is often less favorable to insurers than the law of other jurisdictions.

This article discusses how this trend has developed, why this matters to insurers, and what steps insurers can take in response.

The* Mills *Case

Back in 2010, a Delaware trial court applied Delaware law to an insurance coverage dispute, despite the fact that the insured was headquartered in Virginia and the policy was issued in Virginia. *Mills Ltd. P'ship v. Liberty Mut. Ins. Co.*, 2010 WL 8250837 (Del. Super. Ct. Nov. 5, 2010). *Mills* involved a coverage dispute, under a D&O policy, regarding exhaustion of underlying insurance. The insured was incorporated in Delaware, but headquartered in Virginia, where the policy was issued. The *Mills* court opined that, in cases where "the insured risk" is the business conduct of directors and officers located in states across the country or even throughout the world, Delaware will look to factors including the place of contracting, the place of negotiation of the contract, the place of performance, the location of the subject matter of the contract, and the domicile, residence, nationality, place of incorporation, and place of business of the parties. *Id.* at *5.

While purporting to look at all of these factors, the court stated that, where the underlying litigation involves the directors' and officers' "honesty and fidelity to the corporation," the state of incorporation has a more significant relationship to the policy than the place where the insured has its physical headquarters. In the court's words: "[The insured's] directors and officers caused a Delaware corporation to defraud its investors, which made the corporation liable and triggered the corporation's D&O policy. In a case like this, what difference does [the] headquarters' location make to the company or the people involved?" *Id.* at *6. Accordingly, the court applied Delaware law, holding that Delaware employs the "functional exhaustion" rule, which was fatal to the insurer's exhaustion-based coverage defense.

The Recent Trend

For almost a decade, the *Mills* decision was considered by many to be an aberration, with no other court following its choice of law analysis – until recently. In March of 2018, another Delaware trial court applied *Mills*, holding that Delaware law applied, even though the insured was headquartered in California, the policy was issued there, and the policy included California state amendatory endorsements. *Arch Ins. Co. v. Murdock*, 2018 WL 1129110 (Del. Super. Ct. Mar. 1, 2018). Nevertheless, relying upon *Mills*, the court applied Delaware law, reasoning that the conduct of the insured's directors and officers was centrally

implicated; that the insured risk involved their "honesty and fidelity" to the corporation; that the individual defendants held management positions pursuant to Delaware law; that the situs of the company's shares was Delaware; and that prior court rulings had involved Delaware law. The court held that Delaware law, unlike California, did not preclude an insurance indemnity payment for an insured's fraud, and required the insurers to demonstrate prejudice from the insureds' violation of the consent provision.

Thereafter, in *IDT Corp. v. U.S. Specialty Ins. Co.*, 2019 WL 413692 (Del. Super. Ct. Jan. 31, 2019), the insured was a Delaware corporation with its principal place of business in New Jersey. The court concluded that Delaware law applied because the insured was incorporated in Delaware, the policies covered D&O liabilities involving the insureds' "honesty and fidelity" to the corporation, and the merits of the underlying litigation were governed by Delaware law.

In *Verizon Commc'ns, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 2019 WL 2517418 (Del. Super. Ct. Apr. 26, 2019), the same judge who decided the *Murdock* case held that Delaware law applied to a D&O policy and, thus (for that reason among others), the coverage action should proceed in Delaware, not New York, even though the insurers filed a dueling action in New York.

More recently, in *Pfizer, Inc. v Arch Ins. Co.*, 2019 WL 3306043 (Del. Super. Ct. July 23, 2019), even though the insured's principal place of business was in New York, the policy was issued in New York, the policy contained New York amendatory endorsements, and the underlying lawsuit was filed and pending in New York, the Delaware court applied Delaware law, relying on *Mills* and *Murdock*.

If this trend continues, the insurance industry can expect Delaware trial courts to apply Delaware law to insurance coverage disputes, essentially by default in the absence of a choice of law provision, where the policyholder is incorporated in Delaware, regardless of where the policy was issued or where the policyholder is headquartered.

Why This Matters to Insurers

While anecdotal, we have seen a significant increase in the number of coverage actions filed by policyholders in Delaware in an effort to avoid litigating in a jurisdiction more likely to apply the law of state where the policy was issued. Not only has the number of such actions increased, but the timing of the filing of these actions has changed as well. In order to "plant the flag" in Delaware, policyholders have been filing coverage litigation more quickly than before, resulting in less pre-litigation dialogue or negotiation between the parties.

This trend is also important to insurers because Delaware insurance law can be particularly unfriendly to insurers. For example, in the *Pfizer* case discussed above, the Delaware court was asked to decide a "related claims" issue. Finding that Delaware law, not New York law, applied, the court imposed Delaware's very narrow "relatedness" test and held that two claims were not related because they were not "fundamentally identical." *See Pfizer*, 2019 WL 3306043, at *10. Importantly, if the dispute had been decided under New York law, the insurers could have relied on New York's broader "sufficient factual nexus" test.

Another example is that, unlike courts in other jurisdictions, Delaware courts will not sustain a coverage defense based on an insurer's lack of consent to settle an underlying case, unless the insurer can show prejudice. *See Murdock*, 2018 WL 1129110, at *13.

Delaware is also less favorable to insurers with respect to coverage for disgorgement. *Compare Gallup, Inc. v. Greenwich Ins. Co.*, 2015 WL 1201518, (Del. Super. Ct. Feb. 25, 2015) (where a claim for disgorgement is settled without a final adjudication, there is coverage for the settlement, even if disgorgement is uninsurable), *with Phila. Indem. Ins. Co. v. Sabal Ins. Grp., Inc.*, — F. App'x —, 2019 WL 4014100 (11th Cir. Aug. 26, 2019) (rejecting case law holding similarly to *Gallup* and finding no coverage for settlement of disgorgement claim based on traditional "no Loss" analysis).

How Insurers Can Respond

How can insurers respond to this trend? As to policies already in the marketplace, of course, the industry can continue to seek a good ruling from a different Delaware trial court judge on this issue, presumably based upon a particularly good set of facts. In addition, insurers can seek appellate relief from the Delaware Supreme Court (there is no immediate appellate court in Delaware). However, a challenge to a court's early decision on choice of law may not be possible until the underlying case is tried or otherwise disposed of by motion, and cases rarely go that far down stream. In addition, it is critical that, if the industry does seek relief from the Delaware Supreme Court, it must evaluate carefully the best "test case" to send up, as a "close call" case could yield a decision from Delaware's highest court unfriendly to the industry. In the meantime, absent a decision from the Delaware Supreme court, while a "race to the courthouse" is never the preferred option, insurers should consider filing first in the "right" jurisdiction when faced with a coverage dispute, anticipating that the policyholder will likely file in Delaware.

As to policies yet to be issued, there is one clear option – to include a choice of law provision in the policy identifying the law of a state other than Delaware. Insurers may choose to apply the law of the state where the

insured is headquartered. Many insurers and insureds probably assume that is the law that will govern the policy anyway, so this may simply reinforce pre-existing expectations of the parties. Of course, it will behoove insurers to be aware of any unique risks or concerns presented by a given jurisdiction and to consider the choice of law provision in light of all relevant factors. Another option is to include a New York choice of law provision, which has been traditionally included by certain markets, and therefore s hould not be particularly controversial with policyholders or their brokers. Even this option, however, may be subject to challenge, as illustrated by a recent decision by the California Supreme Court. In *Pitzer College v. Indian Harbor Insurance Company*, 2019 WL 4065521 (Cal. Aug. 29, 2019), the Court held that, even though a policy contained a New York choice of law provision, the court applied California law to certain notice issues, because the issues concerned a "fundamental public policy" of California. Yet another potential option could involve policy language outlining binding arbitration in connection with disputes arising from the application of a policy's choice of law provision.

While it is unfortunate that insurers must now expect Delaware courts to apply Delaware law where the policyholder is incorporated in Delaware, absent a choice of law provision or other policy built-in procedure, this appears to be the "new normal," at least for now. But, as discussed above, there are steps that insurers can take, both with respect to those policies already in the marketplace and future policies.