Directors' and Officers' Liability:

Insurance for Attorney's Fees in Derivative and Class Actions

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When a judgment or settlement in shareholder derivative or class action litigation results in a corporation or a certified class receiving some or all of the benefit sought or relief on a significant claim, the shareholder who pursued the claim may recover an award of the reasonable expenses of litigation, including attorney's fees. D&O insurance policies that treat plaintiffs' attorney's fees as an afterthought have generated coverage litigation concerning those fees—and the outcomes have surprised some.

A divided panel of the Appellate Division, First Department, recently held that a corporate insured's payment of shareholder plaintiff attorney's fees was a covered loss even though the shareholder's derivative suit arguably benefited the insured well beyond any loss represented by the fees. In the class context, a federal court in Minnesota refused to dismiss claims for coverage of payment of class action plaintiffs' attorney's fees, reasoning that, although none of the substantive claims alleged by a plaintiff class against an insured were covered claims, the plaintiff class' demand for attorney's fees was itself a separate, covered claim. A review of standard D&O insurance policy terms and relevant case law suggests that insurers may wish to tighten the language of certain policy definitions and that, until they do, insureds have additional avenues to pursue coverage for payment of plaintiffs' attorney's fees.

Background

Most D&O insurance policies cover a claim by a third party against the insured

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made with respect to a wrongful act that results in a loss. Determining whether a policy covers the insured's payment of plaintiff's attorney's fees begins with the terms of the policy itself, particularly the definitions of "claim" and "loss." In the past, many policies did not even define the term "claim." However, interpretive disputes between insurers and policy holders, and among various courts, have prompted most modern policy-drafters to attempt to minimize confusion by defining the term broadly.

Typically, "claim" is defined as "a written demand for monetary or nonmonetary relief." "Loss" generally includes all "damages, judgments, settlements and defense costs" incurred by a director or officer—or by the corporation itself through indemnifying a director or officer—in the defense and investigation of a claim. (Most policies now also provide coverage for losses attributed directly to the corporation itself under "Entity Coverage.") Often, the policy will employ limiting language, either in the definition of "loss" or by separately defining "damages," in order to preclude coverage for punitive damages, fines, penalties, and other payments that are designed to punish the wrongdoer. It is relatively common, however, for the insured's payment of plaintiff's attorney's fees not to be addressed in any of these key definitions.

Of course, insurance coverage for an award of plaintiff's attorneys' fees only becomes an issue when the insured actually must pay the fees. Under the so-called American Rule of attorney's fees, each party pays its own way, so no coverage issue arises. In shareholder derivative litigation, by statute in New York (Business Corporation Law §626(e)) a shareholder derivative plaintiff whose suit succeeds in whole or in part may receive an award of reasonable attorney's fees and expenses. Successful derivative plaintiffs may recover an award of fees under two recognized equitable exceptions to the American Rule, the "substantial benefit" and "common fund" doctrines. In shareholder derivative litigation, the "substantial benefit" doctrine authorizes a court to award a shareholder plaintiff a reasonable attorney's fee to be paid out by the corporation if the derivative suit results in the corporation, by judgment or settlement, receiving a non-monetary benefit attributable to the litigation.1

The rationale is that the corporation and its shareholders should compensate the shareholder whose efforts conferred a benefit, lest they be unjustly enriched.

Spreading the cost of the litigation to all of its beneficiaries also encourages litigants with meritorious suits to pursue them. When the benefit conferred on the company is a tangible, monetary one, the related "common fund" doctrine permits the litigant to obtain an award of attorney's fees from the fund created by its efforts. In cases where a settlement or judgment in a class action creates a common fund for the class, the court has discretion to award attorney's fees using either the lodestar method or the percentage of the fund approach.

Burden or Benefit?

In *XL Specialty Insurance Co. v. Loral Space & Comm. Inc.*,[2] a divided panel of the Appellate Division, First Department, recently ruled in a 3-2 decision that a company was entitled under a "Management Liability and Company Reimbursement" policy to coverage for its payment of a shareholder's attorney's fees incurred in obtaining non-monetary relief in a derivative suit on behalf of the company. The case stemmed from Loral's issuance of convertible preferred stock to a controlling shareholder in exchange for $300 million, an amount deemed insufficient by certain shareholders. Shareholder BlackRock filed a putative shareholder derivative action in Delaware seeking rescission of the transaction. In a companion class action, another Loral shareholder, Highland, alleged breach of fiduciary duty claims against Loral and its board of directors.

At trial of the consolidated actions, the Court of Chancery reviewed the transactions under the "entire fairness" standard, and determined that the transaction was unfair, but determined that the proper remedy was not rescission but reformation. The court restructured the deal so that the controlling shareholder's $300 million purchased non-voting common stock rather than convertible preferred stock. The court did not award damages or make any findings of liability against Loral's directors.

Thereafter, counsel for BlackRock and counsel for Highland applied for awards of attorney's fees. Loral stipulated to an award of $8.7 million for BlackRock's counsel in the derivative action. The language of the stipulation specified that Loral was paying the fee "[i]n consideration of the results achieved by the derivative plaintiffs in this action." Loral did not reach a similar agreement with Highland, but using the lodestar method to calculate the fees, the Court of Chancery awarded Highland's counsel $10.7 million in fees and expenses. The court determined that the litigation had produced a substantial benefit to Loral, thus warranting an award of fees under the corporate benefit doctrine.

Loral sought coverage of these attorney's fees from its insurer under the policy, which covered, inter alia, a Securities Claim "brought derivatively on behalf of the Company by a security holder of such Company," prompting the insurer to initiate an action in New York state court seeking a declaration that the fees were not covered. Loral prevailed in the trial court. On appeal, the critical issue that would split the panel was whether Loral had suffered a "loss" within the meaning of the policy by paying BlackRock's attorney's fees when those fees stopped Loral from making an unfavorable deal.

The policy defined "loss" as "damages, judgments, settlements or other amounts (including punitive or exemplary damages where insurable by law) and Defense Expenses in excess of the Retention that the Insured is legally obligated to pay." The majority concluded that Loral's payment of BlackRock's attorney's fees was an "other amount[]" that Loral was "legally obligated to pay." This legal obligation arose under the corporate benefit doctrine, because the reformed stock transaction, which BlackRock's derivative suit made possible, had saved Loral from an unfair deal.

Rejecting the insurer's argument that the attorney's fees should be offset against the value of the non-monetary benefit Loral and its shareholders received as a result of the restructured transaction, the majority reasoned that "[a]t best, the reformation of the transaction leveled the playing field and repaired the wrong that Loral would have suffered otherwise." That is, the only benefit Loral received was that "it no longer had to suffer harm," which the Appellate Division concluded did not warrant an offsetting reduction of the coverage obligation.

To Justices James M. Catterson and Rolando T. Acosta, this was a distinction without a difference—one that avoided the "logical conclusion" that "Loral did not sustain a loss but rather benefitted from the [derivative suit]." In a partial dissenting opinion authored by Justice Catterson, the dissenting justices noted that the reformation of the deal prevented a "massive dilution of convertible stock and conversion rights" while still permitting Loral to receive the $300 million investment. As the Delaware Court of Chancery had found, this was "clearly a hugely substantial benefit to Loral."

The dissent conceded the benefit was "not precisely quantifiable," but argued this was irrelevant since the corporate benefit doctrine—as opposed to the common fund doctrine—expressly applies to difficult-to-quantify non-monetary benefits. Citing the doctrine's goal of preventing the corporation and its shareholders from being unjustly enriched, the dissent argued that "the obvious corollary is that shifting the cost to shareholders as a group [by requiring the corporation to pay the plaintiff's attorney's fees] cannot be characterized as a loss."

Although the majority and dissent largely focused on whether Loral suffered a loss, the majority's decision plainly sought to fulfill the parties' contractual expectations. As the majority observed, Loral had paid an additional premium to expand its policy to cover shareholder derivative suits. Since prevailing plaintiffs typically recover attorney's fees in such suits, a declaration that there was no coverage for Loral's payment of BlackRock's attorney's fees would have been contrary to Loral's expectations. The majority offered this advice to insurers who wish to better manage their policy-holders' expectations: "Had the insurers meant to exclude derivative plaintiff's attorneys' fees, they could have limited the definition of 'Loss'…."

Although Highland did not recover any damages in its class action, the Delaware Chancery Court ordered Loral to pay Highland $10.7 million in attorney's fees pursuant to the corporate benefit doctrine. The Appellate Division unanimously decided there was no coverage for the award of fees in a class action. The policy, by its express terms, covered only "Securities Claims," defined to include derivative claims or claims alleging a violation of federal, state or local regulation, or a statute or rule regulating securities, which Highland's common law breach of fiduciary duty claim was not.

Fees as Only Insured Claim

It may seem intuitive that where an insurance policy does not cover a substantive claim, it does not cover any attendant plaintiff's attorney's fees. This is a corollary of the generally accepted principle that an insured is not entitled to reimbursement for defense costs for uncovered claims. In _Millennium Partners, L.P. v. Select Ins. Co._,[3] Justice Marcy S. Friedman ruled that the D&O policy at issue (1) through limiting language in its definition of "loss," did not cover the insured's disgorgement, pursuant to a settlement agreement with the New York Attorney General and the Securities and Exchange Commission, of improperly acquired funds, and (2) consequently, did not cover the insured's attorney's fees and expenses incurred in fighting disgorgement. Plaintiff's attorney's fees, however, may be a different matter.

In _UnitedHealth Group Inc. v. Hiscox Dedicated Corp. Member_,[4] a Minnesota federal court applying New York law refused to dismiss a claim by United that sought coverage for the payment of plaintiffs' attorney's fees in a class action settlement even though the D&O policy covered none of the underlying substantive claims. The class plaintiffs, who had purchased health insurance from a United subsidiary, alleged that the subsidiary inadequately compensated them for their health care costs by manipulating critical market data. They asserted claims under state and federal law, seeking unpaid benefits; injunctive and declaratory relief regarding United's contractual, statutory, and fiduciary obligations; and attorney's fees and costs.

United settled with the class plaintiffs and with the plaintiffs in two similar class actions, establishing a $350 million compensation fund. The settlement agreement provided that the attorneys for the three classes of plaintiffs would be paid out of the compensation fund. United then initiated the coverage action, seeking to compel its insurers to cover the cost of the settlement and United's defense expenses.[5]

The court first considered whether the terms of United's policy covered the substantive claims at issue in the New Jersey class action. The policy provided that the insurers would indemnify "Damages" and "Claim Expenses" that resulted from a "Claim" against United. "Claim" was defined as a "written demand which seeks Damages," and "Damages," in turn, was defined as "any monetary amount in excess of the applicable retention and not exceeding Underwriters' Limit of Liability which an Insured is legally obligated to pay as a result of a Claim."

The policy also provided examples of what did and did not constitute "Damages." For example, while compensatory and punitive damages were covered, penalties, unpaid health care benefits, and the cost of compliance with injunctive and declaratory relief were not. Given these definitions, United conceded that all of the class plaintiffs' claims against it were uncovered, save certain statutory payments and the portion of the settlement attributable to plaintiffs' attorney's fees. Upon determining that the statutory payments were penalties and, thus, not covered damages, the court addressed coverage for the class plaintiffs' attorney's fees.

The court acknowledged that United was taking a "strange" position by arguing that "the [class] plaintiffs' demand that United pay the attorney's fees that [plaintiffs] incurred in pursuing uncovered claims against United was itself a covered claim." However, after examining the policy's broad definitions, the court concluded that the policy might in fact cover such fees. It reasoned that the class plaintiffs' demand for attorney's fees constituted a "Claim"—that is, "a written demand seeking Damages"—since the fees were a "monetary amount" that United was now "legally obligated to pay" pursuant to the settlement agreement. In other words, it did not matter that the actual substantive claims, which necessitated the attorney's fees in the first place, were uncovered since plaintiffs' demand for attorney's fees was itself a wholly separate, covered claim.

The insurers attempted to persuade the court that United was not legally obligated to pay the attorney's fees directly, but rather was only required to make one lump-sum settlement payment to three separate classes of plaintiffs, who would then pay their attorneys out of this fund. This argument struck the court as overly formalistic: "[I]t is irrelevant that United will not be required to cut a separate check to the [class] plaintiffs' attorneys…. [T]o the extent that any portion of the [joint class action] settlement is attributable to a settlement of the [class] plaintiffs' claim for attorneys' fees…that portion of the settlement falls squarely within the Policy's definition of 'Damages.'"

Closing its analysis on coverage for plaintiffs' attorney's fees, the court again acknowledged that the potential result of United's claim, which at that point had only survived a motion to dismiss, was "counterintuitive."[6] It is odd, after all, to think that the insurers could be obligated to pay plaintiffs' attorney's fees for claims for which they would not have to pay the attorney's fees of United, their client.

"But," the court continued, "the Policy says what the Policy says. Under the extremely broad language used by the policy, the claim for attorneys' fees made against United by the [class] plaintiffs was a 'Claim' for 'Damages.'" In essence, the court echoed the advice of the *Loral* court: If the insurers did not want plaintiffs' attorney's fees to be covered, they should have limited the definition of damages.[7]

Endnotes:

1. *In re First Interstate Bancorp Consol. Shareholder Litig.*, 756 A.2d 353, 357 (Del. Ch. 1999).

2. No. 3023, 2011 WL 537161 (1st Dept. Feb. 17, 2011).

3. 882 N.Y.S.2d 849 (Sup. Ct. 2009).

4. No. 09-CV-0210, 2010 WL 550991 (D. Minn. Feb. 9, 2010).

5. United also sought coverage for a $50 million settlement it reached with the New York Attorney General's Office in a suit with similar allegations. See id. at *6-8, 66-77.

6. The court noted that the record would have to be developed further before it was clear (1) to what extent, if any, the $350 million settlement was attributable to the class plaintiffs' claim for attorney's fees, and (2) whether a policy exclusion precluded coverage.

7. For another example of the importance of clearly defining "damages," see *National Casualty Co. v. Coastal Development Services Foundation*, 171 F. App'x 680 (9th Cir. 2006) (finding, over a dissent, that "damages" was an ambiguous term, and thus doubts as to whether a claim for equitable relief and attorney's fees was a claim for damages should be resolved against the insurer as drafter); see also Joseph M. McLaughlin, Directors' and Officers' Liability: "Corporate Indemnification Rights and Directors' and Officers' Liability Insurance Policies," NYLJ, June 8, 2006, at 5.