DIRECTORS' AND OFFICERS' LIABILITY

CORPORATE INDEMNIFICATION RIGHTS AND DIRECTORS' AND OFFICERS' LIABILITY INSURANCE POLICIES

JOSEPH M. MCLAUGHLIN*
SIMPSON THACHER & BARTLETT LLP

JUNE 8, 2006

Federal and state courts have issued noteworthy decisions this year addressing important issues concerning corporate indemnification rights and directors and officers liability insurance policies. This column examines recent decisions addressing: (i) indemnification rights after corporate insolvency or a change of control; (ii) the circumstances under which a D&O policy requires an insurer to fund defense costs on a current basis; (iii) when an insurer may rescind a D&O policy even as to "innocent" insureds based on misrepresentations in the insurance application; and (iv) whether a demand for plaintiffs' attorneys' fees may constitute covered damages arising from an underlying claim for non-monetary relief. The Ninth Circuit's opinion on covered damages highlights the risk to insurers of defining key policy terms in serpentine sentences that impair clear expression.

Indemnification After Insolvency

In *Levy v. Hayes Lemmerz Intern., Inc.*[1], the Delaware Court of Chancery considered several issues arising from a demand for indemnification by former directors of a public company ("Old Hayes") that emerged from bankruptcy as the operating subsidiary of a new holding company ("New Hayes"). Following announcement of an earnings restatement, Old Hayes shareholders and bondholders sued the company's former directors for alleged securities law violations. Old Hayes thereafter filed a Chapter 11 petition, under which it negotiated a reorganization plan which was approved in 2003. The reorganization plan preserved the indemnification rights of the former directors of Old Hayes, but capped the potential liability of the "Reorganized Debtors" at $10 million beyond the amount paid under Old Hayes' D&O insurance policies. In 2005, the former directors settled the lawsuits and informally sought indemnification from both Old Hayes and New Hayes pursuant to their indemnification rights under the Old Hayes bylaws, their indemnification agreements with Old Hayes and, because the reorganization plan defined "Reorganized Debtors" to include both Old Hayes and New

* Joseph M. McLaughlin is a partner at Simpson Thacher & Bartlett LLP.

Hayes, the directors argued that the plan also extended liability for indemnification to New Hayes. The New Hayes board rejected the indemnification request directed to both companies, and the former directors promptly sued Old and New Hayes without making any written demand on either board. After filing suit, the former directors sent the Old Hayes board an indemnification demand letter, to which the Old Hayes board responded with a document request seeking categories of information that purportedly would facilitate an informed decision on the pending indemnification request.

Vice Chancellor Stephen P. Lamb granted New Hayes' motion to dismiss, but sustained the claim against Old Hayes. The court concluded that New Hayes had no indemnification obligation because the plaintiffs were never directors of New Hayes, and because New Hayes had no obligation, by contract or the reorganization plan, to indemnify the former directors of Old Hayes. Corporate successor liability for indemnification arises, the court held, only where plaintiffs seeking indemnification can identify "specific contractual language that actively assigns liability to the new, successor, defendant." The court declined to interpret the provision in the reorganization plan that merely capped any potential liability of New Hayes for indemnification as an assumption of Old Hayes' indemnification obligations, particularly where other provisions of the plan demonstrated that the parties knew how to expressly assign other liabilities to New Hayes.

As to Old Hayes, the court considered and rejected a number of defenses in sustaining the indemnification claim. Old Hayes first argued a process point, contending that the indemnification agreements' requirement that "'the Company shall indemnify Indemnitee to the fullest extent permitted by law as soon as practicable, but in any event no later than thirty days after written demand is presented to the Company'" mandated a written demand on the company, and that written demand was the only event that could trigger the thirty-day period to consider the indemnitee's request. According to Old Hayes, by filing an amended complaint only 16 days after their first written indemnification demand, the former directors deprived the company of its contractually required thirty-day consideration period, thereby forfeiting their rights to indemnification. The court observed that section 145 of the DGCL, which sets forth Delaware's statutory basis for indemnification, contains no demand requirement, but that a Delaware corporation may write a demand requirement into its bylaws. But the Old Hayes indemnification provision did not impose a demand requirement or otherwise provide procedural protections for Old Hayes, the court concluded, because the clear intent of the indemnification agreement was to protect the potential indemnitees "by requiring Old Hayes to respond to a request for indemnification 'as soon as practicable,' and also by allowing the plaintiffs to put Old Hayes on the clock by issuing a written demand." Equally unavailing was Old Hayes' argument that the former directors breached their implied duties to perform the indemnification agreements with good faith and fair dealing when they refused to respond to Old Hayes's requests for information. Noting that Old Hayes had requested certain "unspecified documents," some of which likely were already in Old Hayes's possession, and that Old Hayes had already decided not to indemnify the former directors when the request was made, the court ruled that it was premature to conclude that the former directors violated their duties of good faith and fair dealing.

The court issued an important ruling concerning a company's responsibility when indemnification is or may be sought for separate but related matters. Old Hayes also argued that in order to meet its statutory and fiduciary duties, its board need to suspend final determination about entitlement to indemnification until the conclusion of a pending SEC investigation into the company's misstated financials. In order to receive indemnification for judgments or amounts paid in settlement of civil, criminal, administrative or investigative proceedings, an indemnitee must have acted in good faith and for a purpose that he or she reasonably believed to be in the corporation's best interests. The statute expressly provides that termination of a case by judgment or settlement does not, by itself, create a presumption that the standard of conduct has not been satisfied. Indemnification is never self-executing; a decisionmaker always must determine whether the proposed indemnitee acted in an indemnifiable capacity and meets the applicable standard of conduct. Section 145(d) provides that the determinations may be made by (a) a majority vote of directors who are not parties to the pertinent proceeding, even if less than a quorum; (b) by a committee of such non-defendant directors designated by majority vote of such directors, even if less than a quorum, or (c) if there are no such directors, or if such directors so direct, by independent legal counsel in a written opinion, or (d) by the stockholders.

The court acknowledged that deferring the decision about indemnification "could relieve the Old Hayes board from the uncomfortable position of voluntarily indemnifying the plaintiffs, and then later discovering that the SEC believes them liable on the basis of facts that suggest a lack of good faith." Continuing the recent trend in Delaware to interpret broadly written indemnification provisions in favor of indemnitees, however, the court rejected any attempt to merge the inquiry concerning entitlement to indemnification for the private class actions with the SEC investigation: "That the SEC action concerns, in part, the same facts does not preclude a current indemnification demand. Under the language of the indemnification agreements, the plaintiffs may pursue indemnification for the class action claims now, and may also seek indemnification for the SEC action if and when it is brought." "[A] claim for indemnification in the common law sense is defined by reference to a particular action," the court reasoned, "and becomes legally cognizable when payment is made to a third party on that action specifically." Accordingly, "standard indemnification language, by enumerating the various kinds of actions for which an indemnified party might seek remedy, clearly implies that indemnification is to be treated on a case-by-case basis."

Timing of D&O Insurance Payments

D&O practitioners often assume that D&O policies provide for defense costs on a current, as due basis. *Commercial Capital Bankcorp. Inc. v. St. Paul Mercury Ins. Co.*[2], is a reminder that while contemporaneous payment is the default rule in most jurisdictions, the timing of defense cost reimbursement can be addressed contractually in the policy, and in a manner that departs from pure "current basis" reimbursement. In *Commercial Capital*, the D&O policy provided for contemporaneous defense cost reimbursement, subject to the insurer's right to reduce its payment obligation through an allocation of defense costs incurred in actions involving covered and uncovered claims or persons. Specifically, where defense costs were incurred in defending covered and uncovered claims or persons, the policy provided that the parties would try to reach an allocation formula, but if they could not, then "the Insurer shall advance on a current basis Defense Costs which the Insurer believes to be covered under this Policy until a different allocation is negotiated, arbitrated or judicially determined." Fourteen *Commercial Capital* officers were sued in California Superior Court in an action alleging misappropriation of confidential customer information. In its reservation of rights letter in response to a demand for coverage, the insurer pointed out, *inter alia*, that the underlying complaint asserted several counts alleging intentional torts that were excluded from coverage. The insurer proposed a 50% allocation of defense costs between covered and uncovered claims. The insureds unsuccessfully requested 100% reimbursement, subject to deferred resolution of the insurer's right to any allocation of defense costs, and commenced a declaratory judgment action in the Central District of California, where they sought summary judgment on their request for 100% reimbursement on a current basis.

Canvassing the law on advancement of defense costs under D&O policies, the court concluded that "although the default rule in liability contracts providing for defense costs is that the insurer must pay defense costs as they came due, the parties can contract around this rule," so that a "properly-drafted contract provision such as the one in this case would abrogate the default rule of contemporaneous payment." The court rejected the insureds attempt to circumvent the policy's allocation provision through reliance on cases involving an insurer's duties under a policy containing a duty to defend. The insureds argued that in a "mixed" action where some claims are at least potentially covered, the insurer has a duty to defend the entire "mixed" action and cannot parse claims. Unlike general liability policies, however, under virtually all D&O policies the insurer has no duty to defend the insured – rather, the insurer provides indemnity coverage. The court stated that unlike a D&O insured, "the insured under a policy containing a duty to defend pays premiums for the right to a defense. It would defeat the intent of the contracting parties and rob the insured of its paid-for right to a defense if the insurer could delay payment while it attempted to distinguish covered from uncovered claims." In a D&O policy, however, "to require Defendant to advance all of Plaintiff's defense costs on a current basis despite [the policy's] clear indication of the parties' contrary intent would give Plaintiff an un-bargained-for windfall." Accordingly, the court concluded that the insurer was obligated only to advance on a current basis those defense costs it believes to be covered under the policy until a different allocation is determined in accordance with the policy.

Rescission

An application for D&O insurance typically is filled out by one or two officers of the corporation (usually the CEO and/or CFO) who make certain representations on behalf of all individuals to be insured. In addition to the traditional "warranty statements" made in the application about knowledge of facts which might give rise to a claim, most D&O applications today expressly incorporate certain documents, such as specified company SEC filings and financial statements, and provide that these documents are material to the insurer's evaluation of the risk and expressly serve as a basis for writing the coverage. Allegations of inaccuracy in the documents incorporated into the application frequently form the basis for the very lawsuits for which D&O coverage later may be sought. If the company announces an accounting restatement, it may even be argued that the company has admitted the original financial statements – and the application -- were materially misleading. Without a severability provision in the application, if material representations made to the insurer during the underwriting process turn out to be false, the insurer may be able to return the premium paid and rescind, *i.e.*, void, coverage under the policy as to all insureds.

Most courts recognize an insurer's right to rescind a D&O policy in its entirety, even if certain "innocent insureds" would forfeit coverage, in the absence of a clearly applicable severability provision. The recent California Court of Appeal opinion in *TIG Ins. Co. of Michigan v. Homestore, Inc.*[3] affirming a grant of summary judgment ordering rescission bolsters this authority. The renewal application for coverage at issue contained a limited severability provision permitting rescission as to all insureds if the signer of the application had knowledge of any material misrepresentation in the application. Homestore announced financial restatements, triggering shareholder and other litigation. TIG, an excess insurer, obtained summary judgment in a declaratory judgment action filed to rescind its policy as to all insureds because it was undisputed that the CFO who signed the application knew, at the time he signed, that the application contained misrepresentations. Consistent with the Ninth Circuit's decision in a parallel appeal last year involving several of Homestore's other D&O insurers,[4] the California Court of Appeal held that under applicable state law, rescission of the policy in its entirety was proper because the severability provision was unambiguous and permitted material misrepresentations known to the officer who signed the application to be imputed to innocent directors and officers. The court's observation that "the severability of D&O coverage has been litigated for more than 30 years; and the need for companies and their officers and directors to ensure they obtain coverage with unambiguous severability provisions to protect against exactly what happened in this case has long been identified," should be committed to memory by D&O practitioners.

Covered Damages

The Ninth Circuit's interpretation of the meaning of the crucial D&O policy term "Damages" in *National Cas. Co. v. Coastal Dev. Serv's Found.*[5], reinforces the lesson that clear meaning swiftly departs when contractual language is poorly arranged. Coastal Development submitted a claim to its D&O insurer after it was sued in a California state court action seeking injunctive relief, attorney fees and costs – but no money damages -- for Coastal Development's alleged violations of law in failing to provide adequate services to the developmentally disabled. The policy limit was $5 million, but the insurer argued that its duty was limited to $100,000 in defense costs on the theory that the underlying action did not constitute a "Claim for Damages," and instead was covered only by a $100,000 Non-Monetary Damages Extension Endorsement.

Reversing a district court grant of summary judgment in favor of the insurer, the Ninth Circuit held that the underlying action fell under the $5 million indemnity obligation because it seeks "Damages," defined by the policy as "a monetary judgment, award or settlement ... including prejudgment interest awarded against the Insured on that part of the judgment paid by the Company and all costs taxed against the insured." The court viewed the phrase "including prejudgment interest … and all costs taxed against the Insured" as ambiguous, where "the word 'including' could be introducing a list of specific components of a plaintiff's recovery that are themselves a type of 'damages'- as Coastal Development argues. Or it could be introducing a list of secondary, subordinate awards not meant to be considered as monetary judgments, awards or settlements- as [the insurer] would read it." The court stated that the definitions of key policy terms such as "Claim" and "Damages" also were "circular and ambiguous," which thrust the policy into the interpretive principle that doubts as to meaning will be resolved against the insurer. Applying this rule, the court held that because "the contract leaves ambiguous the distinction between suits for monetary and non-monetary relief, as well as the significance of such a distinction," it was fair to conclude that "Coastal Development reasonably expected that a suit for equitable relief that included exposure to a monetary award of plaintiffs' attorney's fees and costs would be covered by the … Policy as a 'Claim' for 'Damages.'" The court acknowledged that the policy distinguished "between suits for monetary and non-monetary relief in the context of addressing Coastal's 'Claim Expenses' (*e.g.*, its *own* attorney's fees and costs in defending against a 'Claim')", but reasoned that this distinction did "not purport to amend the definition of 'Damages' that addresses Coastal's exposure to a *monetary award in favor of plaintiffs*."

Judge Andrew J. Kleinfeld dissented, viewing the policy as unambiguously providing "different coverages according to whether the claim is for damages" or "non-monetary relief." The underlying litigation sought a declaratory judgment and an injunction – "precisely what has long been understood as "'non-monetary relief'" – placing the insurer's exposure squarely within the $100,000 cap for Claim Expenses incurred as a result of Claims seeking non-monetary relief. "The distinction drawn by the policy would have no meaning," Judge Kleinfeld reasoned, if such traditional forms of 'ancillary' relief as attorney's fees and costs are treated as converting a claim for non-monetary relief into one for damages.

---

1 2006 WL 985361 (Del. Ch. Apr. 5, 2006).

2 419 F. Supp.2d 1173 (C.D. Cal. 2006).

3 137 Cal.App.4th 749, 40 Cal.Rptr.3d 528 (Ct. App. 2d Dist. 2006).

4 *Federal Ins. Co. v. Homestore, Inc.*, 144 Fed.Appx. 641 (9th Cir. 2005).

5 2006 WL 700943 (9th Cir. Mar. 20, 2006).