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NEWSLETTER

Issuance of New Stock to Class Action Plaintiffs Is Not “Loss” Under Excess Liability Policies

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The United States District Court for the District of New Hampshire, applying Delaware law, has held that the issuance of new stock by a corporation in partial satisfaction of a settlement with class members in a securities class action did not constitute a "loss" under the corporation's excess directors and officers liability policies. *Enterasys Networks, Inc. v. Gulf Ins. Co.*, 2005 WL 705302 (D.N.H. Mar. 29, 2005).

Two insurers issued $10 million excess D&O policies to a policyholder corporation at layers above $40 million. The policies defined "loss" as "damages, judgments, settlements, Costs, Charges and Expenses . . . incurred by any of the [insureds]."

A securities class action was brought against the insured corporation. As part of the settlement, the corporation agreed to pay the class members $17 million in cash, and to offer them 8.7 million shares of newly issued stock valued by the class members at $33 million. The corporation then sought coverage from the excess insurers for their alleged share of $50 million in covered "losses" and "more than $27 million" in legal expenses. The insurers denied coverage for the $33 million in newly issued stock on the grounds that it was not a covered "loss" under the policies. Coverage litigation ensued. In addition to the issue regarding a covered "loss," the insurers also sought summary judgment with respect to:

1. Whether their respective policy layers had been triggered by the settlement.
2. Whether the corporation had filed its declaratory judgment action in a timely fashion.
3. Whether one of the carriers had waived the written consent to settle condition in its policy.

The court rejected the corporation's argument that the issuance of new stock constituted an insurable loss, concluding that the issuance of new stock had no effect on the assets of the corporation. According to the court, if the issuance resulted in any loss at all, it would only result in losses to the existing shareholders of the corporation through the dilution of the book value of their shares. Citing "fundamental" corporate law concepts, the court observed that the corporation was a separate legal identity from its shareholders and therefore the shareholders' losses were not the corporation's losses. Moreover, the court noted that the shareholders were not named insureds on the policies.

The court also rejected the argument that the fact that some of the newly issued shares were treasury stock made a difference. According to the court, treasury shares are "functionally equivalent" to "authorized but unissued" shares, which are not assets of the corporation for "most regulatory and accounting purposes." Therefore, the treasury shares were not assets that the corporation was losing. The court also distinguished *UNR Industries, Inc. v. Continental Casualty Co.*, 942 F.2d 1101 (7th Cir. 1991), a case in which an insurer was held liable for the amount of stock that a formerly bankrupt company issued to asbestos claimants as part of its reorganization plan. According to the court, *UNR* involved a situation in which the reorganized company was formed so that its assets could be distributed to the asbestos claimants and other creditors, an action that resulted in significant economic harm to the bankrupt debtor, the insured company. In contrast to *UNR*, however, the instant case did not involve corporate assets being handed over to satisfy claims. Rather, by issuing stock, the corporation was able to relieve itself of a liability with "no economic harm." According to the court, if the issuance of stock was considered a "loss" under the excess policies, the corporation would receive "an inappropriate windfall."

The court denied the insurers' motions for summary judgment with respect to the other issues, concluding that: (1) the record before it was unclear as to the corporation's alleged total legal expenses, which made it impossible to determine whether the excess insurer's policies were triggered, (2) the decision on the timelines of the corporation's declaratory judgment action should wait until the triggered policy question was answered and (3) while it was undisputed that the corporation had not sought written consent from one of the insurers prior to settling with the class plaintiffs, it was unclear on the record whether that insurer could be estopped from asserting that defense.

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