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NEWSLETTER

Promissory Note to Fund Shareholder Litigation Settlement Does Not Constitute Loss Where the Insureds Cannot Be Held Liable

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In an unreported decision, an Illinois federal court has granted an insurer's motion for summary judgment, holding that "[b]ecause there is no evidence to suggest that [the policyholder] had any liability for the shareholder litigation," a promissory note executed by the policyholder, "which is premised on that liability, does not now, and never will, constitute a loss within the meaning" of the D&O policy at issue. *Genesis Ins. Co. v. FTD.Com Inc.*, No. 03 C 4444 (N.D. Ill. Mar. 25, 2005). Additionally, the court held that the policyholder's failure to seek the insurer's consent before signing the promissory note precluded coverage for the shareholder litigation.

The insured company, FTD.com, was a Delaware corporation. Most of the company's voting rights and 83 percent of its stock were owned by its parent, FTDI, and the parent of the parent, IOS. The remainder of the stock was publicly traded. FTDI and IOS subsequently purchased the publicly traded stock and merged the companies. IOS then changed its name to FTD, Inc. and through its wholly owned subsidiary FTDI owned 100 percent of the stock of FTD.com.

Prior to the merger, a committee of two outside directors of FTD.com, who did not own stock in the parent companies, approved the proposal. Pursuant to the merger agreement, IOS agreed that it "shall or shall cause the Surviving Corporation to indemnify, defend and hold harmless each person who is now, or has been at any time prior to the date hereof or who becomes prior to [the effective date of the merger], a director or officer of the Company . . . against" claims.

The prior public shareholders filed suit against IOS, FTDI, FTD.com and several of its directors, including the directors who had evaluated the merger proposal. The complaint alleged that the majority shareholders sold the public stock at an "unfair price" in breach of their fiduciary duties. After the litigation was initiated, FTD.com agreed by "unanimous written consent" to indemnify its directors for the litigation. The parties then settled and exchanged stock issued by FTD, Inc. "on behalf of all Defendants [and] at its sole expense." Following settlement, FTD.com executed a promissory note pursuant to which liability for the settlement "will be apportioned among FTD, Inc., FTDI and FTD.com on the basis of each party's respective liability" for the suit. FTD.com paid the note and sought indemnification under its D&O policy. Coverage litigation ensued.

The D&O policy was issued only to FTD.com. The policy provided that the insurer would indemnify "[l]oss which [the policyholder] is required to indemnify, or which [the policyholder] may legally indemnify the Directors and Officers, arising from Claims first made during the Policy (or Discovery) Period." The policy required the insurer's "prior written consent" before the policyholder and its directors and officers "admit[ted] liability for or settl[ed] any Claim." The policy further provided that "[a]ny Defense Costs incurred, and/or settlements or judgments agreed to prior to the Insurer's consent shall not be covered."

The court first held that the promissory note could constitute a loss under the policy. "Loss" was defined by the policy as "any amounts which the Directors or Officers are legally obligated to pay, such amounts which the Company is required to indemnify the Officers or Directors, or such amounts which the Company may legally indemnify the Directors or Officers, for Claims made against [them]." The court found that even though the settlement entered into with the underlying plaintiffs required that FTD, Inc. pay the settlement amount, the directors potentially faced liability under Delaware law for contribution, justifying FTD.com's decision to execute the promissory note. Since FTD.com agreed by unanimous written consent to indemnify its directors, the promissory note therefore could constitute a loss under the policy. The court rejected the argument that the promissory note only transferred money to the sole shareholder, finding that the "promissory note payment would not have been made absent the settlement" and "the corporate family was depleted of millions by virtue of [the parent's] payment to the shareholder litigation plaintiffs."

The court also rejected the insurer's argument that the promissory note was restitution and therefore uninsurable. The court found that FTD, Inc., not FTD.com, benefited from the low stock price and that the parent was required to return the wrongfully obtained funds. Additionally, the court rejected the insurer's argument that the promissory note was a "contractually-assumed" loss and therefore not covered. The court focused on the policy's definition of claim, which includes "a demand for money made 'against an insured party'" and is not limited to claims against the policyholder's directors. According to the court, since the policy provided for indemnification for losses "arising from claims" made against its directors, "[t]he policy does not say that [the insurer] is only required to pay if [the policyholder] indemnifies the directors for payments they make directly to claimants."

However, while the court found that the promissory note could constitute loss under the policy, the court held that "the undisputed facts of this case establish that [the promissory note] never will be a loss." The court explained that FTD.com's liability to indemnify hinged on whether the directors who evaluated the merger proposal could face liability. The court found that the directors could not be found liable. First, according to the incorporation documents of the company, the directors cannot be liable for breach of the duty of due care. Second, Delaware law does not allow a company to indemnify directors for breach of the duty of good faith. Last, the court found that the directors could not be liable for breach of the duty of loyalty because the directors "had no personal, financial interest in the merger." As such, the court concluded there was no recoverable loss under the policy.

Additionally, the court held that because FTD.com did not seek the insurer's consent before signing the promissory note, the "consent to settle" clause barred coverage. The court first found that the promissory note constituted a "claim" under the policy because it demanded money from the policyholder based on its directors' "anticipated contribution liability for the shareholder litigation." Accordingly, the policyholder was required to seek the insurer's consent prior to signing the promissory note.

For more information, please contact us at 202.719.7130.