
Directors & Officers Insurance

Parent Corporation's Indemnification of Subsidiary's Directors' and Officers' Defense Costs and Settlement Expenses Did Not Preclude Coverage under D&O Insurance Policy

"Loss" Included Indemnification Paid by Third Party

AT&T Corp. v. Clarendon American Insurance Co., ___ A.2d ___,
2007 WL 1892240 (Del., July 2, 2007)

Case at a Glance

AT&T was the largest shareholder in the At Home Corporation. The former appointed its OWN employees directors of the latter. At Home declared bankruptcy. Both AT&T and the At Home Directors were sued for several billion dollars in damages. The D&O insurers refused to advance defense costs for the directors. The directors asked AT&T to pay defense costs, any settlements, and any judgments. It agreed and did so. AT&T sued the D&O insurers both as an assignee and as a subrogee, after it paid substantial monies for defense and settlement. The trial-level Superior Court granted the insurers' motion to dismiss on the grounds that (1) the directors had suffered no loss, since AT&T paid all the bills and (2) that AT&T had no valid equitable subrogation claim since it acted as a "volunteer" and was hence not a subrogee. The Supreme Court of Delaware reversed, holding that directors and officers incur a "loss" within the meaning of a D & O insurance policy, thereby triggering the insurer's obligation to provide coverage, when a third-party parent corporation pays the attorneys' fees and settlement amount arising from the claims against the subsidiary's directors and officers.

Summary of Decision

Facts: Non-Litigation. AT & T Corporation was the controlling shareholder of a subsidiary, At Home Corporation. AT & T designated ten of its employees to serve as directors of At Home. At Home

experienced financial difficulties that eventually resulted in its bankruptcy.

Underlying Litigation. Two suits underlie the insurance dispute. In March 2002, At Home shareholders filed three security class actions against At Home directors and officers. Those cases were consolidated. As usual, the plaintiffs alleged securities violations, fraud, and breach of fiduciary duties. In March 2006, the consolidated case was dismissed in its entirety, and currently is on appeal, in the Second Circuit of the federal system.

The second underlying case went differently. In May 2002, the Bankruptcy Court created the At Home Bondholders' Liquidating Trust ("BHLT"). In November of that year the BHLT-Trustee brought a damage suit against the At Home directors and officers in state court in California. It alleged various breaches of fiduciary duty. In May 2005, the BHLT-Trustee settled for approximately \$400m.

Indemnity and Assignment Agreement. In connection with both these cases, the At Home directors had applied for advances to defense costs, and indemnity from various D&O carriers, but these claims were denied. AT&T agreed to pay both defense costs and settlement costs, so the directors themselves were not actually out any money. AT&T made its payments pursuant to the indemnity and assignment agreements between the directors and AT&T. The insurers alleged that the use of these agreements made AT&T a "volunteer" and hence not really a subrogee.

Insurance Litigation. AT&T therefore sued the insurers. (The D&O insurers are Genesis Insurance Company, Clarendon America Insurance Company, North American Specialty Insurance Company, XL Specialty Insurance Company, and Parady Capital Limited. The last of these appeared individually and as the representatives of Certain Underwriters at Lloyds of London.)

The pivotal question was whether the insured Ds & Os at At Home suffered a "loss" as that term was defined within the relevant policies. Although the relevant policies were different to some degree, they were also substantially similar. They all obligated the insurers to "pay, on behalf of the Directors and Officers, Loss arising from Claims first made . . . against the Directors or Officers, individually or collectively, for a Wrongful Act, *except for such Loss which the Company [At Home] pays to or on behalf of the*

Directors and Officers" (italics added). The term "Loss" was defined in each of the policies, and it meant amounts for which the Ds and/or the Os were either "financially liable" or "legally obligated" to pay, including defense costs. The definition of "Loss," however, excluded "any amount for which the Insureds are not financially liable or which are without legal recourse to the Insureds." Thus, the policies expressly excluded coverage if At Home indemnified its directors and officers. The policies did not, however, expressly exclude coverage if a third party indemnifies them. AT&T was a third party.

Superior Court Decision. The parties apparently agreed California law would govern the underlying dispute. The D&O carriers argued that under the governing law "the At Home directors suffered no 'Loss' because they never paid, never did or will incur any obligation or liability to pay, [either] their defense costs or any judgment or settlement in the Underlying Litigation." The Superior Court agreed with this argument and held that "[b]ecause the At Home directors had no claim against the D&O insurers for coverage, AT&T, as their assignee, had no direct rights. . . . Nor, the Superior Court held did AT&T had a legally cognizable claim for equitable subrogation, because under California law, the subrogee (AT&T) must not have acted as a volunteer, but in indemnifying the At Home directors AT&T had acted as a volunteer."

The Supreme Court of Delaware disagreed with both of these holdings and rejected them. The court rejected the first holding—the one pertaining to whether the directors had sustained a "loss"—for two separate types of reasons, and each of those reasons contained parallel arguments. One of them was (1) based on contract language, while the other was (2) based on how the California case law is and should be read.

(1) *Contract Language.* (a) With respect to policy language interpreted straightforwardly and by itself, there is no coverage if the company being directed indemnifies the directors. However, there is "[n]o similar exception is created for 'Losses' that are indemnified by a party *other than The Company*. The D&O insurers could easily have added a second exception for coverage to capture losses indemnified by third parties, but they did not."

(b) The insurers also argued that the definition of the term "Loss" found in the policies by itself

invalidates the idea that indemnification by a third party is covered. The insurers maintained that directors and officers cannot be "financially liable" and "legally obligated to pay" within the definition of "Loss" if a third party pays the Loss. The Delaware Supreme Court rejected this proposition on the grounds that it would have been entirely unnecessary, if this argument were correct, to add special and specific language regarding indemnifications by the directed companies.

Moreover, in vindicating its holdings, the Delaware Supreme Court points out that if AT&T reneged on its agreements with its employees who were directors of At Home, those directors would still have been liable for paying attorneys fees and damages, if any were proved. What would have happened, the court asks itself, if AT&T had never undertaken to indemnify these directors or if it had breached its undertaking? Here is the court's answer to its question: "The D&O insurers would never have been in a position to argue that the At Home directors incurred no 'Loss' that trigger[ed] D&O coverage." The carriers were able to make argument only because AT&T honored the agreements it made.

(2) A broader legal question, said the court, was this one: "under California law [does] AT&T's commitment—without which the At Home directors would have been entitled to coverage of their defense and settlement costs under the D&O policies—divest those directors of that entitlement [to coverage]?" The Supreme Court determined that no California case answers this question in the negative. It read California law not to support the insurers' view.

The closest case, says the court in its discussion of several cases, was *PLM, Inc. v. National Union Fire Insurance Company of Pittsburgh, Pa.*, 1988 WL 58031, 848 F.2d 1243 (9th Cir. 1988) (Table). Pillsbury had sued PLM. Some of its directors and officers had also been sued. The "PLM directors had individually guaranteed some of the promised settlement payment." When PLM sought reimbursement from National Union for the amounts it paid, the insurer denied coverage based on the guarantee just discussed. The Ninth Circuit held that the "execution of the guaranties created only a contingent obligation to pay on the part of the directors and officers. It was not an obligation to pay[,] and it never became an obligation to pay. Hence, there was no loss as defined by the D&O provision[.]"

Fairly clearly, the Supreme Court implicitly distinguishes the guarantee agreement in *PLM* from the AT&T's indemnification and subrogation agreements. PLM's guarantee agreement does not actually create legal liability or financial responsibility. In contrast, the AT&T indemnification and subrogation agreements do not destroy or undermine precisely those. In addition, this court points out that *PLM* is an unpublished ruling, it is issued by a federal court interpreting state law. Under the applicable rules unpublished opinions cannot be cited as precedent in this sort of situation. And finally, the *PLM* opinion cites no California cases supporting its view.

In refusing to follow the *PLM* case, The Delaware court pointed out that under *Xebec Dev. Partners, Ltd v. National Union Fire Ins. Co.*, 15 Cal.Rptr.2d 726 (Cal.App. 1993), if the AtHome officers' and directors' settlement had been structured to include the entry of a consent judgment, which was then paid by AT & T, the settlement would be considered a "Loss." The fact that the settlement was not structured in this manner was a mere formality that did not affect the economic substance of the transaction. Therefore, a consent judgment was not essential to a finding of coverage.

Subrogation. Alternatively, the Delaware high court held that AT & T had standing to sue as the directors' equitable subrogee. The supreme court rejected the trial court's determination that AT & T acted as a "volunteer" when it provided indemnification and therefore was not equitably surrogated to the directors' and officers' claims for coverage. The supreme court reasoned that AT & T was not acting as a "volunteer" because it was protecting its own interests when it provided indemnification to the directors and officers. Although AT & T was not legally obligated to provide indemnification, it did not act as a "volunteer" in doing so because it had a legally cognizable interest it was entitled to protect. The At Home directors served at AT & T's request, and they were sued based on their conduct in managing an AT & T subsidiary. In order for AT & T to protect its interest in having other employees serve as directors of its other subsidiaries, AT & T had to provide protection from liability.

According to California law, said the Delaware Supreme Court, it is not the case that a subrogee needs to have a legal obligation to indemnify a subrogor in order for that subrogee to have an interest

worthy of protection for subrogation purposes. Indeed, California courts tend to give a very liberal interpretation to the concept of *having an interest* when it is distinguishing a person who may be a subrogee from a person who is a volunteer. Under California law, if one acts in good faith in making such a payment and if this person is acting under a *reasonable belief* that it is necessary for his protection, then he is entitled to subrogation, even if he is mistaken about his having an interest. Indeed, California law defines a "volunteer" as a "stranger or intermeddler who has no interest to protect and is under no legal or moral obligation to pay under the circumstances." Hence, even though AT&T was not legally obligated to indemnify the At Home directors, the AT&T complaint in this case alleges a number of significant facts, which—if true—establish an interest that AT&T, as a reasonable member of the business community, was entitled to protect." After all, it was a majority shareholder of At Home; it had asked its employees to serve as directors, and they probably would not have devoted their time to this if AT&T had not assured them that they would themselves be exempt from having to pay damages.

Comment

As the Delaware Supreme Court admits, it never had to reach the subrogation issue, because the indemnity and assignment agreements considered in the context of the *Contract Issue* resolved the case. Nevertheless, there are two interesting features regarding the *Subrogation*.

First, virtually all states and not just California have a liberal interpretation of what does *not* count as being a volunteer. Legal encyclopedias say the same thing. Any reasonable belief that the subrogee really may be liable for a claim of a certain amount defeats the application of the idea not-a-subrogee. Notice that this applies both to amounts and to whether there is any liability at all. Thus, payments made in a reasonable, good-faith belief in liability are not volunteered. See COUCH ON INSURANCE 3d §§223:26-27 (2005).

Second, there is a substantial inconsistency between the legal elements for subrogation in California and the way in which subrogation is

explained in speeches, law school classrooms, and so forth. (This is not to suggest that the four elements of California law are inconsistent with a pattern found in most subrogation cases.)

In virtually all quick explanations of subrogation, the account is that the subrogee is someone who has "stepped into the shoes" of the subrogor. As a general rule, in this brief explanation there is virtually no requirement that the subrogee not be a volunteer. Frequently, one of the explanatory narratives that is used to explain subrogation is the Good Samaritan story from the New Testament. Fairly clearly, the man who takes care of the injured person in that story is a volunteer, but it is virtually always indicated in CLE speeches, and so forth, that the Good Samaritan would have a cause of action against the ruffians and brigands who left their victim a wounded traveler lying in a ditch.

Furthermore, the "Volunteer Doctrine" does not apply to convention or contractual subrogation. Robert H. Jerry II, UNDERSTANDING INSURANCE LAW §96[e] at 611-612 (2d Ed. 1996). Clearly the AT & T subrogation right was contractual subrogation. Moreover, at least in insurance contexts, the "Volunteer Doctrine" probably does not apply when a liability insurer pays a claim and does not know that the facts do not support the plaintiff's case against the insured defendant. Robert E. Keeton and Alan I. Widiss, INSURANCE LAW §3.10(d)(3) at 249-50 (1988).

That suggests that it might be interesting to compare and contrast the elements of subrogation from state to state. To be sure, most subrogation actions involve plaintiffs who are not volunteers. Often, it is insurance companies that meet all four of the elements. Notice that this Comment concerns how explanations of subrogation are given in various contexts, not how it often works in the context of insurance litigation.

Last, the Superior Court read the elements utilized by the Delaware Supreme Court more literally than the high court did. Clearly, given the other California cases invoked by the supreme court, the elements of the right of subrogation are not correctly in Elements (1)-(4). There is no reference to reasonable belief in that quote, yet other California courts use it, and so now does Delaware. // Quinn