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No Wonder: Denying A D&O Claim As Excluded Loss

Law360, New York (February 06, 2012, 1:42 PM ET) -- The first bankruptcy of the corporate entity that makes both Wonder Bread and Twinkies has an unexpected directors and officers (D&O) coverage decision filling. In United States Bank Nat'l Ass'n v. Federal Ins. Co., No. 10-3472 (8th Cir. Dec. 13, 2011), a creditor's trust sought to recover a $56 million stipulated judgment from a D&O policy covering the bakery giant and its directors.

The U.S. Court of Appeals for the Eighth Circuit rejected the claim because the trust had entered into an "agreement not to execute" with the key involved director. The court found that the relevant policy specifically excluded coverage when, as here, the covered director is absolved from payment under another agreement.

The court also refused to convert an otherwise uncovered claim into a covered one under applicable Missouri law on estoppel.

The Agreement Not to Execute

Though 2012 started off with the news that Hostess Brands Inc. — originally known as Interstate Bakeries — was seeking Chapter 11 protection for the second time, it was the company's first time through the bankruptcy courts that gave rise to the D&O coverage case.

During that proceeding, Interstate assigned certain claims to the creditor's trust, including its claims against the director whose misdeeds helped bring about the bankruptcy. In the assignment agreement, the trust agreed to limit its claims against the director to the applicable D&O polices and expressly agreed not to pursue recovery against his personal assets.

After settlement of the bankruptcy proceedings, the trust brought suit against the involved director. He tendered defense of the suit to Federal Insurance Co., the D&O insurer. Federal both denied coverage and refused to provide defense costs.

The director then participated on his own in a mediation with the trust. He agreed to entry of a $56 million stipulated judgment against him. In return, the trust again promised to limit its recovery to the policy.

The trust then sued Federal, and Federal moved to dismiss. Federal argued that the assignment agreement meant there was no coverage because there was no "loss" under the policy. The relevant policy language excluded from the definition of “loss” amounts "not indemnified by the Insured Organization for which the Insured Person is absolved from payment by reason of any ... agreement."

Granting Federal’s motion, the district court agreed that the policy’s language expressly excluded the claimed loss and granted Federal’s motion to dismiss. The district court rejected the trust’s argument that the director was an abandoned insured entitled to coverage, finding that policy was not a duty to defend policy.

The district court said that Missouri’s abandoned insured law does not allow the creation of coverage when none exists. The trust appealed the dismissal to the Eighth Circuit.

No Covered Loss

On appeal, the Eighth Circuit first considered the impact the assignment agreement had on the policy. The policy defines “loss” as the "total amount any insured person becomes legally obligated to pay" as a result of a claim for wrongful acts.

The court noted the split of authority as to whether an insured is “legally obligated to pay” an amount covered by a separate agreement not sue — and its own ultimately unsuccessful efforts to predict how an undecided state supreme court would resolve the question.

Compare Freeman v. Schmidt Real Estate & Ins. Inc., 755 F.2d 135, 137–39 (8th Cir. 1985) (Predicting Iowa courts would find no legal obligation to pay in presence of agreement not execute), with Red Giant Oil Co. v. Lawlor, 528 N.W.2d 524, 532–33 (Iowa 1995) (rejecting Freeman and finding a remaining legal obligation to pay requiring coverage even in presence of agreement).

Though Missouri law applied to the dispute and the Missouri Supreme Court had not yet addressed the question, the Eighth Circuit said it did not need to guess how that court would resolve the issue.

Instead, the appeals court found that the policy expressly excluded from the definition of loss those amounts which the insured is “absolved from payment by reason of any ... agreement.” The court said that, under the plain language of the policy, the assignment agreement absolved the director from payment. As a result, the $56 million judgment simply did not qualify as a covered loss.

The appeals court rejected the trust’s contrary arguments. The trust claimed the director was not fully “absolved” because he would suffer the stigma of a judgment and might find it difficult to obtain insurance in the future. The court said this interpretation created an impermissible interpretation of the policy because it divorced the term “absolved” from “payment.”

Nor could the trust persuade the court that decision in Wintermute v. Kansas Bankers Sur. Co., 630 F.3d 1063 (8th Cir. 2011) required a different outcome. In Wintermute, the Eighth Circuit reversed a district court decision that no duty to defend existed because a criminal complaint was not a claim for loss.

The Wintermute court found that claim for “wrongful act” rather than a “claim for loss” triggered the insured’s duty. But Wintermute did not apply in this case for several reasons, including the fact that no Wintermute party ever disputed that a covered loss had occurred.

No Coverage by Estoppel

The trust argued alternatively that, because the director was an abandoned insured, it should be allowed to collect the judgment. Under this theory, Federal's refusal to provide the director with a defense meant it was estopped from challenging the settlement.

To support its position, the trust relied on cases that hold that an insured may discharge personal responsibility in a settlement and then let the plaintiff then seek recovery from the insurer if the insurer has contested coverage or wrongfully refused to tender a defense. Hyatt Corp. v. Occidental Fire & Cas. Co. of N.C., 801 S.W.2d 382, 388 (Mo. Ct. App. 1990).

The Eighth Circuit said the trust's argument missed the mark. The court said instead that the material question for the case was "whether Missouri law allows an estoppel to expand coverage beyond the terms of the policy to convert an otherwise uncovered claim into a covered claim."

Citing both Missouri law and its own decision in Esicorp Inc. v. Liberty Mut. Ins. Co., 193 F.3d 966, 970 (8th Cir. 1999), the court found controlling precedent prevented an expansion of coverage through estoppel. As result, the trust's argued theory could not be used to overcome the "absolved from payment" in the policy, and the trust's judgment remained an excluded loss.

Conclusion

The Eighth Circuit's decision in Federal Insurance offers instruction to insurance and bankruptcy practitioners alike. For those considering claims under a D&O policy, the opinion offers a further refinement in the debate on the effect an agreement not to sue has when the covered loss is an amount the insured is "legally obligated to pay."

For those involved in work-out negotiations, it provides an object lesson on the potential long-term consequences of an "otherwise"standard" agreement that seem necessary to get the deal done.

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