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NEWSLETTER

Promissory Note Contingent on Insurance Recovery May Be "Loss"

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The United States District Court for the Northern District of Illinois, applying Illinois and Delaware law, has held that a company's promissory note, which potentially obligates it to reimburse its corporate parent for the settlement of shareholder class action lawsuits, could amount to a covered "loss" under its D&O policy even though the company is not obligated to pay money under the terms of the underlying settlement agreement. *Genesis Ins. Co. v. FTD.COM, Inc.*, 2004 WL 1199984 (N.D. Ill. June 1, 2004).

The insurer issued a D&O policy to a floral company. The policy provided that, among other things, the insurer will pay "on behalf of [the company]:" (1) "Loss which [the company] is required to indemnify, or which [the company] may legally indemnify, the Directors or Officers, arising from Claims first made during the Policy...Period;" and (2) "Loss arising from Securities Claims first made against [the company] during the Policy...Period." The policy defined "Loss" to include: (1) "any amounts which the Directors or Officers are legally obligated to pay;" (2) "such amounts which [the company] is required to indemnify the Directors or Officers, or such amounts which [the company] may legally indemnify the Directors or Officers" and (3) "any amounts which [the company] is legally obligated to pay for Securities Claims made against [the company]."

The majority of the floral company's shares were owned by another company, and a minority of its shares were publicly traded. The parent of the company that owned a majority of the floral company's shares acquired a 100 percent interest in the floral company by buying out the interests of the minority public shareholders. After the transaction was complete, the public shareholders of the floral company filed a class action lawsuit against the floral company, the majority shareholder and the parent of the majority shareholder alleging that inadequate consideration had been paid for the floral company's stock. In August 2003, the lawsuit settled. Under the terms of the settlement agreement, the shareholders received $10.7 million worth of stock of the parent company. Meanwhile, in October 2003, two months after the class action settlement agreement was signed, but before the court approved it, the floral company executed a promissory note to the parent company for repayment of the settlement amount. The note provided that the insured floral company would reimburse the parent for the $10.7 million settlement payment unless it is "determined pursuant to the Insurance Litigation that the liability of [the floral company] pursuant to the [Shareholder] Litigation is for an amount less than the Settlement Amount." In that case, the floral company would only have to repay the lower amount. Coverage litigation ensued and the insurer filed a motion for judgment on the pleadings, arguing that it had no duty to indemnify the company because the company was not "legally

obligated" to pay under the underlying settlement agreement and therefore it had not suffered a covered "Loss."

Initially, the court found that, by itself, the settlement agreement did not legally obligate the floral company to pay any amount. According to the terms of the agreement, the parent company issued $10.7 million in shares "at its sole expense" and incurred all costs, taxes and fees associated with the payment. The agreement also provided that if the parent failed to deliver the shares, counsel for the plaintiff shareholders could either terminate the settlement or force the parent to consent to specific performance. The court determined that, under Delaware law, these provisions clearly indicated that the parent was the only entity legally obligated to pay under the settlement agreement. Moreover, the court was not persuaded by the floral company's reliance on the fact that the parent paid "on behalf of all Defendants," explaining that this language "does not, by itself, create a legal obligation for [the floral company] or any other party to pay any amounts due under the Settlement Agreement to the Shareholder Plaintiffs."

Notwithstanding this conclusion, however, the court held that, under Illinois law, viewing all inferences in favor of the floral company, the promissory note could be considered a valid apportionment of money paid under the settlement agreement such that it "could constitute a legal obligation to pay for a claim made for a wrongful act, *i.e.,* a 'Loss' under the Policy." The court first rejected the insurer's argument that the provision in the promissory note limiting the floral company's repayment to the amount of liability determined in the insurance coverage litigation obligated it to pay only up to its liability under the settlement agreement, which was zero. Instead, the court concluded that the provision applies to the amount of the floral company's liability pursuant to the "Securities Litigation," not the settlement agreement. The court also rejected the insurer's assertion that the promissory note only created a conditional obligation, which required a finding of liability in the insurance litigation. In the court's opinion, the promissory note created a "present obligation" of $10.7 million with a "contingent reduction" if the floral company is not found fully liable in the insurance litigation. The court explained that whether or not this reduction would apply is presently undetermined and would depend on an "allocation determination," so the floral company still "could prove a set of facts that would demonstrate it suffered a covered 'Loss' under the Policy." The court therefore denied the insurer's motion for judgment on the pleadings.

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