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NEWSLETTER

Other Decisions of Note

July 2008

California Intermediate Appellate Court Holds that Unexcused Failure to Attend Court-Ordered Mediation Session Will Result in Sanctions

A California appellate court has held that, pursuant to its local rules, the failure of an insurer, including an excess insurer, to send a representative to a court-ordered mediation of its insured's appeal where "potential insurance coverage" exists will result in monetary sanctions. *Campagnone v. Enjoyable Pools & Spas Service & Repairs, Inc.*, 77 Cal. Rptr. 3d 551 (Cal. Ct. App. 2008). Under the court's local rule, "[a]ll parties and their counsel of record must attend all mediation sessions in person with full settlement authority." Additionally, the rule requires that "[i]f any party has potential insurance coverage applicable to any of the issues in dispute, a representative of each insurance carrier whose policy may apply also must attend all mediation sessions in person, with full settlement authority. Any exception to this requirement must be approved in writing by the mediator."

Based on this rule, the court concluded that "the unauthorized failure of a party, the party's attorney, or a representative of the party's insurance carrier, to attend a court-ordered appellate mediation necessarily constitutes conduct that is an unreasonable violation of [the local rule], warranting imposition of sanctions." The court did not sanction the insurer here because it had no notice of the mediation. However, the court held that, henceforth, the unexcused failure of any insurer with potential insurance coverage to attend mandatory mediation without full settlement authority will result in it being sanctioned. The court also did not sanction the insured or its counsel because the local rule does not explicitly assign them with the duty to notify the insurer of the mediation. However, the court put parties to appeals and their counsel on notice that, henceforth, they too will be sanctioned if they fail to notify insurers of mediations.

"Deepening Insolvency" a Valid Theory of Damages for Breach of Fiduciary Duty Claims

The United States Bankruptcy Court for the District of Delaware has held that "deepening insolvency" remains a valid theory of damages for breach of fiduciary duty claims, even if it is no longer a viable cause of action in its own right. *Miller v. McCown De Leeuw & Co. (In re Brown Sch.)*, 386 B.R. 37 (Bankr. D. Del. Apr. 24, 2008). The court rejected an argument that claims for breach of fiduciary duty, corporate waste, and civil conspiracy were disguised "deepening insolvency" claims, even though the measure of damages for those claims included the amount of the deepening insolvency.

The court considered motions to dismiss a bankruptcy trustee's complaint alleging that the debtor's majority shareholder had breached its fiduciary duty and "wrongfully prolonged the existence of the Debtors" by causing the debtor to engage in certain pre-petition transactions that favored the majority shareholder over other creditors in violation of the majority shareholder's duty of loyalty to the debtor. The trustee brought claims against the majority shareholder and related defendants for breach of fiduciary duty, aiding and abetting breach of fiduciary duty, fraudulent and/or voidable transfers, deepening insolvency, civil conspiracy and corporate waste.

The defendants argued that each of these claims relied on a "theory of deepening insolvency for the underlying claims and the measure of damages" and should therefore be dismissed under *Trenwick American Litigation Trust v. Billett*, 2007 Del. LEXIS 357 (Del. 2007), *aff'g Trenwick American Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006) (holding that Delaware does not recognize an independent cause of action for deepening insolvency). The court dismissed the deepening insolvency claims but concluded that the *Trenwick* decision could not be read so broadly as to mandate dismissal of claims alleging violations of the duty of loyalty.

The defendants also argued that deepening insolvency, the only measure of damages that the trustee alleged, is an "impermissible measure of damages" for a breach of fiduciary duty claim in light of the ruling in *Trenwick*. The court disagreed and held that deepening insolvency is a valid theory of damages if those damages were suffered as a result of the alleged breach.

Washington Appeals Court Affirms Denial of Coverage Based on Warranty Exclusion and Failure to Disclose Potential Claim on Insurance Application

A Washington State appellate court, applying Washington law, has held that an insurer properly denied coverage under an errors and omissions policy where a policyholder failed to disclose a known potential claim when submitting its insurance application. *Nordquist v. Lumbermans Mutual Casualty Co.*, 2008 WL 2314102 (Wash. Ct. App. Jun. 2, 2008).

In October 2001, the policyholder, an attorney who had failed to file a client's personal injury suit within the statute of limitations, entered into a settlement agreement whereby he would pay the client $15,000 within one year and the client would release his potential malpractice claim upon receipt of the payment. In November 2001, before making any payment under the agreement, the attorney submitted his insurance application. The application asked: "After inquiry, does any firm member know of any circumstance, situation, act, error or omission that could result in a professional liability claim or suit against the firm?" The attorney checked the box marked "No." Having failed to pay the client the money by the agreed-upon date, the policyholder submitted a renewal application in October 2002, again answering "No" to the same question. The client filed a malpractice suit in September 2003, and the attorney requested coverage.

The policy excluded coverage for any claim caused by "[c]ircumstances or situations which may reasonably be expected to result in a 'Claim,' known by any insured at any time prior to the inception date" of the policy. The

insurer denied coverage due to the attorney's prior knowledge of the client's potential claim. The Washington Court of Appeals reasoned that the attorney's attempt to settle the claim in October 2001 established that he knew of circumstances that could give rise to a claim when he submitted the original application, and further explained that the attorney knew that he already had failed to make the payment before submitting the renewal application.

Court Refuses to Permit Reimbursement for Uncovered Defense Costs

The United States District Court of the Virgin Islands, applying the law of the Virgin Islands, has refused to permit an insurer to recover defense costs not insured under its policy, reasoning that the policy did not provide for such a right and the insurer could not unilaterally alter the agreement through its reservation of rights letter. *General Star Indem. Co. v. Virgin Islands Port Authority*, 2008 WL 2235338 (D.V.I. May 29 2008).

The policyholder was sued in connection with the construction activities at an airport that it managed and sought coverage under policies that provided "Employment Practices Liability" and "Public Officials Liability" coverage. The insurer initially concluded that the suit did not trigger any obligations under the policies, but nonetheless defended under a reservation of rights and brought the instant coverage action to determine its rights under the policies.

The court ruled that the policies did not provide any coverage. With respect to the insurer's effort to recover the previously advanced defense costs, the court noted that some courts have ruled that an insurer is entitled to reimbursement to prevent the policyholder's otherwise unjust enrichment. It also explained, however, that other courts have refused to permit an insurer to seek reimbursement, reasoning that the policyholder is not unjustly enriched because the insurer has, at least in part, provided a defense for its own benefit and further reasoning that an insurer cannot create a right to reimbursement not contained in the policies through a reservation of rights letter. Considering which of the two approaches to follow, the court explained that an insurer in the Virgin Islands can, when a claim is tendered, "(1) seek a declaratory judgment that it has no duty to defend the insured, (2) defend the insured under a reservation of rights, or (3) refuse to either defend or seek a declaratory judgment action at its own peril that it might later be found to have breached the duty to defend." The court reasoned that, given this framework, "an insurer may elect to defend a claim against an insured in order to benefit from a lower judgment or settlement amount in the long run." Further, the court noted that, by Virgin Island statute, an insurer cannot amend the policy through a separate letter or agreement unless such amendment is "made a part of the policy." The court therefore concluded that the insurer could not amend the policy to include a reimbursement right through its reservation of rights letter and held that the insurer did not have a right to reimbursement.

No Duty to Defend Company Where No Individual Insured Named Is a Defendant

The United States Court of Appeals for the Ninth Circuit has held that a D&O insurer had no duty to defend a lawsuit against an insured entity where "no individual officer or director was a named defendant [in the lawsuit] either in the caption or the body of the complaint." *Converse Prof. Group, Inc. v. Federal Ins. Co.*, 2008 WL 2329605 (9th Cir. Jun. 3, 2008). The court rejected the policyholder's argument that coverage was

available under insuring clauses A and B because the lawsuit could have been amended to include officers or directors. In doing so, it relied on *Bowie v. Home Ins. Co.*, 923 F.2d 705 (9th Cir. 1991), which had determined that a duty to defend "presupposes the existence of a lawsuit against an 'insured.'"