

Foreclosure Does Not Constitute Damages under a D&O Policy and Officer Did Not Act Within His Insured Capacity When Violating By-Laws

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A California intermediate appellate court has held that an insurer did not owe its insured a duty to defend a lawsuit seeking foreclosure of an insured's property as foreclosure does not constitute "damages" under a directors and officers liability policy. *Mount Zion Baptist Church v. State Farm General Ins. Co.*, 2009 WL 1802779 (Cal. Ct. App. June 25, 2009). In so doing, the court also held that there was no potential for coverage under the policy because: (1) an officer of the insured entity, a church, was not acting within his "management responsibilities" when he misappropriated church property, and (2) the officer did not act negligently.

The case arose out of allegations that an officer of the insured church violated church by-laws and its constitution by transferring property owned by the church to himself individually without the approval of the church board of trustees. The officer then allegedly used that property as collateral for a minority-owned business to secure a government contract. The property also served as a payment bond for the government contract with the officer executing a lien against the property in favor of the United States government. The minority-owned business later contracted out a portion of the government contract to a third party. During this time, the officer passed away, and a separate officer of the church transferred the property back to the church by forging the deceased officer's name to the deed. When the minority-owned business failed to pay the third party in full for its completed services, the third party eventually filed a complaint against the church seeking foreclosure of the property and satisfaction of a portion of the amount owed for work performed for the minority-owned business, for which the lien was executed. The insured church ultimately settled the suit with the third party for a fraction of the amount owed. The church sought coverage for the underlying suit and settlement under the D&O policy. The insurer denied coverage, and the insured filed a complaint against the insurer alleging breach of contract and breach of the implied covenant of good faith and fair dealing. Based upon stipulated facts, the trial court held that the insurer did not owe the insured a duty to defend.

The court's decision rested on three grounds. First, the court noted that the policy provided that the insurer

"will pay those sums that the insured becomes legally obligated to pay as damages." The court stated that because the "complaint [the church] tendered to [the insurer] sought only foreclosure . . . , there was no potential for coverage and [the insurer] had no duty to defend." The court ruled that as the "underlying action was one for foreclosure only," and the church had no obligations to the third party who brought the suit, and the third party had no other claims against the insured church, the third party "could not and did not sue [the church] for damages." The court rejected the church's contention that the foreclosure was the "functional equivalent" of damages and therefore should be covered, holding that the parties could have included the term "functional equivalent" of damages in the policy if desired but did not and that the court "cannot rewrite the parties' policy." The court also rejected the insured's argument that because the church and the third party eventually settled for money, there was always the potential for coverage. The court stated that most cases may settle for money and that to accept the insured's argument would mean that "there would always be the potential for coverage under any policy using this language and, therefore, always a duty to defend. We decline to interpret the policy in such a way."

Second, the court held that the officer of the church "was not acting within the scope of his management responsibilities or duties to the church," and thus the officer's actions did not fit within the definition of "Wrongful Acts" or the "Insured." The court noted that the officer "was acting contrary to his management responsibilities and duties to [the church] and that the officer not only "never sought authorization for his actions, but also that the church would not have given its authorization." Therefore, the court held that the officer was not acting in an insured capacity.

Lastly, the court rejected the church's contention that the officer "acted negligently in transferring and encumbering the property" and that, as such, the officer's actions fell within the definition of "Wrongful Acts," which was defined as "any negligent acts, errors, omissions or breach of duty directly related to the operations of your church." The court found that the officer's "alleged motive or mistaken belief behind his acts do not make his intentional acts negligent."