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NEWSLETTER

Controlling Shareholder’s Bankruptcy Does Not Render Entity Insolvent; Fraud Claim Uninsurable as a Matter of Law

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Applying Minnesota law, a federal district court has held that, where an entity's principal shareholder was insolvent, but the entity was not, the individual's insolvency could not be attributed to the entity for purposes of establishing Side A coverage for “Non-Indemnifiable Loss.” *Zayed v. Arch Ins. Co.*, 2013 WL 1183952 (D. Minn. Mar. 20, 2013). The court further held that allegations of fraudulent inducement did not trigger an exclusion for claims “arising from” contractual liability, but that the claim was uninsurable as matter of law.

The D&O policy at issue insured a holding company up to $1 million for “Loss” and its directors and officers up to $500,000 for “Non-Indemnifiable Loss” incurred by those individuals. The policy defined “Non-Indemnifiable Loss” as “Loss” that an insured organization could not indemnify because of a legal prohibition or insolvency.

An investor in the company brought suit for breach of contract and various torts against the company and its CEO, who held 34% of the company's stock, alleging that the CEO misrepresented the company's financial health in order to obtain a $2.5 million investment. The investor settled those claims in return for a $1 million judgment against the company and a $500,000 judgment against the CEO with the judgments apportioned entirely to the investor's claims that it was fraudulently induced into making the investment. A trustee who was assigned the insured's rights under the policy sought indemnification for the settlements. Having initially paid the policyholder's defense costs, the insurer disclaimed coverage.

In the coverage litigation that followed, the court first held that the insurer had no duty to indemnify the claimant for the $500,000 settlement given that it was not “Non-Indemnifiable Loss.” According to the court, the policyholder was not “insolvent” within the meaning of the policy, which defined the term to mean “the appointment of any conservator, liquidator, receiver, trustee, or similar official” or becoming a debtor in possession. The policyholder did not satisfy either condition.

The court rejected the claimant's argument that the entity should be treated as insolvent under a “reverse-piercing” theory because the CEO was insolvent. In so holding, the court noted that the reverse-piercing theory had been applied only where the insolvent shareholder owned 100% of the entity's stock and there was extensive comingling of personal and corporate property. The court held that the “more fundamental” reason the policyholder's argument failed was that, if the CEO were treated as legally indistinguishable from the entity, Side A coverage would not exist because such coverage is available only for officers and shareholders who could not be indemnified by the entity.

The court then held that coverage for the fraudulent inducement claim was not barred by the policy's contractual-liability exclusion, which excluded coverage for “Loss . . . arising from . . . any liability under any contract or agreement . . ..” The court noted that the exclusion applied only to loss that would not exist but for contractual *liability*, distinguishing situations in which the loss arises out of a contractual relationship. Here, although the investment at issue was the subject of a contract and there would have been no investment to recover absent the existence of the contract, the court held that the exclusion did not apply because the claim for fraudulent inducement would have existed even if the policyholder had fulfilled all of its obligations under the contract.

Finally, the court held that the underlying claim was uninsurable as a matter of Minnesota law, rejecting the claimant's argument that the underlying causes of action (conversion, breach of fiduciary duties, and violations of the Minnesota Securities Act) could have arisen from either intentional or unintentional wrongdoing. The court looked beyond the complaint's labels and determined that the substance of the underlying claim was that the CEO intentionally lied to induce the investment. The court noted that the concept of uninsurability under Minnesota law is “largely . . . driven” by concerns regarding moral hazard, and held the loss here uninsurable because “if someone in [the CEO's] position could foist the consequences of his behavior onto his insurer, he would have little incentive to be truthful.”