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NEWSLETTER

Ninth Circuit Determines Questions of Fact Preclude Summary Judgment in Favor of Insurer Regarding Allegations of Willful Acts and Disgorgement Sought by Bankruptcy Trustee

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The United States Court of Appeals for the Ninth Circuit, applying California law, has held that questions of fact regarding whether alleged breaches of fiduciary duty by directors and officers of a bankrupt grocery company were negligent or willful precluded summary judgment for a D&O insurer. *Unified Western Grocers v. Twin City Fire Ins. Co.*, No. 05-15986 (9th Cir. Aug. 14, 2006). The court also held that, although California public policy precludes indemnification or reimbursement for restitution of ill-gotten gains, the underlying complaint sought damages that did not constitute ill-gotten gains.

The insurer issued a D&O policy to the corporate parent of a grocery company operating in Hawaii. The policy did not include entity coverage, but it did obligate the insurer to reimburse the entity for losses for which the entity had indemnified its officers and directors in connection with a covered claim during the policy period. The policy also contained an exclusion that precluded coverage for an individual serving in an outside capacity for claims brought by or with "the solicitation, assistance or participation of the entity in which the [individual] serves in the Outside Position or any director, officer, trustee, regent, governor or employee of such entity."

The bankruptcy trustee of the subsidiary of the policyholder sued the individuals, who were directors and officers of both the parent and the subsidiary, alleging that they engaged in a scheme to siphon the corporate assets of the subsidiary through approval of an allegedly fraudulent sale of the subsidiary. The complaint alleged three counts against the officers and directors for which they sought coverage under the policy: breach of fiduciary duty, aiding and abetting, and civil conspiracy. The insurer denied coverage, maintaining that the complaint alleged willful acts for which coverage was precluded by California statute, that the complaint sought restitution of ill-gotten gains which is uninsurable under California case law, and that the exclusion in the policy regarding outside capacity precluded coverage for the claims by the bankruptcy trustee against an individual insured who served as a director of the subsidiary after it was sold. The district

court granted summary judgment in favor of the insurer.

On appeal, the Ninth Circuit first held that questions of fact regarding whether the complaint alleged only willful acts precluded summary judgment for the insurer. Section 553 of the California Insurance Code states that "[a]n insurer is not liable for a loss caused by the willful act of the insured; but he is not exonerated by the negligence of the insured, or of the insured's agents or others." The court acknowledged that California case law establishes that "Section 553 reflects a fundamental public policy of denying coverage for willful wrongs" and that the statute functions as an implied exclusionary clause to be read into all policies of insurance. The court then explained, however, that it was "reluctant to frame coverage based on isolated allegations in an underlying complaint" because "[t]he same underlying conduct that is eventually proven to be merely negligent may be asserted in the complaint as intentional and willful." The court held that, although the conspiracy claim against the individuals contained allegations of a willful scheme, the breach of fiduciary duty cause of action could rest either on willful or negligent actions.

The court specifically stated that "the trustee did not hinge liability on a fraud or deceit on the corporation or its creditors, but on a conflict of interest by the [directors and officers] while they acted as officers and/or directors of [the subsidiary]" and that "[t]he insureds may be subject to liability solely for their negligence in holding conflicting positions and approving a transaction which allegedly caused the bankruptcy of [the subsidiary]." Accordingly, the court held that "the damages alleged in the Underlying Complaint do not unavoidably originate from intentional and willful conduct by the insured."

The court also rejected the insurer's argument that the allegedly negligent and willful conduct was inextricably intertwined so as to fall within the ambit of case law interpreting Section 553. In this regard, the court noted that "[t]he presence of allegations in the Underlying Complaint that assert a broader scheme to defraud creditors does not automatically subsume all allegations of a negligent character into the sphere of willful conduct" because "[i]t is commonplace under liberal pleading rules for complaints to assert alternative theories of liability."

Turning to the question of the lack of coverage under the policy for reimbursement for restitution of ill-gotten gains, the court acknowledged that *Bank of the West v. Superior Court*, 833 P.2d 545 (Cal. 1992), and other California case law "precludes indemnification and reimbursement of claims that seek the restitution of an ill-gotten gain." The court noted, however, that "[t]he label of 'restitution' or 'damages' does not dictate whether a loss is insurable" and held that the allegations of the underlying complaint did not restrict the recovery sought to restitutionary amounts. Rather, the court noted that the underlying complaint sought damages for the actions of the defendants that deepened and accelerated the subsidiary's insolvency and that "[t]his calculation of total damages was not based on the amount wrongfully acquired by the Corporate Defendants, but on the amount of unpaid debt eventually accumulated by [subsidiary] before its bankruptcy." The court reasoned that summary judgment was precluded because, "[w]hile the complaint alleges the wrongful receipt of funds from [the subsidiary], other allegations seek damages proximately caused by the Defendants' actions in an amount greater than the amount of money actually alleged to have been taken by the Defendants."

Finally, the court held that the "outside capacity" exclusion in the policy did not preclude coverage for claims against a director of the policyholder who continued to serve in an outside capacity for the subsidiary after it was sold. The policyholder contended that the exclusion should not apply to claims brought by the bankruptcy trustee against the individual because the trustee represented the subsidiary's estate, not the subsidiary. The court held that the term "trustee" in the exclusion was ambiguous because it was not defined in the policy and was used in other policy provisions to refer "both to bankruptcy trustees and other types of trustees who act within corporate management." The court specifically reasoned that "[a]lthough the 'ordinary and popular sense' of the phrase 'any trustee' may reasonably be viewed in the abstract as including bankruptcy trustees, the surrounding language of the policy exclusion at issue raises an ambiguity" and concluded that the exclusion should thus be construed "against the insurer in a manner that affords coverage for" the director serving in an outside capacity.