

ALERT

MAY 17, 2012

GLOBAL INSURANCE GROUP

News Concerning
Recent Professional Liability Issues



COZEN
O'CONNOR
www.cozen.com

Washington Court Holds that a Corporate Officer's Breach of Contract Is Not a Covered "Loss" from a "Wrongful Act" Under a D&O Policy

Benjamin J. Stone • 206.373.7237 • bstone@cozen.com

In a recent case, *Sauter v. Houston Cas. Co.*, No. 66809-9-1, (May 14, 2012), a Washington appeals court analyzed a type of policy not often considered by Washington courts – a director and officer (D&O) policy. In its decision, the appeals court addressed important issues concerning limitations in coverage under a D&O policy for contract claims.

Sauter was an officer of a limited liability company (LLC). The LLC obtained a line of credit and Sauter signed the loan documents required by the bank. Sauter also signed a guarantee for the loan, pledging seven properties he owned as security. The LLC defaulted on the loan and the bank demanded payment from Sauter as the guarantor of the loan. Sauter demanded coverage from the insurer that issued a D&O policy to Sauter and other officers of the LLC.

The insuring agreement of the policy stated: "The Insurer shall pay on behalf of the Insured Persons Loss resulting from any Claim first made against the Insured Persons during the Policy Period for a Wrongful Act." The policy defined "wrongful act" in relevant part as an "act ... by ... any of the Insured Persons, while acting in their capacity as ... such on behalf of the Insured Organization."

The appeals court held there was no coverage for the bank's claim against Sauter under the guarantee. The court began by addressing a narrow factual question: was Sauter acting in his capacity as an officer of the LLC when he guaranteed the loan? There was coverage only if this question was answered affirmatively because wrongful act was defined as an act by an officer while acting in his capacity as an officer. In guaranteeing the loan, the court held that Sauter was acting in his personal capacity, not as an officer of the LLC. In reaching this conclusion, the court cited the guarantee,

which Sauter signed personally, and the security, properties Sauter owned personally. The court also compared the guarantee to the loan documents. The loan documents had been signed by Sauter as "Michael J. Sauter, Manager of S-J Management, LLC." The court held that the difference in the signatures established that Sauter acted personally – not in his capacity as an officer of the LLC – when he guaranteed the loan.

The court also reasoned that, to find that Sauter signed the guarantee in his capacity as an officer of the LLC would defeat the very purpose of the guarantee. As the court reasoned: "Had Sauter acted in his official capacity on behalf of [the LLC] when he executed the guaranty – as he did when he signed the underlying business loan agreement – [the LLC] would be both the debtor and the guarantor with regard to the ... loan. Such cannot be the case."

The court also reasoned that, had Sauter signed the guarantee as an officer of the LLC, he would not be covered under the D&O policy. The court explained that Sauter was covered under the policy only for personal liability he incurred in his capacity as an officer of the LLC. He was not covered for liability incurred by the LLC. If he signed the guarantee in his capacity as an officer of the LLC, the court said, he would not be personally liable under the guarantee. Instead, the company would be liable. As a result, Sauter would not be covered under the policy.¹

¹ In reaching this result, the court did not address the other coverage typically available under a D&O policy, coverage for a company for indemnification of a corporate officer. This might be because the D&O policy at issue in *Sauter* did not offer this coverage or because this type of coverage was irrelevant since the LLC was insolvent and could not indemnify Sauter.

The court then addressed a second, broader, issue: was the claim under the guarantee a loss resulting from a wrongful act. The court reasoned it was not, for two reasons. First, the court reasoned that a voluntary contractual obligation could not be a loss that could be insured under a D&O policy. Citing a case from California, *August Enter., Inc. v. Philadelphia Indem. Ins. Co.*, 146 Cal. App.4th 565, 582 (2007), the Washington court stated that allowing coverage to exist for an insured's voluntary contractual obligations "would create a moral hazard problem, encouraging corporations to risk a breach of their contractual obligations, knowing that, in the event of a breach, the D&O insurer would ultimately be responsible for paying the debt."

The court added that, even if it could be a loss, there was no coverage under the particular terms of this policy because this policy required a loss resulting from a "wrongful act." In reaching this conclusion, the court relied on an often-cited case from Nevada, *American Cas. Co. of Reading, PA v. Hotel & Rest. Employees and Bartenders Int'l Union Welfare Fund*, 113 Nev. 764 (Nev. 1997) (*American*). In *American*, the Nevada Supreme Court held there was no coverage for an insured's breach of an indemnification agreement because there was no loss resulting from a wrongful act. The *American* court reasoned that the insured was "required to pay [its] contractual obligation. This contractual obligation did not result from [the insured's] wrongful act of refusing to satisfy it. To hold otherwise would allow an insured to turn all of its legal liabilities into insured events by the intentional act of refusing to pay them." The Washington court held that,

similarly, Sauter was liable because he signed the guarantee, not because he failed to pay the guarantee. As the court explained: "In other words, his obligation to Commerce Bank was not the result of Commerce Bank's demand on the guaranty; instead, his obligation was the result of the guaranty itself." As a result, there was no loss resulting from a wrongful act and, hence, no coverage under the policy.

Sauter is a significant ruling regarding coverage under D&O insurance under Washington law. The court recognized – and enforced – a limitation on coverage to acts committed by a corporate officer in his or her capacity as an officer. Acts committed in a personal capacity, including a guarantee of a loan to a company, are not covered under a policy that limits coverage in this manner. More importantly, for the first time, a Washington court held that a contractual obligation is not a loss under a D&O policy. This aspect of the decision is significant and potentially far reaching. Although the *Sauter* decision concerned a guarantee, the broad language used by the court is applicable to other contract claims as well. And finally, the court held that a breach of contract claim is not covered under a D&O policy which requires that a loss result from a wrongful act to be covered.

To discuss any questions you may have regarding the issues discussed in this alert, or how they may apply to your particular circumstances, please contact Benjamin J. Stone at 206.373.7237 or bstone@cozen.com.