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INDUSTRY WATCH: D&O

"Catch Me If You Can": Improper Denial of Securities Claims by D&O Insurance Companies

By William G. Passannante and Alex D. Hardiman

The number of securities class actions and the size of the settlements associated with those class actions continue to increase. Even excepting the unusually large settlements reached in the Enron and WorldCom cases, the total value of securities class action settlements in 2005 exceeded $3.5 billion. (See Laura E. Simmons and Ellen M. Ryan, *Post-Reform Act Securities Settlements—2005 Review and Analysis.* Cornerstone Research, 2006.)

In the face of the increased exposure to securities litigation over the last few years, both in defense costs and in settlement amounts, companies have purchased securities claim coverage under their directors and officers' liability insurance policies (D&O Policies) to provide coverage for the company against such claims.

D&O insurance companies, however, are playing a high-stakes game of "catch me if you can." Unbeknownst to policyholders when faced with a securities claim, many insurance companies have been taking the improper position that the most common forms of damages sought in securities class actions are not covered under their D&O Policies. That is, at claims time they attempt to avoid the primary reason cited for buying the D&O Policies in the first place.

Promise to Cover Securities Claims Damages and Settlements

Securities claim coverage typically provides that the D&O Policy will cover "Loss…which [the policyholder] shall become legally obligated to pay as a result of a Securities Claim…for a Wrongful Act." In turn, "Securities Claim" is most often defined in relevant part as a claim alleging violations of the Securities Act of 1933 or the Securities Exchange Act of 1934. "Wrongful Act" is generally defined as "any actual or alleged error, misstatement, misleading statement, act, omission, neglect or breach of duty" committed or attempted by the policyholder. The term "Loss" is generally defined specifically to include defense costs, damages and settlement amounts.

Thus, a policyholder purchasing securities claim coverage properly expects the D&O Policy to pay the policyholder for the amounts incurred as a result of a securities claim, including those amounts paid in settlement.

Improper Stealth "Exclusion" and "Sham" Insurance

In the face of a policyholder's demand for indemnity in relation to a securities class action settlement, insurance companies have repeatedly been taking the improper position that amounts paid to settle some of the most common securities claims, such as claims for violation of section 11 and section 12 of the 1933 Securities Act, are "uninsurable" as a matter of law. Insurance companies do not rely on any language found in the exclusions section of their D&O Policies, but rather point to the definition of Loss which typically includes a statement that "Loss shall not include matters which are uninsurable under the law." The insurance companies then wrongly characterize the damages available under sections 11 and 12 of the 1933 Securities Act as "restitutionary" in nature and take the position that restitution (the return of money taken from a victim) is uninsurable as a matter of law.

This coverage position contradicts the explicit promise in the D&O Policy to cover all Loss as a result of securities claims, including settlements, and renders the coverage illusory. The position amounts to selling sham insurance. The insurance companies' position is contrary to the plain wording of the D&O Policy and a mischaracterization of the nature of the damages available under sections 11 and 12 of the Securities Act of 1933. *See e.g., Beecher v. Able,* 435 F. Supp. 397, 409-11 (S.D.N.Y. 1975) (characterizing the nature of section 11 damages as "compensation for the damage caused by the wrong done" and not characterizing it as any form of restitution).

The insurance companies have relied on a small number of decisions which they contend support their position. Most recently, this year in *Alanco v. Carolina Cas. Ins. Co.,* 2006 WL 1371633 (D.Ariz., May 17, 2006), a federal trial court suggested that securities claim damages sought in the underlying case were uninsurable because they constituted "disgorgement of ill-gotten gains" or restitution in the context of the particular facts of the underlying securities claim. Alanco relied on an unpublished Indiana trial court decision *Conseco, Inc. v. Nat'l Union Fire Ins. Co.,* 2002 WL 31961447 (Ind.Cir.Ct. Dec. 31, 2002) and a 7th Circuit Court of Appeals decision, *Level 3 Communications Inc. v. Federal Ins. Co.,* 272 F.3d 908 (7th Cir. 2001) which are the most common authorities relied on by insurance companies in support of this argument. Excellent arguments exist distinguishing the facts and reasoning of those cases from the overwhelming majority of classic securities class actions in which coverage applies and policyholders must aggressively advance those arguments. An educated policyholder can "catch" them at their game.

ABOUT THE AUTHORS

William G. Passannante is a senior shareholder in the New York office of Anderson Kill & Olick, P.C. and is co-chair of the firm's Insurance Recovery Group. Mr. Passannante regularly represents policyholders in insurance coverage disputes. Mr. Passannante can be reached at wpassannante@andersonkill.com or 212-278-1328.

Alex D. Hardiman is an attorney in the New York office of Anderson Kill & Olick, P.C. and is a member of the firm's Insurance Recovery Group. Mr. Hardiman is the editor of the Executive Insurance Advisor and has written and spoken on a variety of D&O issues. Mr. Hardiman can be reached at ahardiman@andersonkill.com or 212-278-1471.

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