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Does Your D&O Policy Cover What It Says It Covers?

An Unsettling Trend in Insurance Coverage Litigation

By Cort Malone and Toby Freund

Cort Malone Toby Freund

There is a disturbing trend emerging out of certain insurance coverage decisions involving Directors & Officers (D&O) insurance that should be of concern to all D&O policyholders. In a limited set of circumstances, involving coverage actions seeking D&O recovery for underlying securities class-actions alleging that the corporate entity profited from its own misrepresentations, insurance companies have argued that courts should re-write D&O insurance policies and deny policyholders the benefits of the insurance they purchased. Some courts have accepted this argument and denied recovery for underlying securities settlements that are expressly covered under D&O policies by deeming these losses restitutionary in nature and/or "uninsurable as a matter of law." Other courts, however, have issued decisions that cast doubt on the propriety of the insurance companies' argument and the effect of the decisions limiting coverage. This article addresses these rulings, and the options available to policyholders to avoid the loss of bargained-for coverage.

Level 3 v. Federal Insurance Company

In *Level 3 Communications, Inc. v. Federal Insurance Company*, 272 F.3d 908 (7th Cir. 2001), the court accepted the insurance companies' argument in favor of overriding the express coverage provided for in the policy by calling into play the policy's definition of "Loss," and asserting that it should not include damages that are "restitutionary" in nature because they allegedly are not a loss as that word is commonly defined. In heeding the insurance companies' position, the Seventh Circuit found that, despite the express coverage for securities claims under D&O policies, certain types of damages are restitutionary in nature, and thus uncovered.

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In *Level 3*, the underlying plaintiffs alleged that the company had made fraudulent representations about the value of its stock, and sued under Section 10(b) of the Securities Exchange Act of 1934. Level 3 negotiated a favorable settlement and submitted a claim to its D&O insurance company, which was denied. The court in *Level 3* found that any damages that Level 3 expended in the settlement could not as a matter of law represent "Loss" as defined in the insurance policy because such damages were not an injury to Level 3, but rather restitution of undeserved funds—the return of monies that Level 3 had fraudulently obtained.

Level 3's Legacy

In *Conseco, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, the D&O policy at issue included coverage for "Losses" defined as "damages, judgments, settlements, and Defense Costs" arising from a "Securities Claim ... for any

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actual or alleged Wrongful Act." *See Conseco, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 2002 WL 31961447 at *4-5 (Ind. Cir. Ct. Dec. 31, 2002). The underlying plaintiffs in Conseco alleged violations of Section 10(b) of the 1934 Act, and also brought claims under Sections 11 and 12 of the Securities Act of 1933. Section 11 of the 1933 Act provides shareholders with a cause of action in instances where a corporation issues a "misleading" registration statement. Conseco argued that the Section 11 claims against it did not fall within the ambit of the *Level 3* holding because, unlike claims under Section 10(b) of the 1934 Act, Section 11 claims do not require a finding of *scienter*, or intentional wrongdoing, on behalf of the policyholder. The distinction drawn by Conseco, however, fell upon deaf ears, and the *Conseco* court followed *Level 3* in finding that the underlying settlements represented "uninsurable" restitutionary payments.

Conseco has given credence to the insurance companies' argument that the *Level 3* holding applies equally to securities suits (1) in which the underlying claims are expressly covered under the terms of the insurance policy, and (2) in which the underlying claims have no *scienter* or intent requirement. This decision is troubling for two main reasons: (1) courts should not re-write insurance policies when interpreting the definition of "Loss"; and (2) D&O securities claims are far afield from the types of conduct that traditionally have been considered uninsurable as a matter of law. The result is a slippery slope under which it is entirely possible that a court could find no coverage whatsoever for an underlying shareholder lawsuit brought under Section 11 of the 1933 Act that alleges solely innocent oversights by the corporation.

"By making careful decisions when purchasing insurance, and seeking out experienced coverage counsel when claims are denied, policyholders can ... protect themselves from extraordinary underlying exposures"

Favorable Decisions for Policyholders

Although *Conseco's* expansion of the holding of *Level 3* has created a potential landmine for policyholders, some favorable decisions for policyholders have started to emerge in other jurisdictions. First, it is important to note that the ultimate coverage determination with respect to this subset of securities claims is a matter of state substantive law. As such, there is the potential that new jurisdictions, in cases of first impression, will heed and enforce the contractual agreements between policyholders and their insurance companies.

In one such example, the Superior Court of New Jersey in *Liss v. Federal Insurance Company*, 2006 WL 284468 (N.J. Super. A.D. Oct. 6, 2006) reversed a trial court's order that relied on *Level 3*, stating that *Level 3* was inconsistent with New Jersey law. Similarly, in *Pan Pacific Retail Properties, Inc. v. Gulf Insurance Company*, 471 F.3d 961 (9th Cir. 2006), the Ninth Circuit held that the insurance companies were not entitled to summary judgment on the ground that genuine issues of fact existed as to whether an underlying shareholder settlement actually constituted uninsurable restitutionary payments. An appellate court in New York also recently found it to be a matter of fact whether an underlying "settlement attributed to disgorgement actually represented

ill-gotten gains or improperly acquired funds." *Vigilant Ins. Co. v. Bear Stearns Cos., Inc.*, 34 A.D.3d 300, 302 (1st Dep't 2006). These cases provide support for D&O policyholders and demonstrate that coverage for this specific subset of securities claims requires a fact-specific determination on a case-by-case basis.

Potential Implications of "Uninsurability"

While insurance companies have argued in *Level 3* and *Conseco* that the allegedly "restitutionary" payments are not "Losses" as defined in the relevant policies, there is another troubling argument that these insurance companies have propounded with respect to this particular type of securities claims. This additional argument asserts that some securities claims fall within coverage exclusions for matters that are "uninsurable as a matter of law." This argument should fail because these D&O securities claims do not meet the standard for claims that are uninsurable. There is a two-pronged test for determining what conduct is uninsurable as a matter of law: (1) would denying insurance coverage incentivize positive policyholder behavior; and (2) is the liability imposed intended as a deterrent or as compensation to the underlying plaintiffs. *See, e.g., Ranger Ins. Co. v. Bal Harbour Club, Inc.*, 549 So.2d 1005, 1007 (Fla.1989).

In the case of D&O claims seeking coverage for securities lawsuits generally—and Section 11 claims in particular—the answer to both questions lies in favor of finding insurance coverage. Courts that have addressed such D&O claims have explicitly stated that there is no *scienter* or intent requirement necessary on the part of the policyholder. Thus, there is no incentive for denying coverage. To the extent that these claims are restitutionary, as the above decisions contend, it is self-evident that the underlying losses are compensatory, and not deterrent in nature. However, D&O policyholders must be prepared to face these arguments posed by their insurance companies.

In the wake of *Level 3*, D&O policyholders cannot be too cautious or start too soon in assessing how to protect themselves. By making careful decisions when purchasing insurance, and seeking out

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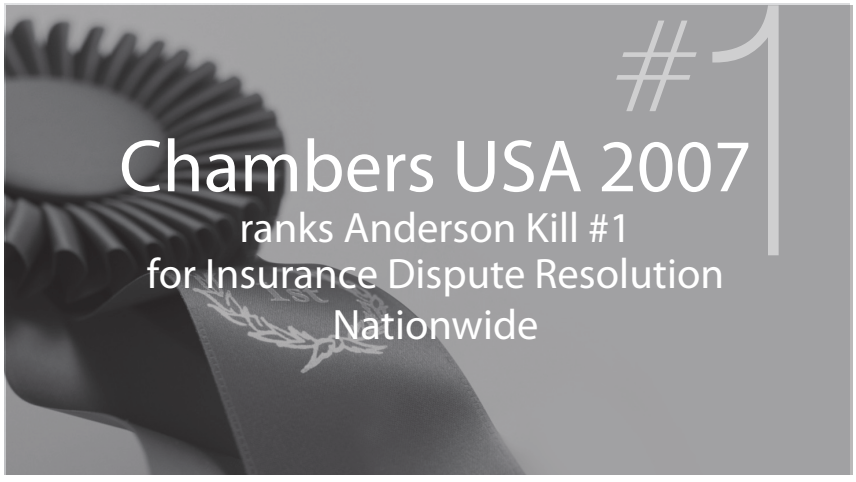

Bold Precautions

By Mark Garbowski

A recent news article reminded me of a client several years ago that came to Anderson Kill seeking a solution to a problem. The client had recently settled a liability claim against the advice of assigned defense counsel, and without insurance company approval. That the company settled was an extremely aggressive decision. If it was wrong, the consequences meant risking all its insurance coverage for the claim. This news article detailed the growing liability faced by companies facing liabilities similar to those already resolved by our client. Because they did not settle when our client did, their potential loss is exponentially greater, and very likely far exceeds their available insurance coverage. They currently are considering a huge settlement demand in return for immunity from criminal charges and a release from civil liability. Their caution actually increased their exposure.

We take for granted that risk involves both probability and consequences, but this was not always obvious. A single 17th century French intellectual, Blaise Pascal, is responsible both for inventing probability theory as a mathematician, and demonstrating the importance of consequences as a philosopher. The idea known as *Pascal's Wager* demonstrates that consequences can be more

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important than probabilities when assessing risk. In application, the lessons of Pascal's Wager are often misapplied to advise excessive caution where a bold move can actually limit one's risk.

As it turned out, we helped our client obtain an insurance payment for the full value of its aggressive settlement, but the decision to settle would have been correct even had we not succeeded. The settlement jeopardized the insurance recovery, but also put a cap on the client's maximum potential loss. It limited the consequences even though it made the insurance recovery more improbable. This will not always be the case, but it is always important to remember that talking on a new risk can sometimes limit an existing one.

Bonne chance.

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experienced coverage counsel when claims are denied, policyholders can overcome the formidable challenges of today's D&O coverage environment and protect themselves from extraordinary underlying exposures.

Cort Malone is an attorney in the New York office of Anderson Kill & Olick, P.C. Mr. Malone represents policyholders in matters ranging from small insurance coverage disputes to large, multi-issue insurance coverage litigations.
(212) 278-1382
cmalone@andersonkill.com

Toby Freund graduated law school in 2007 and is currently pending admission to the New York Bar.
(212) 278-1165
tfreund@andersonkill.com

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