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Settling A Securities Suit: 'Loss' Under D&O Policy?

Law360, New York (January 27, 2009, 12:00 AM ET) -- The insuring agreement in the typical directors and officers liability policy (“D&O policy”) provides coverage for “loss” sustained by the policyholder in connection with any “claim” seeking damages for actual or alleged “wrongful acts,” subject to the policy’s terms and conditions.

The term “loss” is usually defined by such policies to include, among other things, “damages, judgments, settlements and defense costs.” Many policies also exclude from the “loss” definition certain types of payments by policyholders to resolve claims, such as fines and penalties, punitive damages and payments that are “uninsurable” as a matter of law or public policy.

Even a cursory review of the circumstances surrounding disposition of securities cases shows that the vast majority of cases that are not dismissed on dispositive motion are resolved at some point by settlement.

At or shortly after the time of settlement, policyholders typically seek reimbursement from their D&O insurers for the settlement payments made to the underlying plaintiffs.

When presented with these types of claims, insurers have in recent years sought to avoid coverage by contending that the policyholder’s payment to settle underlying securities litigation is not a “loss” sustained by the policyholder, but instead is the disgorgement of ill-gotten gains.

Insurers may contend that D&O insurance policies do not provide coverage for what, in essence, is the policyholder’s return of funds that the policyholder was never entitled to in the first place.

A number of courts have upheld the insurer’s denial of coverage based on this defense and stated that settlement of securities fraud litigation by issuers is not a covered “loss” under standard D&O policies.

See e.g., Level 3 Communs. Inc. v. Fed. Ins. Co., 272 F.3d 908, 910 (7th Cir. 2001) (stating that “[t]he interpretive principle for which [the insurer] contends — that a ‘loss’ within the meaning of an insurance contract does not include the restoration of ill-gotten gains — is clearly right.”).

The reasoning of courts that have reached this result is based in part on the relief sought by the plaintiffs in typical securities litigation.

Securities fraud plaintiffs almost always seek damages from the issuer based on the difference in the price actually paid for the securities and the theoretical value of such securities if the alleged misrepresentations had not occurred. See e.g., Level 3 Communs. Inc., 272 F.3d 908.

In Level 3, Judge Posner, writing for the Seventh Circuit, described such damages sought in the underlying securities fraud litigation as “standard damages relief in a securities fraud case.” Id. at 910.

Judge Posner then proceeded to characterize the damages as restitutionary in character because the damages “seek[] to deprive the defendant of the net benefit of the unlawful act.”

Id. at 910-911.

Other courts have likewise held that a party may not insure itself against the risk of having to return improperly obtained funds. See e.g., CNL Hotels & Resorts Inc. v. Houston Cas. Co., 505 F. Supp. 2d 1317 (M.D. Fla. 2007), aff'd in part, 291 Fed. Appx. 220 (11th Cir. 2008) (quoting Vigilant Ins. Co. v. Bear Stearns Cos. Inc., 34 A.D.3d 300 (N.Y.Sup. 2006)).

In CNL Hotels & Resorts, the court quoted Judge Posner for the proposition that "a[n] insured incurs no loss within the meaning of the insurance contract by being compelled to return property that it had stolen, even if a more polite word than 'stolen' is used to characterize the claim for the property's return." 505 F. Supp. 2d. at 1323.

Based on this rationale, insurers contend that the underlying settlement of a securities fraud lawsuit by an issuer is merely the return of fraudulently obtained funds to which the issuer was never entitled and, therefore, such settlements are restitution and not covered "loss" under standard form D&O policies.

If coverage counsel find themselves in a jurisdiction that follows Level 3 or CNL Hotels & Resorts, counsel must thoroughly investigate the funds or other property, if any, that the policyholder received from the underlying plaintiffs and whether the settlement payment in the securities litigation can be characterized as the return of such proceeds obtained as a result of the wrongdoing alleged in the underlying complaint.

"A restitution remedy is distinct from a damages remedy because '[r]estitution measures the remedy by the defendant's gain and seeks to force disgorgement of that gain' while '[t]he stated goal of the damages remedy is compensation of the plaintiff for legally recognized losses.'"

Virginia Mason Medical Center v. Executive Risk Indemnity Inc., 2007 U.S. Dist LEXIS 85724, *9 (W.D. Wash. Nov. 14, 2007) (quoting D. Dobbs, Law of Remedies, §§ 4.1(1) & 3.1 (West 1993)).

"The fundamental distinction is not whether the insured received 'some benefit' from a wrongful act, but whether the underlying claim seeks to recover only the money or property that the insured wrongfully acquired."

Unified Western Grocers Inc. v. Twin City Fire Ins. Co., 457 F.3d 1106 (9th Cir. 2006); Pan Pacific Retail Properties, Inc. v. Gulf Ins. Co., 471 F.3d 961, 967 (9th Cir. 2006) (examining "whether any genuine issues of material fact remain as to whether the nature of the claims reflected in the settlement and whether any of these claims may have sought non-restitutionary compensation for injuries suffered by the shareholders, which would be covered under the insurers' [D&O] Policies.").

The answer to this inquiry can also turn on the role that the policyholder played in the securities fraud alleged by the underlying plaintiffs.

A distinction arises when the defendant in the securities litigation is not the issuer of the securities but rather a professional organization that assisted with the securities offering, such as an underwriter, accounting firm or other entity.

In such situations, the policyholder typically is a co-defendant in the securities litigation with the issuer as a result of the policyholder providing a service to the issuer, such as when an underwriter participates, typically with other underwriters in a syndicate, to bring a bond offering to the market.

In this scenario, the underwriter-policyholder is not typically the recipient of the allegedly fraudulently obtained funds, but instead receives only the fee paid by the issuer for the underwriting work.

In addition, in the underlying securities litigation, the damages sought by the plaintiffs against

the underwriter or accounting firm are not limited to the fee obtained for the policyholder's professional services, but instead typically is the full measure of damages sought by the plaintiff from the issuer.

Faced with this issue, a number of courts have recognized that "[i]n a Section 11 case, if an entity makes a payment that constitutes something other than disgorgement of its own ill-gotten gains, it has suffered a loss." Bank of America Corp., 2007 NCBC 36, *50 (Dec. 19 2007); CNL Hotels & Resorts, 505 F. Supp. 2d at 1324.

A settlement payment by a non-issuer defendant in a securities fraud case provides an example of such a situation in which an entity makes a payment that clearly constitutes something other than restitution. As such, these settlements cannot be restitutionary in nature and, therefore, clearly constitute "loss" under standard form D&O policies.

While the propriety of the economic analysis employed by some courts in addressing the issue of covered "loss" is subject to serious debate, it is important to keep in mind that coverage disputes are, at their core, about the policy wording. It is well-settled that terms of an insurance policy are to be interpreted in accordance with their plain meaning.

See e.g., Pereira v. Cogan, 2006 U.S. Dist. LEXIS 49263 (S.D.N.Y. July 12, 2006) (quoting Zunenshine v. Executive Risk Indem. Inc., 1998 U.S. Dist. LEXIS 12699 No. 97 Civ. 5525 (S.D.N.Y 1998) ("when a contract is not ambiguous, the court should assign the plain and ordinary meaning to each term and interpret the contract without the aid of extrinsic evidence.").

In assessing whether monetary settlements of underlying securities fraud actions constitute "loss" under D&O policies, counsel should start with the policy's definition of "loss." Many D&O policies define "loss" expressly to include "settlements."

In most policies, the term "settlement" as used in the definition of "loss" is not itself defined, which in most jurisdictions means that the term "settlement" should be broadly construed. As such, under the plain meaning of the standard D&O policy language, underlying securities fraud settlements, whether entered into by issuers or underwriters, should be covered "loss."

The decisions that hold otherwise tend to gloss over the policy wording and instead focus upon economic principles which are subject to debate and, in any event, are not set forth in the typical D&O policy.

If carriers wish to exclude the settlements of securities litigation from the definition of "loss" in their policies, then we suggest that carriers substantially revise the standard definition of "loss."

D&O policies frequently contain detailed exclusions from coverage, and carriers should have no problem crafting clear language to exclude underlying securities fraud settlements from the definition of "loss." Whether insurers could market and sell D&O policies with such a limitation on coverage is another matter.

As described above, standard form D&O policies define "loss" to include settlements. Policyholders, insurers and coverage counsel should recognize that established rules of contract construction require that "loss" and "settlement" be interpreted in accordance with their plain meanings.

Therefore, regardless of how one comes out on the economic issues discussed above, settlements of securities fraud litigation constitute "loss," and are covered under such policies, subject to the policies' other terms and conditions.

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