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The Courts Rule on D&O Coverage in Public Offering Cases

When is a company loss not a covered loss? When the company is paying back ill-gotten gains. So said a US District Court in Florida recently in a case that addressed misleading statements in a public offering. Following a $35 million settlement, the defendant submitted the bill to its Directors & Officers (D&O) carrier, and insurer and insured ended up in court. The court found that because the payment involved the return of money that the defendant should have never had, it did not constitute an insurable loss. This victory for the insurer raises considerable liability issues for corporate directors, signers of registration statements and their underwriters in the context of a public offering, either primary or secondary.

The Case

In 2004, a leading hotel chain was sued in two class actions (later consolidated) that alleged, among other things, violations of Section 11 of the Securities Act of 1933 regulating public offerings. The plaintiffs sought to recover the difference between what they paid for the stock and what they allege they would have paid had certain misrepresentations not been made in the offering documents. They calculated the difference at about $8 per share. In 2006, the parties reached a settlement and a $35 million fund was established to reimburse the underlying plaintiffs. The hotel company then sought coverage, coverage was denied, and the company sued, asserting that the settlement amount constituted a loss as defined in its policies and that under Florida law, Section 11 claims were properly insurable.

The Character of the Payment

After the primary carrier settled its portion of the claim (following an adverse determination by the court on another issue), the court went on to reject the hotelier's arguments. It found for both of the insured's excess carriers, determining that there was no coverage for the Section 11 settlement.

Two details of the case were particularly noteworthy. A question arose over which state's laws applied in the case, Florida (where the company was based) or New York (where the contract was argued to have been executed). The court decided that New York law applied, but then went on to say that if Florida law *had* applied, the result would have been the same: disallowing coverage because the damages involved the restoration of ill-gotten gains. The court also rejected the company's use of the landmark 2001 case *Level 3 Communications*. The court found that it is the "restitutionary character of the payment that is important as opposed to the alleged malfeasance of the Insured."

Moving Forward

While the ruling itself may not have been novel, this court was the first federal court to effectively validate the decision of the Indiana State Court in a similar case in early 2003, *Conseco, Inc*. The *Conseco* court was previously alone in specifically addressing Section 11 claims and finding that they were uncovered. Like the *Conseco* court, the court here looked at the hotel company's payment and found that "if the insured is simply being forced to return money to which it was not entitled, the event is not a loss." What's more, in addressing the company's argument that a failure to allow recovery in this instance would "eviscerate the express grant of liability coverage," the court took the further step of stating that "regardless of the statute under which the original claim is asserted, and regardless of whether the policy references that statute, if the insured is simply being forced to return money, it is simply not reasonable for an insured to assume that it is a loss."

Alert

The decision is currently under appeal but even if the decision is reversed, it may be overturned for reasons that don't address the central holding of the case: that where Section 11 damages are deemed to be disgorgement, they are not covered under D&O policies. This means that it may be wise to consider this decision as if it were final.

What the Court Did *Not* Say

Stepping back, it is important to note that the court was careful to say that Section 11 claims are *not* "per se uninsurable." It also went out of its way to state that where individual directors or officers are part of a Section 11 settlement, it is possible that such a claim may well be insurable. Otherwise, insurability may be limited to either defense costs and/or only those settlements where an entity or its directors or officers make a payment "that constitutes something other than disgorgement of its own ill-gotten gains."

The question of the differences between states also remains open. While the Florida court in effect addressed two states, Florida and New York, there is always the possibility of different findings in different locales.

What the Future Has in Store

According to a 2006 report by Cornerstone Research on D&O claims, Section 11 and/or 12 allegations appear in approximately 20 percent of D&O lawsuits, and appear to result in increased settlements. In light of the court's decision in this case, it may now be time to address this situation up front with your D&O insurers. A number of D&O carriers have introduced wording that would expressly acknowledge coverage for Section 11 claims where they are not categorized in the settlement or court award as disgorgement. The challenge, which is ours to meet, is to find wording that does not simultaneously add extraneous exclusions to the policy. Similarly, we may want to consider whether the time has come to add a choice-of-law provision (indicating which state's law will apply to the policy) to our D&O contracts. Food for thought.

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