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Coverage For Section 11 Damages

Since 2000, the D&O insurance market has debated whether settlements or judgments in claims alleging violations of Section 11 of the Securities Act of 1933 (“1933 Act”) are insurable loss. The few court decisions which addressed that question generally concluded that those damages were uninsurable because they constituted the disgorgement of ill-gotten gains. In August 2008, the Eleventh Circuit Federal Court of Appeals ruled that a \$35 million settlement in a Section 11 class action lawsuit was uninsurable under a D&O insurance policy, relying upon some of those prior cases.

The following summarizes this important new decision, discusses several remaining questions, and explains how D&O insurance brokers and underwriters are reacting to these issues.

A. Background

For decades, insurance case law has consistently held that the restitution or disgorgement of ill-gotten gains by an insured is not insurable loss under an insurance policy even if the policy does not contain an express exclusion for such loss. The rationale for that conclusion is premised on the notion that if the restitutionary damages were paid by the insurer, the insured would be allowed to retain the ill-gotten gain. Such a result would violate public policy and improperly reward the insured for obtaining the ill-gotten gain.

This well established principle becomes controversial when applied to coverage for a securities class action lawsuit alleging violation of Section 11 of the 1933 Act. That statute prohibits misrepresentations in a company’s registration statement filed with the SEC in connection with the company’s initial public offering or a subsequent secondary offering of its securities. In a Section 11 class action, the plaintiff class members in essence allege that they purchased securities from the company at an artificially inflated price due to misrepresentations by the company and/or its directors and officers. The plaintiffs seek to recover from the defendants the amount they overpaid for the securities due to the misrepresentation.

Over the last few years, D&O insurers began to argue that a settlement payment in a Section 11 claim constitutes restitutionary damages or disgorgement of ill-gotten gain since the company is returning to its shareholders the excessive sale price which the company received due to the alleged misrepresentations. In a 2002 decision, an Indiana state appellate court ruled that a settlement payment by the company in a Section 11 claim is uninsurable under a D&O policy because the settlement constitutes the restoration of an ill-gotten gain. *Conseco, Inc. v. National Union Fire Ins. Co.*, 2002 WL 31961447 (Ind. App., Dec. 31, 2002 (unpublished)) That decision followed a 2001 decision by the Seventh Circuit Federal Court of Appeals which held that a

settlement payment by the company in a claim which alleged misrepresentations allowed the company to purchase another company at too low price was uninsurable loss. *Level 3 Communications, Inc. v. Federal Ins. Co.*, 272 F.2d 908 (7th Cir. 2001). As explained by the Seventh Circuit:

[A] “loss” within the meaning of an insurance contract does not include the restoration of an ill-gotten gain.... An 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.

Those decisions generated much debate in the D&O insurance market. Brokers and many insureds argued that the decisions eliminated coverage for one of the primary exposures for which D&O insurance is purchased – i.e., securities class actions under the Securities Act of 1933. Insurers responded by explaining the rational logic of not insuring disgorgement of ill-gotten gain and by noting that most securities class actions are brought by purchasers of securities in the open market under Section 10(b) of the Securities Exchange Act of 1934, which is unaffected by this uninsurability argument since the company did not receive the sale proceeds in those open market transactions.

B. New CNL Appellate Decision

Although that debate has continued, relatively few additional cases addressed this Section 11 insurability question until the August 2008 decision by the Eleventh Circuit in *CNL Hotels & Resorts, Inc. v. Twin City Fire Insurance Company*, 2008 U.S. App. LEXIS 17686 (11th Cir., August 18, 2008). In that case, shareholders who purchased shares in a stock offering by CNL filed a class action against CNL alleging misrepresentations in violation of Section 11. That lawsuit was settled for \$35 million, and CNL sought coverage for that settlement from its D&O insurers. Some of the excess insurers denied coverage for the settlement on the basis that the settlement constituted uninsurable restitutionary damages. The trial court, applying New York law, agreed with the insurers and the court of appeals affirmed in an unpublished opinion. The appellate court rejected the following three arguments by the company as to why the settlement should be covered.

First, CNL argued that in light of the settlement, there was no finding of fraud by CNL, and therefore it was impossible to conclude that CNL wrongly acquired the sale proceeds. The Eleventh Circuit ruled that this argument misunderstands the idea of restitution:

The return of money received through a violation of law, even if the actions of the recipient were innocent, constitutes a restitutionary payment, not a “loss.” It is immaterial whether CNL committed fraud. CNL received money directly from the [class members] through the sale of shares, and CNL returned some of the money after the [class members] alleged that the sale of shares by CNL violated the law.

The court observed that CNL did not dispute the allegation by the plaintiff class that class members purchased shares from CNL for \$20 per share when the shares were actually worth only \$12 per share. Therefore, the settlement was uninsurable restitution.

Second, CNL argued that damages under Section 11 are not restitutionary because the amount of damages permitted by the statute focuses on the loss suffered by the plaintiff instead of the gain incurred by the defendant. In rejecting that argument, the court held that, at least when the loss to the plaintiff is equal to the gain of the defendant, Section 11 does not preclude restitutionary relief.

Third, CNL argued that the settlement was not restitution because underlying settlement agreement between CNL and the plaintiff class expressly stated that the settlement payment was not “restitution or disgorgement.” In rejecting that argument, the court stated that the underlying settlement agreement is not binding on any third party or the court. Since the policy governs coverage issues, the court concluded that CNL’s argument is “too lacking in merit to warrant discussion.”

C. Impact of Decisions

The following summarizes some of the open questions relating to coverage for Section 11 claims in light of the new *CNL* decision and prior caselaw.

1. D&O Coverage. There is no reference in the *CNL* decision to directors and officers of CNL either being defendants or participating in the settlement. The other prior Section 11 cases either limited its restitutionary damage analysis to coverage for the company or did not address whether the analysis equally applied to defendant directors and officers. Therefore, it is unclear whether this “uninsurability” defense applies to coverage for directors and officers who are defendants in a Section 11 claim.

Directors and officers who are not selling shareholders do not realize personal gain from the company’s sale of securities at an artificially inflated price, and therefore do not realize ill-gotten gain in connection with the company’s stock offering. As a result, this restitutionary damage analysis logically should not apply to coverage under the D&O policy for defendant directors and officers. That conclusion is supported by a few recent decisions which held that the restitutionary damage coverage defense applies only to the defendants who actually received the ill-gotten gain. See, e.g., *Bank of Am. Corp. v. SR Int’l Baus. Ins. Co.*, 2007 WL 4480057 (N.C. Super. Dec. 19, 2007) (settlement payment by a defendant securities underwriter in a Section 11 class action was insurable loss because the underwriter, unlike the issuer company, did not receive any proceeds from the offering); *Westport Ins. Corp. v. Hanft & Knight, P.C.*, 2007 U.S. Dist. LEXIS 90599 (N.D. Pa. Dec. 10, 2007) (uninsurability of disgorgement is limited to defendants who actually reaped ill-gotten gains, and not to those who did not).

Although directors and officers typically do not realize personal gain from the company’s sale of securities, if the company indemnifies the defendant directors and officers for a Section 11 settlement, the uninsurability coverage defense arguably could apply to the coverage for the company’s indemnification payments under Side B of the D&O policy since the company

is arguably using its ill-gotten gain to pay the indemnification. Although that argument has been raised by insurers in some Section 11 claims, no direct judicial authority current exists to support or refute that argument.

2. Defense Costs Coverage. Similarly, a question exists whether this uninsurability coverage defense applies only to the settlement or judgment amount, or also applies to defense costs incurred by the insured in seeking to avoid disgorgement of the allegedly ill-gotten gain. Logically, the defense costs payments are not themselves restitution or disgorgement and therefore arguably are insurable. However, some courts have concluded that defense costs in a claim seeking rescissionary damages are, like the rescissionary damage itself, uninsurable. See, e.g., *Alanco Techs., Inc. v. Carolina Ins. Co.*, 2006 U.S. Dist. LEXIS 31988 (D. Ariz. May 17, 2006) (defense costs in an action seeking rescissionary damages are not covered under a D&O policy because defense costs are recoverable only for covered losses); *Executive Risk Indemnity v. Pacific Educational Services, Inc.*, 2006 WL 2506467 (D. Hawaii Aug. 25, 2006) (insurer has no duty to defend a lawsuit that only alleges a claim for restitution of ill-gotten gains); *Pan Pacific Retail Properties, Inc. v. Gulf Ins. Co.*, 2006 U.S. App. LEXIS 26669 (9th Cir. Oct. 26, 2006) (defense costs in claim only seeking uninsurable restitutionary remedies are also uninsurable).

C. Underwriting Response

When this Section 11 insurability issue first surfaced during the hard market several years ago, some insurers amended their D&O policies to expressly exclude in the definition of “Loss” amounts constituting restitution, rescissionary damages or disgorgement of ill-gotten gains. This response sought to confirm the lack of coverage for such payments and to avoid surprises or confusion by insureds in a Section 11 claim.

Not surprisingly, as the D&O insurance market softened in more recent years, policies were again amended to delete that express exclusion and to grant express coverage for Section 11 settlements and judgments to the extent possible. Today, most D&O policies contain a provision which seeks to confirm coverage for Section 11 losses, although those provisions vary greatly. For example:

- Some provisions state that the insurer shall not assert that any Section 11 loss is uninsurable;
- Some provisions state that the insurer shall not assert that Section 11 defense costs or settlements are uninsurable, but preserve the insurer’s right to raise uninsurability if the insured persons or the company is adjudicated to have realized ill-gotten gain;
- Some provisions state that the illegal personal profit exclusion does not apply to Section 11 claims;

- Some provisions prohibit the insurer from asserting that any Section 11 losses incurred by insured persons is uninsurable, although the insurer preserves the right to raise the uninsurability coverage defense with respect to company loss.

D. Summary

The new *CNL* decision is strong support for the insurers' argument that Section 11 settlements by the company are uninsurable, although it is less clear whether defense costs and Section 11 settlements by defendant directors and officers are also uninsurable. Many D&O policies issued in today's soft market attempt to eliminate or minimize this coverage defense, but it is far from clear whether a policy provision can override a public policy prohibition against the insurability of rescissionary damages, restitution or disgorgement of ill-gotten gain. As a practical matter, this coverage defense will probably arise less frequently in light of the current policy provisions which attempt to prohibit the insurers from asserting the defense, but where a policy allows the insurer to assert this coverage defense or when the D&O market hardens again, this coverage defense may still be an important limitation to a D&O insurer's liability.