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'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.

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'Instant Options' Claims Are Covered
Insurance For Backdated Options

By William G. Passannante and Alex D. Hardiman

A recent statistical analysis of the "instant options" grants found that as many as one-third of companies have used backdated options as part of their compensation packages by allowing employees to buy stock at a lower, retroactive price and thereby maximize returns. (*See* Stephanie Saul, "Study Finds Backdated Of Options Widespread." *The New York Times*, July 17, 2006.) The SEC and other government agencies have launched numerous civil and criminal investigations of the practice, specifically focusing on allegations that certain companies manipulated the dates at which the options would be granted so as to maximize returns.

In addition, the practice has already spawned a variety of civil lawsuits, including derivative and shareholder class actions. These lawsuits generally allege breaches of fiduciary duty by companies' directors and officers (D&Os) and violations of the securities laws by the companies and their D&Os for alleged failure to disclose properly the backdated options or alleged misleading or false statements

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made in SEC filings and press releases allegedly to the detriment of shareholders. Many, many hours of defense counsel time are being spent which should be paid under D&O insurance policies.

Policyholders who are potentially subject to these backdated options claims and investigations should ensure that they take the necessary steps to protect their rights to insurance coverage.

Insurance Industry Reaction to Backdated Options Claims

The insurance industry says that it views backdated options claims as a potentially significant source of claims. Chubb's chief underwriter has stated that "[i]f we have any cause for concern, we may exclude the risk," indicating that the insurance industry may be looking for avenues to deny or limit their exposure to backdated options claims. (*See* Liam Pleven, "Options Timing Raises Concerns Among Insurers." *The Wall Street Journal*, June 20, 2006.) A leading lawyer for the insurance industry was more pointed: "I don't want to say every claim is going to be denied … But there is enough here that there are going to be some significant coverage issues in many of these cases for at least some of the defendants." (*See* Dan Bailey, Bailey Cavalieri, quoted in, Miles Weiss & Jesse Westbrook, *Nasdaq Unit Says Options Scandal May Drive Up Rates (Update2)*. Bloomberg June 8, 2006.) The "prevent defense" has already started to form.

D&O Policies Cover Backdated Options Claims

Directors and officers' liability insurance policies (D&O Policies) provide coverage for backdated options claims. Generally, D&O Policies provide coverage for all "Loss" (which includes defense costs and amounts paid in settlement or judgments) incurred as a result of claims against alleging "Wrongful Acts" by D&Os, typically defined as any "breach of duty, neglect, error, misstatement, misleading statement, omission or act." Thus, allegations that a D&O committed

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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.

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wrongful acts in connection with backdated options constitute a covered claim and D&O Policies should respond with payments for the defense costs and ultimately, if necessary, amounts paid in settlement or as a result of a judgment. Many D&O Policies also contain coverage for the company against securities claims brought in connection with the backdated options issue and this may include coverage for the costs of responding to a government investigation. Policyholders should also review their fiduciary liability policies for possible coverage for certain types of backdated options claims that may be brought alleging detrimental effects on employee benefit plans.

Avoid Common Traps

D&O Policies are "claims made" policies providing coverage for claims made during the policy period. Policyholders should give immediate notice to their insurance companies of any backdated options claims. Just as important, however, policyholders also should give notice of any circumstances or facts regarding backdated options practices that may give rise to a claim in the future, a requirement in most D&O Policies. If such notice is given, and a backdated options claim is later made that arises out of those circumstances, D&O Policies typically provide that the claim will be deemed to have been made during the policy period in which notice is given. A failure to give notice of circumstances during one D&O Policy period may lead to denial of a claim in the future that occurs during a renewed or replacement policy period. As a result, in order to maximize the possibility of insurance coverage, if a company or its D&Os are the subject of an SEC informal letter of inquiry or investigation relating to backdated options issues, then the company should give notice under its D&O Policies. Not only may there be possible coverage for the costs relating to the inquiry or investigation, but such notice will help protect against potential notice defenses to coverage in the event of a claim. Similarly, if a company decides to conduct an internal investigation of issues relating to backdated

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options and the investigation indicates the possibility of potential claims, the company should consider notice of that investigation under its D&O Policies.

Resist Attempts by Insurance Companies to Limit Coverage for Options Backdated Claims

Insurance companies will likely raise a variety of exclusions to limit or deny coverage for backdated options claims, including exclusions for fraudulent acts or the "gaining of unlawful profit" or that any damages or settlements arising out of the claims are supposedly "uninsurable as a matter of public policy." None of these purported exclusions should apply to prevent coverage for defense costs or settlements and may apply only potentially to limit coverage for damages in very limited circumstances. Policyholders should resist attempts by their insurance companies to limit or deny coverage under their insurance policies for backdated options claims.

The instant options backdating scandal presents a typical example of behavior which may well have been permissible at one time, becoming proscribed at the later time. The insurance which likely applies was sold before this "new awareness," and should apply to cover instant options claims.

Mark Your Calendar

The Forgotten Promise:
Strategies and Tactics to Maximize the Value of D&O Insurance

Thursday, October 12, 2006

FREE Seminar

Time: Registration: 3 - 3:30 p.m.
Seminar: 3:30 - 5:30 p.m.
Cocktail Reception: 5:30 - 6:30 p.m.

Location: The Metropolitan Club
Sears Tower
Michigan Room, 66th Floor
233 S. Wacker Drive
Chicago

Program Overview:

This D&O conference will examine emerging issues in the D&O insurance claims process and securities class actions. Specifically, this program will cover strategies and tactics to minimize D&O liability and maximize the return on liability insurance.

For further information or to register, please visit our website at www.andersonkill.com or contact Andrea McLean at (212) 278-1400.

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We hope that you have found this issue of the *Executive Insurance Advisor* informative. We invite you to contact the group chair or editor listed below with your questions and/or concerns.

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