AKO FINANCIAL SERVICES

ALERT

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Is Your Settlement Insured? The Wrong Words Can Prevent Coverage

By R. Mark Keenan and Craig M. Hirsch

In the current climate of zealous regulators bringing countless securities investigations, how your financial institution chooses to "speak" in reaching a settlement may have serious implications on your insurance coverage. The tiniest syntactical misstep in a settlement may sound the death knell for your claim.

In stipulating to a binding settlement agreement, look for two classic red flags in the proposed language: (1) "disgorgement of profits" or "ill-gotten gains" and (2) "fines" or "penalties." In both cases, you can lose insurance coverage.

"Disgorgement of Profits" and "Ill-Gotten Gains" May Not Receive Coverage

Recent court decisions hold that ill-gotten gains obtained by a corporation through glaringly fraudulent and deceptive conduct may not be covered under insurance policies, especially in the D&O and professional liability context. Thus, the disgorgement of improperly acquired funds may prohibit the corporate policyholder from receiving insurance coverage as a matter of public policy.

During settlement negotiations with a government agency or third-party, you should always attempt to eliminate words or provisions within the proposed agreement alluding to the relinquished settlement money as "ill-gotten." The following examples may impede your efforts to invoke coverage:

- "improperly obtained"
- "wrongfully extracted"
- "disgorgement of profits" or "disgorgement of ill-gotten gains"
- "pay restitution to claimants"

> ***"The tiniest syntactical misstep in a settlement may sound the death knell for your claim..."***

While the first three examples may present grounds for a denial of coverage, the term "restitution" is a bit stickier. Some courts hold that restitution-type damages — where the corporate-policyholder remits funds which properly belong to another party — are not covered under the law. *Level 3 Communications, Inc. v. Federal Ins. Co.*, 272 F.3d 908 (7th Cir. 2001); *Reliance Group Holdings, Inc. v. National Union Fire Ins. Co.*, 594 N.Y.S.2d 20 (App. Div. 1993). On the other hand, if settlement payments are earmarked for distribution to private claimants who have suffered actual losses, the corporation may legitimately argue that the money should be treated as *compensatory damages* for insurance purposes. Such damages are traditionally covered under professional liability policies, making their "restitution" label within the settlement agreement irrelevant.

The Cautionary Tale of Credit-Suisse First Boston

In *SEC v. Credit Suisse First Boston Corp.*, 2002 WL 479836 (D.D.C.), Fed. Sec. L. Rep. P 91, 695, the District Court for the District of Columbia

ANDERSON KILL & OLICK, P.C.
1251 Avenue of the Americas
New York, NY 10020-1182
(212) 278-1000 Fax: (212) 278-1733

ANDERSON KILL & OLICK, P.C.
1600 Market Street
Philadelphia, PA 19103
(215) 568-4202 Fax: (215) 568-4573

ANDERSON KILL & OLICK, P.C.
One Gateway Center, Suite 901
Newark, NJ 07102
(973) 642-5858 Fax: (973) 621-6361

ANDERSON KILL & OLICK, L.L.P.
2100 M Street, N.W., Suite 650
Washington, DC 20037
(202) 218-0040 Fax: (202) 218-0055

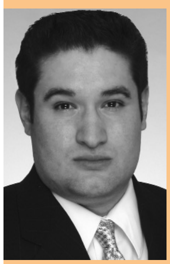
ANDERSON KILL & OLICK (Illinois), P.C.
1821 Walden Office Square, Suite 400
Schaumburg, IL 60173
(847) 952-5430 Fax: (847) 952-5431

ANDERSON KILL & OLICK, P.C.
Two Sound View Drive, Suite 100
Greenwich, CT 06830
(203) 622-7668 Fax: (203) 622-0321

www.andersonkill.com

who's who

R. Mark Keenan is a senior shareholder in the New York office of Anderson Kill & Olick, P.C. and Co-Chair of Anderson Kill's Financial Services Group. Mr. Keenan's practice focuses on Insurance Coverage, Securities Law and Litigation and international commercial insurance matters. Mr. Keenan regularly represents policyholders in insurance coverage disputes involving broker/dealer, hedge funds, investment advisors and other financial institutions. Mr. Keenan can be reached at mkeenan@andersonkill.com or (212) 278-1888.



Craig M. Hirsch is an attorney in the New York office of Anderson Kill & Olick, P.C. and a member of Anderson Kill's Financial Services Group. Mr. Hirsch can be reached at chirsch@andersonkill.com or (212) 278-1470.

ordered Credit Suisse to disgorge $70 million wrongfully extracted from large portions of its customers' profits made by flipping "hot" IPOs. The improperly obtained profits arrived in the form of excessive brokerage commissions produced by Credit Suisse clients in making securities trades unrelated to the IPO transactions.

Agreeing to a settlement with the SEC for numerous statutory violations, Credit Suisse consented to an entry of judgment *without admitting or denying the allegations* of the SEC's formal complaint, yet acquiesced to a provision stating the $70 million was "obtained improperly."

Subsequently, Credit Suisse unsuccessfully brought a declaratory judgment action against its insurance company seeking coverage for the settlement. The Appellate Division of the Supreme Court of New York held that the disgorgement of improperly obtained profits could not be recovered *as a matter of law*. "The risk of being directed to return improperly acquired funds is not insurable," the Appellate Division unambiguously stated. "Restitution of ill-gotten funds does not constitute 'damages' or 'loss' as those terms are used in insurance policies." *Vigilant Ins. Co. v. Credit Suisse First Boston Corp.*, 782 N.Y.S.2d 19, 20 (App. Div. 2004).

As the court states, the argument that ill-gotten funds or improperly obtained profits are not recoverable is a matter of public policy. When insurance coverage becomes an imprimatur to commit theft and fraud upon third-party investors, the law will not enforce the policy.

Fines and Penalties Cannot Be Recouped

Fines and penalties are usually uninsurable as well. The use of the words "fine" or "penalty" within the settlement agreement normally precludes insurance coverage as specified in the definition of "loss" within most professional liability policies. A standard loss provision in an insurance policy will encompass various damages, costs and settlements, but will specifically exclude fines and penalties from the purview of coverage:

> The term "Loss" shall mean . . . compensatory damages, punitive damages where insurable by law, judgments, settlements, costs, charges and expenses . . . provided however, Loss shall not include fines and penalties imposed by law . . .

Solutions: There is Hope

Carefully selecting and lobbying for placement of specific language into the settlement agreement can help you find shelter within this insurance tempest. Any funds transferred according to the settlement should be classified as "compensatory" or simply as "produced payments" to prevent your insurance company from issuing a denial. In addition, if the settlement payments are ultimately destined for a distribution fund created to satisfy the actual damages of aggrieved third-party claimants, the language of the agreement should promulgate this in order to protect your insurance coverage. Finally, at all costs, bully for the removal of modifiers such as "wrongful," "illicit," "improper" and "illegal" used to describe why your firm opted for settlement.

In heated settlement negotiations, only the strong survive. ■

We hope you find this issue of the Financial Services Alert informative. We invite you to contact the Group Chairs, R. Mark Keenan, at (212) 278-1888 or mkeenan@andersonkill.com or David M. Schlecker, at (212) 278-1730 or dschlecker@andersonkill.com with your questions or concerns.