# IMA Executive Risk Solutions

*Year End Update*

## Inside



## *Cases of Interest*

### False Claims Act (FCA) Settlement Covered Despite Being Labeled "Restitution"

A federal district court in Illinois recently upheld coverage under a directors and officers (D&O) liability policy where the evidence showed the settlement actually represented compensatory damages, despite being labeled as "restitution" in the settlement agreement. The coverage dispute arose following the insurer's refusal to reimburse defense costs or amounts paid in settlement.

The underlying case began when subpoenas were issued to the insured by the Department of Justice (DOJ). The insurer took the position the subpoenas did not meet the definition of a Claim under the insured's D&O policy. Subsequently, a tolling agreement was effectuated, which was accepted as a Claim by the insurers. The matter was eventually resolved in exchange for a $100 million payment by the insured.

Ultimately, the insured was able to resolve the coverage dispute with all D&O carriers on its program except for the final $10 million excess layer policy. While admitting the settlement amount to be reasonable, the excess insurer denied coverage in full, arguing the settlement was uninsurable as a matter of law and thereby excluded from the definition of Loss in the policy. The insurer's position was rooted in language contained in the settlement agreement which labeled half of the settlement as restitution.

Notably, the phrase 'restitution to the U.S.' is standard language used in DOJ releases for False Claims Act cases. The reason behind this relates to the fact that settlements paid to the government are not tax deductible unless labeled as restitution.

With respect to whether coverage was afforded under the excess D&O policy here, the court was forced to determine if the portion of the settlement labeled "restitution" constituted disgorgement of ill-gotten gains, or instead represented compensatory damages.

After a lengthy analysis of the conduct at the heart of the investigation and the basis of the settlement figure, the court found the carve-out within the definition of Loss to be an exclusion, thereby shifting the burden to the insurer to prove that the exclusion applied.

Relying on evidence submitted which showed the term "restitution" was included solely for tax purposes and that the FCA only allows for the imposition of civil penalties and compensatory damages, the court rejected the insurer's position and held the $50 million portion of the settlement labeled "restitution" to fall within coverage under the excess policy. *Astellas US Holding, Inc. v. Starr Indemnity & Liability Co.*, 2021 WL 4711503, (E.D. Ill. October 8, 2021).

## *Cases of Interest*

### Bump-Up Exclusions and Separate Retentions for M&A Claims Remain an Issue of Concern

Two recent cases highlight the pitfalls and problems insureds face when coverage is sought for claims arising out of business transactions (i.e., M&A). In the first case, an insured sought coverage under its D&O program for claims brought against it arising out of a buyout transaction. Claims were brought in Delaware state court as well as federal court. The Delaware case was premised on breach of contract allegations regarding call rights set forth in the governing limited partnership agreement, while the second suit alleged violations of the Securities Exchange Act of 1934.

In this first case, the D&O insurers sought to apply an increased retention applicable under the "Mergers & Acquisitions Endorsement". However, the court rejected the insurers' interpretation of the endorsement, finding the transaction fell outside the categories of transactions covered by the endorsement. As such, a $1 million retention applied, as opposed to the $2.5 million retention under the M&A endorsement. Without quoting the full endorsement here, the decision rests on the fact that it referenced other policy language which only described two types of transactions, neither of which had taken place.

The second case involved what is typically referred to as a "Bump-up Exclusion" in D&O policies. Following the merger of two publicly traded companies, stockholders filed numerous cases challenging the fairness of the deal. While accepting coverage for defense costs in the underlying cases, the D&O insurers denied coverage for any settlement or judgment, relying on the bump-up exclusion.

Ultimately, the underlying cases were all resolved for a total of $90 million. The policyholders then brought this case, arguing the settlement should *not* be excluded from coverage. As with the case discussed immediately above, the decision turned on the precise words contained within the D&O policy. The exclusion specified that for an acquisition, coverage is limited to defense costs only.

However, under Delaware's well-developed body of corporate law, the court found the 'reverse triangle merger' effectuated here was not an acquisition as described in the exclusionary language. "Under these circumstances, the Merger was hardly comparable to the straightforward takeover of one company by another suggested by the Bump-Up Exclusion and therefore is reasonably viewed as something other than 'the acquisition' referenced in the Bump-Up Exclusion.

There are several takeaways here. First, it is always best to minimize exclusionary language in a D&O policy, in order to avoid post-claim disputes. Second, even when insurers craft exclusions in the broadest terms possible, the specifics dictate their applicability. Lastly, it highlights the benefits of being incorporated in a state such as Delaware that has a robust body of corporate and case law from which judges can seek guidance. *CVR Refining, LP v. XL Specialty Insurance Co., et. al.*, 2021 WL 5492671, (Del. Super. November 23, 2021); *Towers Watson & Co. v. National Union Fire Insurance Co., et. al.,* 2021 WL 4555188 (E.D. Va October 5, 2021).

## *Cases of Interest*

### Coverage for False Claims Act Case Capped at Sub-limit

A federal district court in Georgia tasked with determining the extent of coverage under a D&O policy for multiple *qui tam* suits found in favor of the insurers, thereby limiting coverage to one million dollars for defense costs, rather than the full $25 million D&O program limit.

During the policy period in question, three False Claims Act ("FCA") lawsuits were filed against the insured. Only after the U.S. moved to intervene in the case was notice provided to the insurers. Relying on an endorsement labeled "Government Funding – Defense Costs Coverage", the insurance companies agreed to provide a defense up to one million dollars while otherwise denying coverage. The insured brought this case to challenge the coverage position.

Although there were several findings by the court in this case, two against the insured were most noteworthy. First, the court found the endorsement to be unambiguous and applicable in matters where the government sought the return of funds. Moreover, treble damages and penalties all arose out of the government's effort to recoup wrongfully paid funds, rendering the entire FCA suit subject to the sub-limit. The court also found the insured failed to obtain written consent for its proposed staffing of the defense (that included six separate law firms). Implicit oral consent was found insufficient given the policy language requiring *written* consent.

In contrast to the above, the court ruled against the insurance companies on a couple issues. First, it rejected the position that the insurers had been prevented from associating in the defense of the case prior to the date notice was provided. Given that the complaint had been filed under seal, the court found this position meritless and concluded a "Claim" was not made until the pleadings were served on the defendants. In addition, the court rejected the primary insurer's attempt to seek rescission of the policy in full. Having been in possession of information of that sort for years, the court found the delay unreasonable. It found any causes of action for fraudulent inducement or misrepresentation should have been brought long ago.

In conclusion, this case stands as a reminder that an insured who fails to obtain insurer consent regarding staffing of its defense runs the risk of being forced to justify each and every bill later on. It is also a reminder for insureds to be aware of coverage limitations contained in endorsements. A good broker will always explain the intent behind such provisions and the implications thereof. *SavaSeniorCare, LLC v. Starr Indemnity & Liability Co., et. al.*, 2021 WL 4429088, (N.D. Ga September 27, 2021).

## *Cases of Interest*

### Settlement Labeled "Disgorgement" Not Excluded from Coverage as a Penalty

In a long running coverage dispute regarding whether a $140 million settlement payment was afforded coverage under the insured's D&O tower, the New York Court of Appeals reversed the intermediary appellate court to find in favor of coverage.

In 2003, the SEC began investigating Bear Stearns for late trading and deceptive market timing practices. Eventually, a settlement was reached whereby the insureds did not admit or deny the allegations and agreed to pay $160 million in disgorgement as well as a $90 million civil penalty.

With the D&O insurers having disclaimed coverage, and the amounts in dispute being material, litigation was brought by the insured in an attempt to secure coverage. (Note: Bear Stearns, which was purchased by J.P. Morgan in 2008, sought insurance coverage for $140 million of the disgorgement, excluding $20 million of revenue it had generated from the improper trading).

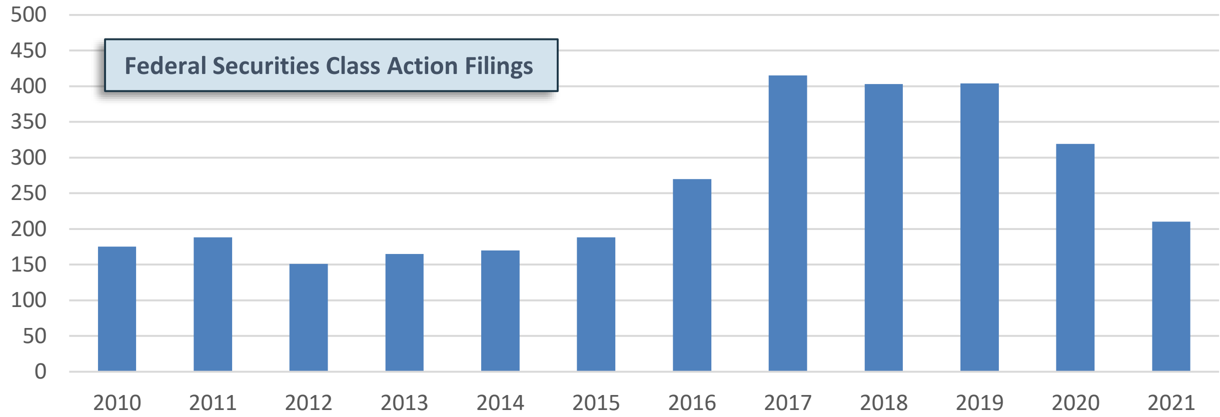
The trial court denied the insurers attempts at having the matter dismissed; however, the intermediate appellate court reversed. Relying on an opinion issued by the U.S. Supreme Court in the interim, the New York Court of Appeals reversed again, holding the portion of the settlement labeled disgorgement ($160 million) did *not* constitute a "penalty" within the meaning of the D&O policies and was therefore covered loss.

The Court of Appeals reasoned that a penalty is distinct from a *compensatory* remedy because penalties are punitive and not measured by losses from wrongdoing. Evidence submitted by the insured showed the disgorgement payment was tied to profits realized by its customers, not the bank itself. "Inasmuch as it was derived from estimates of the ill-gotten gains and harm flowing from the improper trading practices, and was intended – at least in part – to compensate those injured by the wrongdoing allegedly facilitated by Bear Stearns, the disgorgement payment could not fairly have been understood as a "penalty" in the context of this wrongful act professional liability insurance policy." *J.P. Morgan Securities, Inc. v. Vigilant Insurance Co.*, 2021 WL 5492781, (N.Y. November 23, 2021).

## D&O Filings, Pricing and Other Developments

### D&O Filings

- As we previously reported, 2020 D&O claim filings resulted in the first measurable year-over-year decrease in eight years.
- In 2021, filings continued their downward trend, with 210 total Federal Securities Class Action Claims.
- The 2021 total represents a 36% year-over-year decrease. This is still above the historical average of 173, but the gap is closing.




### D&O Pricing and Other Developments

- With D&O litigation continuing its downward trend, dismissal rates remaining elevated, and new capacity entering the marketplace, D&O pricing adjustments for recent renewals have consistently been more favorable than year ago levels.
  - Average D&O price increases are well below 2021 levels, with an increasing number of recent renewals seeing either single-digit premium increases or, in limited circumstances, premium *decreases*.
  - Companies considering an IPO or de-SPAC transaction can continue to expect elevated pricing and retentions, but both of these are also generally more favorable than 2021 levels.
  - D&O pricing is also still dependent on a company's specific situation, so messaging the risk profile in the right way to D&O underwriters remains important.
- SEC enforcement activity against public companies declined for the second year in a row in 2021, with 53 new actions.
- On the IPO front, 2021 was another strong year, with 394 companies raising a total of over $160 billion (excluding SPACs).
- Shortly after year end, Delaware passed legislation that allows the use of captive insurance companies for D&O insurance. Although this is a recent development that many are still working through, it does appear to create an alternative path forward for some companies, particularly those in challenging industries. We are following this development closely and actively working with our clients to secure the most efficient form of risk transfer available, whether via captive or otherwise.

*Sources: Cornerstone Research; Stanford Law School; IMA proprietary database*

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IMA Executive Risk Solutions is our world-class team of 20+ professionals focused on providing thoughtful advice, a unique legal perspective, a broad range of executive risk insurance solutions, and excellent service to our valued clients. Our professionals have deep experience handling complex executive risk exposures for a variety of clients – from pre-IPO start-ups to multi-billion dollar corporations.

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