

CORPORATE FRAUD:
The Intersection of Civil Suits and
Criminal Prosecutions

Friday, November 12, 2004
HealthSouth Conference Center
Birmingham, AL

DIRECTORS & OFFICERS' INSURANCE COVERAGE
(Afternoon Panel Discussion)

David Donaldson
DONALDSON & GUIN, LLC
2 North 20th Street, Suite 1100
Birmingham, AL 35203
www.DonaldsonGuin.com

I. Why D&O Insurance?

A. Indemnification may be inadequate.

1. Delaware does not authorize indemnification for derivative claims or suits brought by the corporation. D&O policies may provide coverage subject to various "conduct" exclusions.
2. Indemnification for 10b-5 claims may be precluded by public policy. See 17 C.F.R. §§ 229.510 and 229.512(I); *Globus v. Law Research Service, Inc.*, 418 F.2d 1276 (2nd Cir. 1969), cert. denied, 397 U.S. 913 (1970); *Baker, Watts & Co. v. Miles & Stockbridge*, 876 F.2d 1101 (4th Cir. 1989); *First Golden Bancorporation v. Weiszman*, 942 F.2d 726 (10th Cir. 1991). D&O insurance policies typically provide coverage for certain securities and other federal law claims, subject to various "conduct" exclusions.
3. Delaware requires Ds and Os seeking indemnification to have acted in good faith and in the reasonable belief that his/her actions were in the best interests of the corporation. D&O insurance may provide protection for acts which do not satisfy the "good faith" and "reasonable belief" standards, so long as the insurance coverage does not otherwise violate public policy.
4. Indemnification rights may change if there is a change in the applicable law or the corporation's articles of incorporation.

B. The issuer may become insolvent. Note: If the Issuer files bankruptcy and is an owner of the policy (if it is an insured), the Trustee may claim that the policy is an asset of the estate.

II. Can the insurer avoid coverage by alleging fraud?

A. D & O applications typically require copy of issuer's financial statement. If the insurance company can prove actual reliance on materially false and misleading financials in the procurement of coverage, the policy may be void *ab initio*. See Ala. Code § 27-14-7; *State Farm v. Oliver*, 658 F. Supp. 1546 (N.D. Ala. 1546) (aff'd 854 F.2d 416); *Alfa v. Oglesby*, 711 So. 2d 938 (Ala. 1998).

B. There is an inherent dilemma regarding D&O coverage for securities fraud. Ds & Os are entitled to coverage for claims based on inaccurate financials. If inaccurate financials alone are sufficient to void policy, D&O coverage for securities claims would be illusory. D&O policies may contain a "severability" provision intended to preserve coverage for "innocent" insureds even if coverage is voided due to misrepresentation of material information by other insureds. See *In re HealthSouth Corp.*, 308 F. Supp.2d 1253 (N.D. Ala. 2004).

IV. Coverage Issues.

A. Who is covered?

1. If the policy covers both the issuer and the Ds & Os, there is a risk that the company could deplete the policy limits, leaving insufficient protection for the Ds & Os..

2. Where D&O insurance provides coverage for Ds & Os and for company only to the extent that it indemnifies Ds & Os, there is no coverage for company for claims against company arising from conduct of Ds & Os.

Farmers & Merchants Bank v. Home Ins. Co., 514 So.2d 825 (Ala. 1987).

B. What types of claims are covered?

1. *Level 3 Communications, Inc. v. Federal Insurance Co.*, 272 F.3d 908 (7th Cir. 2001). Company A acquired Company B. Shareholders of B alleged that defendants made misrepresentations causing Plaintiffs' shares to sold at an artificially low price. Coverage denied in suit to recover the true monetary value of the Plaintiffs' shares. "[A] 'loss' within the meaning of an insurance contract does not include the restoration of an ill-gotten gain . . ." *Id.* at 910-911.
2. *Conseco, Inc. v. National Union Fire Ins. Co. of Pittsburgh, PA*, 2002 WL 31961447 (Marion County, Indiana 2002). Claims for violations of Sections 11 and 15 of the 1933 Act for misrepresentations in connection with IPO. Held, no coverage because claims constituted restitution to plaintiffs of the inflated sale price of the securities sold by issuers in the public offering.