wiley

NEWSLETTER

Court Holds Settlement Amounts for Section 11 Claims are Not “Loss”

April 2007

The United States District Court for the Middle District of Florida has held that amounts paid into a settlement fund for a shareholder class action lawsuit alleging violations of Section 11 of the Securities Act of 1933 do not constitute covered "Loss" under a D&O policy. *CNL Hotel & Resorts, Inc. v. Houston Casualty Co.* 2007 WL 788361 (March 14, 2007, M.D. Fla.). The court applied New York law to reach its result; however, the court suggested that Florida law would support the same result.

A number of insurers issued primary and excess D&O policies to the policyholder company. The primary policy defined "Loss" as sums which insureds "are legally liable to pay solely as a result of any Claim insured by this Policy, including Claims Expenses, compensatory damages, settlement amounts and legal fees and costs awarded pursuant to judgments, but excluding fines, penalties, taxes, any amount allocated to uncovered loss pursuant to Section VII of this Policy, or matters uninsurable pursuant to any applicable law."

The coverage litigation arose after the company paid $35 million and sought to recover the settlement amounts from its D&O carriers. Relying on *Vigilant Insurance Co. v. Bear Stearns Companies, Inc.*, 814 N.Y.S.2d 566 (table), 2006 WL 118368 (N.Y. Sup. Ct. Jan. 11, 2006), the court first noted that, under New York law, it is "well-settled that a party may not insure itself against the risk of having to return money that it has obtained improperly." It also explained that New York law "is in accord with decisions from numerous other jurisdictions, " including the decision of the Seventh Circuit in *Level 3 Communications, Inc. v. Federal Insurance Co.*, 272 F.3d 908 (7th Cir. 2001). The court quoted extensively from the decision in Level 3, including its holding that "a 'loss' within the meaning of an insurance policy does not include the restoration of an ill-gotten gain."

The company attempted to distinguish *Level 3* on the grounds that, in that case, the Seventh Circuit was applying Section 10(b) of the Securities Exchange Act of 1934 and was considering allegations of fraud not at issue here. The court rejected that argument as "differences without distinction," reasoning that "the important factor in determining 'loss' is the restitutionary character of the payment at issue, not the malfeasance (or lack thereof) on the part of the entity making it." For the same reason, the court rejected the company's effort to distinguish the other cases based on the fact that the definition of "Securities Claim" in the policy at issue specifically referenced the Securities Act of 1933. The court explained that "[r]egardless of the statute under which the original claim is being asserted, and regardless of whether the policy references that statute, if the insured is simply being forced to return money to which it is not entitled, the event is not loss" and "it is simply not reasonable for an insured to assume otherwise."

The company also argued that the holding would be unfair to individual defendants who might face liability even though they did not receive the benefit of the overpriced securities. The court explained that no such individual was seeking coverage in this case, but that, in such a circumstance, the amount could be insurable.

Accordingly, the court held that the company's $35 million settlement payment did not constitute loss under the policies and that the insurers were not liable to reimburse any portion of the settlement.