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NEWSLETTER

North Carolina Court Holds Section 11 Damages Against Underwriter Constitute Insurable "Loss"

February 2008

A North Carolina Superior Court has held that amounts an underwriter paid to settle claims for alleged violations of Section 11 of the Securities Act of 1933 constitute loss insurable under a professional liability policy. *Bank of Am. Corp. v. SR Int'l Bus. Ins. Co.*, 2007 WL 4480057 (N.C. Super. Dec. 19, 2007).

In 2000 and 2001, the insured bank served as an underwriter of bond offerings for WorldCom, Inc. The bank subsequently was named as a defendant in securities litigation arising out of the collapse of WorldCom. The plaintiffs alleged that the bank had violated Section 11 of the Securities Act of 1933 by negligently making or allowing false statements to be made in the registration statements for the bond offerings. The bank eventually paid $460.5 million to settle the litigation.

One of the bank's excess professional liability insurers denied coverage for the settlement on various grounds, including: (1) the settlement did not constitute insurable "loss" under the policy; (2) the bank's breach of its warranty statement in the policy precluded coverage; and (3) the insurer was entitled to rescind the policy based on the bank's material misrepresentations. The bank instituted coverage litigation in North Carolina.

The court first held that the bank's settlement constituted "loss" under the policy, rejecting the insurer's argument that Section 11 damages are uninsurable as a matter of law. The court held that no North Carolina precedent established that Section 11 damages were uninsurable as a matter of law. The court explained that it was "unlikely that the appellate courts of this State would relieve an insurer of liability for claims arising out of coverage that the insurer actively sought to write based on an argument by the insurer that it was bad public policy for the insurer to write that coverage." The court distinguished the cases on which the insurer relied, *Level 3 Communications, Inc. v. Federal Insurance Co., 272 F.3d 908 (7th Cir. 2001)*, and *CNL Hotels & Resorts, Inc. v. Houston Casualty Co.*, 505 F. Supp. 2d 1317 (M.D. Fla. 2007), because the Section 11 damages in those cases could be characterized as disgorgement of ill-gotten gains. In contrast, the bank here was merely an underwriter, not the issuer, of the bonds and did not receive any proceeds from the offerings. The court rejected the insurer's argument that the bank had agreed to underwrite the bond offerings so that the issuer could use the proceeds of the offerings to repay certain loans the bank had made. The court found a

lack of evidence on this point and held that, in any event, such repayment would not constitute ill-gotten gains by the bank if the loans were legitimate.

The court next addressed the insurer's contention that the bank had breached a warranty statement in the policy. The warranty statement provided that "no person proposed for coverage is aware of any fact or circumstance or any actual or alleged act, error, or omission which he or she has reason to suppose might give rise to a future claim that would fall within the scope of the proposed coverage." The court held that the warranty statement posed a subjective inquiry: the "warranty request seems clearly designed on its face to require someone at the highest levels of the Bank to assure that there were no hidden claims of which the Bank was aware and that the person signing the statement did not believe that any circumstances existed which would give rise to such a claim." The court found that the bank's CFO, who had been deposed, did not have subjective knowledge of facts and circumstances that he believed would give rise to a claim in excess of $250 million. The court also found that the insurer had failed to adduce evidence that any potential insured had knowledge of potential liability in excess of $250 million arising from the bank's WorldCom underwritings.

The court denied the bank's motion for summary judgment on the insurer's claim of rescission. According to the court, issues of material fact existed as to whether the bank and its broker had made material misrepresentations or omissions in the underwriting process.

The court also denied the bank's motion for summary judgment that the insurer had acted in bad faith. In the court's view, the underlying lawsuit involved complex and novel theories of liability, and, therefore, the bank's entitlement to coverage had remained uncertain for a long time. The court also held that the insurer's position on Section 11 damages, while incorrect, was not "strained or fanciful" so as to merit a finding of bad faith.