

Eighth Circuit Holds that Securities Exclusion Unambiguously Precludes Coverage

November 2008

The United States Court of Appeals for the Eighth Circuit, applying Minnesota law, has held that the securities exclusion in a directors and officers liability policy issued to a securities brokerage firm unambiguously precluded coverage in connection with underlying actions alleging that the firm committed numerous wrongful acts in the course of placing \$140 million in bonds that defaulted. *In re SRC Holding Corp.*, 2008 WL 4693247 (8th Cir. Oct. 27, 2008). Wiley Rein LLP represented the insurer in the case.

The insurer issued a directors and officers liability policy to a securities underwriter and brokerage firm. By endorsement, the policy precluded coverage for:

[A]ny Claim based on, arising out of, directly or indirectly resulting from, in consequence of, or in any way involving any actual or alleged violation of:

- The Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, any other federal law, rule or regulation with respect to the regulation of securities, any rules or regulations of the United States Securities and Exchange Commission, or any amendment of such laws, rules or regulations; or
- Any state securities or "Blue Sky" laws or rules or regulations or any amendment of such laws, rules or regulations; or
- Any provision of the common law imposing liability in connection with the offer, sale or purchase of securities.

The policyholder did not purchase concurrent errors and omissions coverage.

The policyholder underwrote \$140 million worth of municipal bonds for long-term care facilities for Alzheimer's patients. The bonds eventually defaulted, and the policyholder and its directors and officers were the targets

of lawsuits and arbitration proceedings. The firm sought coverage under the policy for its liabilities and those of its directors and officers. The insurer denied coverage based on the securities exclusion. After defending itself and its directors and officers, the policyholder filed for bankruptcy. Subsequently, the trustee of the firm's bankruptcy estate filed an adversary proceeding in the United States Bankruptcy Court for the District of Minnesota, seeking coverage under the policy. Two separate groups of former directors and officers of the policyholder firm intervened in the action to seek the same relief sought by the bankruptcy trustee.

On cross-motions for summary judgment, the bankruptcy court held that the securities exclusion was unambiguous, but applied to preclude coverage only for alleged wrongful acts in connection with the sale of the policyholder firm's own securities. The court's conclusion was based largely on the testimony of the broker who placed the policy, the court's conclusion that a broad reading of the securities exclusion would render coverage illusory, and the court's determination that the policyholder reasonably expected to receive the coverage sought. The bankruptcy court's ruling applied equally to the bankruptcy trustee and the intervenor directors and officers. The insurer appealed to the district court, which affirmed the bankruptcy court's ruling.

On appeal, the United States Court of Appeals for the Eighth Circuit reversed the rulings of the bankruptcy and district courts, holding that the securities exclusion was "broad and unqualified" and precluded coverage for the underlying lawsuits and arbitrations against the policyholder. In so holding, the court stated that the lower courts' finding that the securities exclusion was unambiguous precluded any reliance on the broker's testimony as to the "purpose" of the exclusion and further noted that "the effect of [the securities exclusion] as it may be generally applied in practice is not the legal authority that governs our coverage inquiry here; it is the mutually agreed-upon policy's plain language that binds [the parties] in the first instance." Overall, the court concluded that "[a]bsent an irreconcilable conflict with an independent portion of the contract, [the securities exclusion] is not limited to claims arising out of [the policyholder's] sale of its own securities" because "[s]uch a limitation is nowhere to be found in its language."

The court further rejected the trustee's and intervenors' arguments that a broad reading of the securities exclusion rendered the policy ambiguous because such a reading would conflict with other endorsements in the policy, particularly the General E&O Exclusion (with Management Carveback). The E&O exclusion precluded coverage for claims involving the policyholder's provision of Investment Banking Services, Security Broker/Dealer Services, or Securities Underwriting. The Management Carveback, however, provided that the exclusion "is not intended, however, nor shall it be construed, to apply to Loss, including Defense Expenses, in connection with any Claim against an Insured to the extent that such Claim is for a Wrongful Act by Insured Person in connection with the management or supervision of any division, Subsidiary or group of the Parent Corporation offering any of the aforementioned services." In rejecting the trustee's and intervenors' arguments regarding the Management Carveback, the court concluded that the E&O exclusion was not superfluous because it precluded claims, such as certain antitrust suits not involving securities violations, that were not otherwise barred by the securities exclusion. The court further held that the Management Carveback was not rendered superfluous by a broad reading of the securities exclusion because claims such as shareholder derivative suits or for tortious interference with contract that would not be barred by the securities exclusion

were saved from applicability of the E&O exclusion by virtue of the carveback. The court also specifically noted that preclusive overlap between the securities exclusion and the E&O exclusion was "not sufficient to disregard the broad and unqualified language of" the securities exclusion because "[n]othing prevents the parties from using a 'belt and suspenders' approach in drafting the exclusions, in order to be 'doubly sure.'"

With regard to the illusory coverage and reasonable expectations doctrines, the court held that the lower courts' reliance on both doctrines was misplaced. The court held that "[t]he illusory-coverage doctrine just does not apply here" because no part of the premium for the policy was specifically allocated to purchase particular categories of coverage, and "coverage under the policy is not a delusion" because other claims, such as employment practices claims and shareholder derivative suits, were covered by the policy. The court similarly held that the lower courts' reliance on the reasonable expectations doctrine was erroneous "because the contract language is unambiguous."

Finally, the court rejected the trustee's and intervenors' argument that the insurer was obligated to defend the underlying actions because the securities exclusion did not apply to preclude coverage for violation of the rules of the National Association of Securities Dealers. The court noted that "what the policy insures against is wrongful acts—not violations," such that the securities exclusion is not limited "to particular theories of legal recovery" and reasoned that the related claims language in the policy bolstered this result by making it clear "that if the same set of operative facts underlies both federal-and state-securities law violations and the alleged violations of unenumerated legal authority, such as NASD rules, the broad, plain language of [the securities exclusion] excludes coverage for all of those violations." The court further held that the facts underlying the alleged NASD violations were "well within the 'arising out of' exclusionary language of [the securities exclusion] and the expansive Related Claims provisions of the policy."