

Financial Irregularity Claims: Are You Covered?

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A number of companies have had to restate earnings over the last year or are faced with the prospect of doing so in the coming months. Earnings restatements, in turn, can lead to shareholder derivative suits, as executives at some companies – Enron, Waste Management and Rite Aid, for example – are all too aware. According to a recent report, U.S. companies have already paid more than \$1 billion to settle shareholder suits this year alone. And, shareholder derivative suits are on the rise.

Directors and Officers (“D&O”) liability and other types of insurance policies can play a critical role in the defense and settlement of stockholder suits. But, as recently made clear in the Enron proceedings, insurers increasingly are trying to use every available defense to avoid paying restatement and other types of D&O claims. It is critical that companies and high-level executives understand the coverage afforded by their D&O policies and how to counter insurers’ arguments that claims are not covered. After a brief description of the nature of D&O coverage, this article highlights key D&O battleground issues your company might face if, hit with a stockholder suit, its directors and officers seek coverage under a D&O policy. This article also identifies other types of insurance policies your company likely has that may also provide coverage for claims arising from alleged securities laws violations or accounting irregularities.

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D&O POLICIES

A. D&O Coverage Generally

D&O policies provide coverage both for indemnity and defense costs for directors and officers (and sometimes other employees) alleged to have breached certain duties and obligations in the performance of their work for the company. D&O policies usually provide that the insurer will reimburse the corporation for the costs expended by the corporation to defend and indemnify its directors and officers or, if the corporation cannot or will not indemnify the directors and officers, the insurer may cover such individuals directly. Sometimes, the D&O policy also provides “entity” coverage, or coverage for the company itself for certain types of

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coverage, or coverage for the company itself for certain types of claims.

D&O policies explicitly provide defense costs, and the D&O carrier typically must "advance" defense costs for claims while the underlying litigation is ongoing. D&O policies are usually "claims-made" policies, meaning often that the policy in effect when the suit or claim is brought against the policyholder is the one that must respond.

D&O policies provide coverage for "Wrongful Acts," often defined to include "any breach of duty, neglect, error, misstatement, misleading statement, omission or act" by the directors and officers in their capacity as such. Among the types of claims covered by most D&O policies are shareholder suits based on alleged securities fraud and Securities and Exchange Commission ("SEC") investigations.

Some D&O policies even cover alleged intentional wrongdoing, particularly where there is no proven dishonesty or criminal conduct. This could be crucial in a restatement or securities fraud claim, where the alleged wrongful conduct of directors and officers may extend beyond negligence or carelessness to encompass alleged intentional wrongs. Of course, the definition of "Wrongful Acts" must be read in conjunction with the policy exclusions and conditions before the true scope of coverage under any given D&O policy can be determined.

B. Key D&O Battleground Issues

- Misrepresentation In The Application Process Defense**
In an effort to avoid providing coverage for restatement claims, insurers are sharpening an old tool - the misrepresentation defense. Insurers may argue that because of alleged misrepresentations in the application process (the submission of incorrect financial statements, for example), the entire D&O contract should be rescinded. Policyholders must be very wary of the misrepresentation defense because, if successful, it can result in the policy being declared null and void and the directors and officers left without coverage not just for the claim at issue but any other claims the policy might have covered.

The law of misrepresentation varies from state to state. In many states, the showing an insurer must make to void an insurance policy based upon misrepresentation is codified. In any event, an insurer can successfully void a policy based upon a misrepresentation (or omission) only if the misrepresentation is "material." To be material, the alleged misrepresentation must have affected the insurance company's: 1) decision to underwrite or not underwrite the risk; 2) estimation of the degree or character of the risk; or

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3) determination of premium for the policy. In some states, the insurer can obtain rescission only if, in addition to materiality, the insurer can prove that the policyholder intentionally sought to mislead the carrier.

In some cases, courts have held that incorrect financial statements submitted with a D&O application constitute a material misrepresentation, particularly where the company understood that the financial statements provided to the insurer did not portray the company's true financial health. Still, the insurer bears the burden of proving that there has been a misrepresentation and that it is material - both complex questions of fact that often must be resolved by a jury. Accordingly, the insurer may have great difficulty proving that it would not have written the D&O coverage or would have charged a different premium had the insurer known that the policyholder's earnings were not quite the same as represented.

2. Severability

To the extent there has been a misrepresentation in the application process that could void the policy, the question becomes whether the policy is void as to all directors and officers or only those actually responsible for the alleged misrepresentation. Some D&O policies contain what is known as a severability clause. In cases where the D&O policy contains a severability clause, certain directors and officers who are not responsible for the alleged misrepresentation should be entitled to coverage even if the policy is void as to others.

3. The Dishonesty Exclusion

Insurers may also attempt to invoke the "dishonesty" exclusion to deny claims based upon the restatement of earnings. One type of "dishonesty" exclusion precludes coverage "if a judgment or other final adjudication . . . establishes that acts of active and deliberate dishonesty were committed." Courts that have interpreted this exclusion usually have required willfully or intentionally dishonest, fraudulent or criminal conduct to defeat coverage. Further, and critically important, insurers usually cannot take advantage of this type of dishonesty exclusion to bar coverage unless there has been a final adjudication or judgment against the insured officers and directors that establishes that they acted with dishonest purpose. If the underlying action is settled prior to final adjudication, it can be very difficult, if not impossible, for an insurer to prevail using this exclusion.

4. Allocation of Defense and Settlement Costs Between Covered and Uncovered Parties

Shareholder suits can be brought against the company itself as well as its directors and officers. Unless the D&O policy provides "entity" coverage (coverage for the company itself), the D&O insurer will attempt to allocate costs between the covered directors and officers and the uncovered company. This could result in the D&O insurer paying significantly less than it otherwise should, with the directors and officers or company responsible for the remainder. Defense costs, however, should be covered as long as they are "reasonably related" to a covered claim, even if also useful in the defense of an uncovered claim. With respect to settlements or judgments, some courts have adopted the "larger settlement rule." Under this rule, allocation is appropriate only where there is company liability that is independent of and not duplicated by the alleged liability of the covered directors and officers or the settlement is more costly because of the corporation's liability. Allocation can be a very complex and hotly disputed issue.

OTHER INSURANCE POLICIES THAT MAY PROVIDE COVERAGE FOR CLAIMS BASED ON ALLEGED FINANCIAL IRREGULARITIES

In addition to D&O policies, other types of insurance policies your company likely has could provide coverage for lawsuits arising out of alleged accounting misdeeds. Fiduciary Liability Insurance ("FLI"), for example, provides coverage for losses arising out of alleged breaches of fiduciary duty with respect to employee benefit plans. Employee Benefits Liability Insurance ("EBLI") is closely related to FLI insurance, and is sometimes encompassed within an FLI policy or attached as an endorsement to a company's comprehensive general liability ("CGL") policy. EBLI policies provide coverage for employees alleged to have made errors while performing non-discretionary tasks in the administration of an employee benefits plan, i.e., providing incorrect information to employees concerning employee benefits.

Depending upon the circumstances, fidelity and ERISA bonds as well as dishonesty or crime insurance could provide coverage for alleged financial-related wrongs. Accounting and law firms should turn to their errors and omissions ("E&O") policies when faced with claims that their professional services contributed to alleged accounting irregularities or financial misdeeds. Finally, although insurers often argue that comprehensive liability policies provide no coverage for purely economic losses, CGL policies could also be triggered by certain types of claims (i.e. infliction of emotional distress) arising from alleged accounting irregularities.

KNOW YOUR RIGHTS

Before litigation hits, your company and its directors and officers should understand the extent of the coverage potentially afforded by its D&O and other potentially applicable insurance policies. Further, most policies require prompt notice of claims and sometimes even potential claims, and companies should take care to comply with the policy's notice provisions. Late notice is one of the insurers' common defenses, and one that easily can be forestalled by alert policyholders. Finally, policyholders should not simply take "no" for an answer. Insurers often deny claims, only to pay after the policyholder disputes the insurer's coverage position. Experienced coverage counsel can assist policyholders in maximizing the value of their D&O policies and other insurance assets when faced with litigation over the restatement of earnings or other claims.