

# THE RESOLUTION OF THE CONSECO SECURITIES AND COVERAGE LITIGATION:

## *What Really Happened, How it Happened and What it Means Going Forward*

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On March 31, 2000, financial giant Conseco, Inc. announced that it would take an after-tax charge of roughly \$350 million in order to write down the value of certain interest-only securities. The write-down wiped out approximately forty percent (40%) of Conseco's income for 1999 and caused the company to shed some \$2.1 billion in market cap. Not surprisingly, the announcement was greeted with immediate and numerous securities class action and derivative lawsuits against Conseco and fifteen (15) of its directors and officers who, in turn, tendered those suits for coverage under the company's \$100 million D&O program.

After the D&O carriers denied coverage for the consolidated securities litigation<sup>1</sup> on various grounds—including the primary policy's prior

and pending litigation exclusion—Conseco filed a coverage and bad faith lawsuit in June, 2001.<sup>2</sup> In January, 2002, with the Coverage Litigation pending, and unbeknownst to the carriers, Conseco settled the Securities Litigation for \$120 million—the fourteenth-largest such settlement in the post-Reform Act era<sup>3</sup>—with that amount split between so-called Section 11 damages (roughly \$82 million) and Section 10 damages (roughly \$38 million).<sup>4</sup> The settlement expressly called for the insurers to fund \$100 million (the amount of the D&O program's limits) and Conseco demanded that they do so or face an additional bad faith claim.

Although the primary insurer and the second and fourth excess insurers agreed to pay their limits in full and without condition, the remaining carriers—to their ultimate benefit—opted to take different, more creative, routes. The top layer excess carrier successfully moved to dismiss the Coverage Litigation on the basis that the portion of the settlement constituting defined "Loss" did not reach its attachment point.<sup>5</sup> The first excess carrier, meanwhile, leveraged its coverage defenses into a separate settlement that later allowed it to recoup \$5 million of its \$15 million limit.

In the end, two notable decisions of interest to insurers were handed down. First, on December 31, 2002, an Indiana state court ruled that the \$82 million in Section 11 damages did *not* constitute defined "Loss" under the D&O policies, and was therefore uninsurable. Then, on September 20, 2004, a federal court granted summary judgment to the first excess carrier on its claim to \$5 million of the settlement proceeds under its separate settlement of coverage issues with the insureds. This article examines the process and logic behind both decisions, and discusses their ramifications for insurers going forward.

### THE RESTITUTION RULING

Not long after learning of the \$120 million settlement, the top layer excess carrier filed its motion to dismiss the Coverage Litigation. One argument made in the motion was that the Section 11 damages did not constitute defined "Loss" under the subject policies, meaning that the carrier's \$75 million attachment point had not been reached.

In a December 31, 2002 opinion, the Indiana state court agreed with the carrier.<sup>6</sup> The court found it "axiomatic that insurance cannot be used to pay an insured for amounts an insured wrongfully acquires and is forced to return."<sup>7</sup> Using the Seventh Circuit's "particularly instructive" decision in **Level 3** as a template,<sup>8</sup> and examining the legislative history behind the 1933 Act, the court found that the \$84 million in Section 11 damages could not "be anything but restitutionary" and therefore not insurable.<sup>9</sup> The court explained that, from a pragmatic standpoint:

if someone represents the value of something and then you purchase it at that price, and later it is discovered the seller's representations were not the truth, the only damages you can obtain is [sic] the difference between the price at which the item was purchased and its true value—restitutionary damages for the ill-gotten gain of the seller.<sup>10</sup>

According to the court, classifying Section 11 damages as "compensatory" rather than "restitutionary" was a "purely semantical" argument that would not affect the outcome. The court found that, under a **Level 3** analysis, the proper focus is on the *type of damages awarded*, not on the underlying causes of action, making it applicable to cases other than those that simply assert Section 10 claims.<sup>11</sup>

Although this analysis would have been sufficient, the *Conseco* court went further, rejecting additional policy-based and equitable arguments advanced by the insureds and finding that:

- although the definition of "Claim" in the primary policy included matters arising out of "the purchase or sale, or offer or solicitation of an offer to purchase or sell, any securities," that provision must be read in conjunction with the policy's other terms and conditions—including the definition of "Loss"—and could not, by itself, support a finding of coverage;<sup>12</sup>

*continued on page 7*

*Conseco Resolution continued from page 6*

- unlike the situation where the application of an exclusion renders coverage illusory, the existence of “Loss” was a necessary condition to potential eligibility for coverage and did not render coverage illusory;<sup>13</sup>
- in purchasing the D&O policies, the Conseco defendants could have had no “reasonable expectation” of obtaining coverage “for monies they wrongfully took from investors and must now return;”<sup>14</sup>
- the presence of the individual insureds (who realized no gain when the subject securities were issued) as defendants did nothing to change the restitutionary nature of the settlement, especially since they had “absolutely no liability to pay” any portion of the settlement or the attorney fees and costs in defending the litigation;<sup>15</sup> and
- the insureds could not, on the record presented, support a claim that the carrier had fraudulently induced them to believe that there would be coverage for Section 11 violations.<sup>16</sup>

### **THE \$5 MILLION RECOUPMENT**

The other interesting result from the Securities Litigation settlement was the ability of the first excess carrier to recoup \$5 million of its \$15 million limit which came about after some intense negotiations. The carrier obtained two critical concessions in those April, 2002 negotiations before agreeing to pay its \$15 million limit toward settlement. **First**, it required that the Conseco defendants—both corporate and individual—release it from all potential bad faith and extra-contractual damages, depriving those parties (and, ultimately, the securities plaintiffs) of important leverage against the carrier. **Second**, sensing an imminent bankruptcy filing by Conseco, the first excess carrier insisted that the company maintain security for the payment’s return so that if the insurer prevailed in the Coverage Litigation, it would be able to recover at least some of its funds. In practical effect, this required Conseco to negotiate with the securities plaintiffs on the first excess carrier’s behalf, and ultimately led to the securities plaintiffs maintaining \$5 million in a separate escrow to secure any “payment obligations” the Conseco defendants might ultimately have to the insurer “whether by final judgment, settlement, dismissal or otherwise...”

As expected, Conseco did file for bankruptcy in December, 2002 and ultimately settled with the top layer excess carrier. Conseco’s earlier release of bad-faith claims precluded it from obtaining any further recovery from the first excess carrier, and with the earlier top layer excess carrier settlement in place, the only potential beneficiaries from a certain-to-be costly coverage battle were the securities plaintiffs. With no economic motivation to pursue the Coverage Litigation against the first excess carrier, Conseco instead opted to settle with the insurer. The key aspects of that settlement were Conseco’s: (1) admission of no coverage under the first excess policy for the Securities Litigation; and (2) consent to a \$15 million judgment against it in favor of the first excess carrier, which allowed the insurer to pursue recovery of the full \$5 million escrow *without* litigating the complex issues present in the Coverage Litigation.<sup>17</sup>

With the settlement and judgment in hand, the first excess carrier intervened in the Securities Litigation to obtain the \$5 million held in escrow. Over the securities plaintiffs’ opposition, the federal court granted the carrier’s motion for summary judgment, allowing it to recoup the full \$5 million.<sup>18</sup> In short, the federal court found that: (1) the judgment against Conseco in favor of the first excess carrier in the Coverage Litigation was a binding “payment obligation” on Conseco; (2) under the Securities Litigation settlement, the escrow account was specifically designed to cover such obligations; and (3) the first excess carrier was entitled to receive the full \$5 million.<sup>19</sup> In the end, the securities plaintiffs paid the first excess carrier the full \$5 million plus more than \$600,000 in pre- and post-judgment interest.<sup>20</sup>

### **LESSONS TO TAKE FROM THE CONSECO DECISIONS**

So what do these decisions mean for carriers? For one thing, the state court decision should mean that carriers will be in a much stronger position to challenge coverage for Section 11 or Section 12 damages or settlements that are explicitly found to be “rescissionary measure[s].”<sup>21</sup> The decision also implies that there should be no coverage for *any* claims for damages that are restitutionary in nature, regardless of their origin—whether statutory or common-law—or how they are framed by plaintiffs. This tool might be particularly useful in securities litigation, where demands for disgorgement by

“black hats” are becoming ever more common. It also is refreshing to see a court accept that not all defined “Claims” bring with them defined “Loss”, even when they are settled before issues of liability can be decided. From an underwriting perspective, the state court decision also validates traditional insurer views on the purpose behind and scope of D&O insurance, by making it at least somewhat more difficult for companies to claim a “reasonable expectation of coverage” for what are really corporate obligations. It should be interesting to see how future courts continue to define the balance between the “reasonable expectations” of insureds and the essential purpose of D&O policies.

What the state court decision should *not* be read to support, however, is the position that a demand for restitution-style damages automatically supports a total denial of coverage. The court noted that a securities class action suit containing a request for Section 11 damages might also implicate other elements—for instance, defense expenses—that were not *per se* uninsurable and therefore still “Loss” under a D&O policy.<sup>22</sup>

The federal court decision, meanwhile, might be viewed as more of an object lesson; namely, that favorable outcomes are possible for insurers willing to take some additional risks—principally the costs and uncertainties of litigation—rather than simply pay substantial sums and give up on any recoveries. A prime consideration in deciding whether to take those risks, of course, is to first ensure that the carrier has fully discharged its responsibilities to the insureds, thereby setting up a good record for future decision-making. It is also vital that all involved in the decision-making process remain committed to completing the execution of previously-made strategic decisions. Carriers with those critical pieces in place enjoy greater flexibility—and, by extension, can be more creative—in their negotiation strategies.

In sum, the *Conseco* decisions should be viewed as two more tools for insurers to use against both the continuing wave of securities litigation and the increasingly aggressive measures of defense counsel and insureds anxious to settle those cases.

*Endnotes for this article can be found on the PLUS web site where the article, including endnotes, can be viewed in full.*