

No D&O Coverage For Payment To Shareholder Class

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Directors' and officers' insurance policies are full of holes and do not provide coverage for many basic corporate exposures. The *Genzyme* case discussed below demonstrates the prevalence of the insurers' defense that many settlement payments do not constitute "loss" under the D&O policy but rather are restitutionary payments that are not covered.

Summary

On September 28, 2009, the United States District Court for the District of Massachusetts dismissed a lawsuit filed by Genzyme Corporation ("Genzyme") seeking insurance coverage from Federal Insurance Company (the "Insurer") under its D&O insurance policy (the "Policy") for a settlement of a shareholder class action. *See Genzyme Corp. v. Federal Ins. Co.*, 2009 WL 3101025, civ. Action no. 08cv10988-NG (D. Mass. Sept. 28, 2009). In determining that there was no insurance coverage for the settlement, the Court relied primarily upon the definition of "loss" in the Policy and a "Bump-Up exclusion" in the Policy, which relieved the insurer of liability for any "inadequate or excessive consideration in connection with [the] purchase of securities."

Background Of Underlying Claim

Genzyme is a biotechnology company. It had sold a series of "tracking stock" designed to track the performance of certain business divisions of the company. From December 2000 through June 2003, three series of Genzyme tracking stock were outstanding, specifically, the Biosurgery, Molecular Oncology and General Divisions. On May 8, 2003, Genzyme announced that it was going to exercise the optional exchange provisions in its Articles of Organization, which would effectively eliminate the corporation's tracking stocks by exchanging all outstanding Biosurgery Division and Molecular Oncology Division shares for common stock in the General Division. Shareholders holding stock in the Biosurgery and Molecular Oncology Divisions were compensated as part of this share exchange based upon the current market value of their stock as compared to the value of the common stock of the company.

A number of shareholder lawsuits were filed against Genzyme and its officers and directors as a result of this share exchange, and these shareholders were certified as a class on August 6, 2007. While the complaint contained

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seven counts, it primarily alleged that Genzyme and its officers and directors conspired to depress the market value of outstanding Biosurgery Division stock in order to exchange it for common stock at a rate that would result in a profit for the General Division shareholders – including Genzyme's top officers and directors – at the expense of Biosurgery Division shareholders. Genzyme agreed to settle the class claims by making a one-time payment of \$64 million.

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Insurance Coverage Dispute

Genzyme sued the Insurer for coverage under its D&O Policy. The Court determined that Genzyme did not have coverage for the settlement payment as a result of two key terms in the Policy – an exclusion from the definition of a covered "loss" for "matters uninsurable under the law" and a "Bump-Up" exclusion¹ which provided, in pertinent part, that:

[The Insurer] shall not be liable ... for that part of Loss... which is based upon, arising from, or in consequence of the actual or proposed payment by any Insured Organization of allegedly inadequate or

excessive consideration in connection with its purchase of securities issued by any Insured Organization.

As an initial matter, the Court determined that the settlement payment was uninsurable under Massachusetts law for reasons of public policy. The Insurer cited abundant case law supporting the notion that an insured does not incur an insurable "loss" when he is merely forced to disgorge money or other property to which he is not entitled (i.e., an "ill-gotten gain"). *See, e.g., Level 3 Communications, Inc. v. Federal Ins. Co.*, 272 F.3d 908 (7th Cir. 2001). Genzyme argued that the settlement payment was not restitutionary in nature since the company did not receive any benefit from the share exchange.

The Court sided with the Insurer, stating that while the company itself did not profit from the transaction, it did effectively benefit one class of shareholders at the expense of another class of shareholders, and the settlement was designed to redress this imbalance. The Court was concerned that requiring coverage under these circumstances would transform insurance policies into "profit centers" for companies, stating "[e]veryone would win, except for the insurance company forced to bear the loss of paying off the disgruntled shareholders." *See* decision at *8.

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The Court then turned to the Bump-Up exclusion in the Policy. Genzyme argued that the share exchange did not involve an actual "purchase" of securities since it was a share exchange and therefore the exclusion was inapplicable. The Court relied upon the dictionary definition of "purchase" which includes an exchange for something of equivalent value, and found that the share exchange was in fact a "purchase" as that term was used in the Policy. Accordingly, the Court held that the exclusion was an absolute bar to coverage under Insuring Clause 3 – coverage for securities claims brought against the entity.

Genzyme further argued that even if it was barred from recovering for securities claims brought against it as a result of the Bump-Up exclusion, it was still entitled to reimbursement for the money it paid to indemnify its directors

and officers, since the settlement was a global resolution of the claims in the underlying lawsuit. The Court disagreed, stating that no court has "split the baby" in this manner where coverage for claims against the entity were barred, since companies can only act through their directors and officers. Moreover, the Court was concerned that permitting this type of distinction with regard to a global settlement would permit companies to structure settlements in a manner to maximize coverage under the indemnification provisions of a D&O policy where the payment was in fact restitutionary in nature.

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Conclusion

This decision to deny coverage for settlement payments made to shareholders was largely driven by public policy concerns. The Court was very keenly attuned to the risk that providing coverage for these types of shareholder settlements would encourage fraud and chicanery by insured corporations. The decision also has far-reaching impact beyond D&O policies containing a Bump-Up exclusion since the Court relied upon the disgorgement/restitution exclusion as an independent basis for barring coverage. In doing that, the Court expanded that exclusion to include a stock redistribution or recalibration. This was a novel analysis of an exclusion found in nearly every D&O policy and may give insurers ammunition to go farther afield in their denials of coverage on the basis of this exclusion, in situations where, as in *Genzyme*, the company itself did not profit from the underlying transaction. Accordingly, insureds may need to argue that the judge's creative recalibration analysis is restricted to the specific and unusual circumstances of the *Genzyme* case and should not be broadly applied.

¹ According to the Insurer, this exclusion is apparently referred to in the insurance industry as a "bump-up" exclusion because it is used to describe litigation seeking to increase or "bump-up" the consideration paid for security.