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NEWSLETTER

Damages Award of Increased Merger Consideration Is Uninsurable

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In an unreported decision, a California federal district court has held that a settlement for additional merger compensation is restitutionary in nature and therefore uninsurable as a matter of law. *Pan Pacific Retail Properties, Inc. v. Gulf Ins. Co.*, Case No. 03-CV-679-WQH (S.D. Cal. July 14, 2004).

The case involved two professional liability policies issued to a purchaser and a seller, respectively, involved in a merger. One insurer issued a D&O policy to the purchaser. That policy defined "loss" as "compensatory damages, settlement amounts and legal fees and costs awarded pursuant to judgments, but excluding fines, penalties, taxes any amount allocated to uncovered loss...or matters uninsurable pursuant to any applicable law." The policy provided that "[w]ith respect to the insurability of punitive, exemplary, multiple or liquidated damages, the Insurer will not contend for any reason, unless appropriate to do so as a matter of law, regulation or public policy, that such damages are uninsurable; and the insurability of such damages shall be governed by the internal laws of any applicable jurisdiction which permits coverage of such damages."

A second insurer issued a D&O policy to the seller. That policy defined "loss" as "damages, judgments, settlements and Defense Cost." It also provided that "Loss does not include:...any amount not indemnified by the Insured Company for which the Director or Officer is absolved from payment by reason of any covenant, agreement or court order;...matters uninsurable under the law pursuant to which this Policy is construed."

As part of a merger, the two companies agreed to a stock exchange. Pursuant to the merger agreement, the purchaser was obligated to indemnify the seller for claims arising out of the merger. After the two companies circulated a joint proxy statement regarding the proposed stock exchange, the seller's shareholders filed suit against the directors and officers, alleging breach of fiduciary duty, negligent misrepresentation, fraud and unjust enrichment based on a purportedly inadequate share price. The companies tendered the complaint under their respective policies, and both insurers denied coverage. The insurers also refused to participate in settlement discussions. After the underlying action settled, both companies filed this coverage action alleging bad faith refusal to fund the settlement.

The court first held that, as a matter of law, "restoration of an 'ill-gotten' gain is not insurable." The court explained that, in the case of disgorgement, "to permit the wrongdoer to transfer the cost of disgorgement to an insurer would eliminate the incentive for obeying the law. Otherwise, the wrongdoer would retain the

proceeds of his illegal acts, merely shifting his loss to an insurer."

Evaluating the substance of the underlying settlement, the court held that the damages awarded as part of the settlement were in effect additional merger compensation and therefore restitutionary. The court rejected the insurer's argument that as a *per se* rule damages for breach of the duty to disclose reduce the value of the stock and therefore must be restitutionary in nature. Instead, the court considered whether the damages were restitutionary based on the particular facts of this case. The court noted that the settlement fund "was distributed on a per-share basis" and that the basis of the complaint filed in the underlying action was that the stock price was too low. The court therefore concluded that the settlement gave the plaintiffs "exactly what they sought—more money for their shares."

The court also held that the seller had suffered no loss and therefore, there was no coverage obligation under its policy. Pursuant to the merger agreement, the purchaser was obligated to indemnify the seller for claims arising out of the merger. In addition, only the purchaser paid the attorney's fees to defend the underlying class action. Accordingly, the court refused to grant the seller a windfall under the insurance policy.

The companies also alleged that the insurers breached their duty to advance defense costs. The court found no duty under the seller's policy because the seller did not pay any of the defense costs. The purchaser's policy required that the policyholder agree in writing to repay the insurer for "any advanced Defense Costs which are finally established not to be covered by the Policy." The court held that the purchaser was not obligated to advance defense costs because although the insurer had reiterated this requirement, the correspondence between the insurer and the policyholder did not "'confirm' a duty on the part of [the insurer] to advance or reimburse defense costs in the absence of security." The court also rejected the argument that, upon receipt of invoices, the insurers were required to reimburse the companies for defense costs. The court explained that both policies required an agreement on allocation before any payment of defense costs.

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