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IMPLICATIONS OF THE GENZYME DECISION: LOSS UNDER A D & O POLICY

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Recently, in *Genzyme Corp. v. Federal Insurance Co.*, 2010 WL 3991739 (1st Cir. 2010), the U.S. Court of Appeals for the 1st Circuit construed the definition of loss in a D & O policy and a so-called "bump-up" exclusion that precluded coverage for claims seeking an increase or "bump-up" in the consideration for the company's securities. The court applied these provisions to a settlement by Genzyme of a case alleging that a reorganization of Genzyme's equity ownership structure resulted in an inadequate price to owners of one of its classes of common stock. Although the decision reversed the lower court's ruling in favor of the insurer, the appellate decision demonstrates how D & O insurers may protect themselves from being forced to cover such corporate transactions in the future.

The Underlying Cases

Genzyme used three series of "tracking stock" designed to track the performance of particular business divisions rather than the company as a whole. Series were issued for the General Division, the Biosurgery Division, and the Molecular Oncology Division. In May 2003, Genzyme announced that it had decided to eliminate the tracking stocks and exchange a fractional share of the General Division stock for each tracking share of the other divisions.

Owners of the biosurgery tracking stock brought a securities class action against Genzyme and certain of its directors and officers. The complaint alleged that the defendants had schemed to depress the value of biosurgery's tracking stock so that it could be folded into the General Division at an exchange rate that would be favorable to General Division shareholders. In August 2007, Genzyme settled all of the class members' complaints against the company and its officers and directors for $64 million.

Genzyme sought coverage for the settlement amount. Its insurer, Federal, denied coverage on the grounds that: (1) the settlement was not an insurable loss under the policy, and (2) coverage was precluded by the bump-up exclusion. Genzyme sued for coverage, and Federal moved to dismiss.

The district court declined to analyze the issue based on the commonly understood meaning of the term "loss," focusing its analysis instead on considerations of public policy, which were carved out from the definition. The court noted that, "it is hard to see how Genzyme received any material benefit from the Share Exchange that could be disgorged by a restitutionary remedy." Thus, the court distinguished precedents holding that restitution or disgorgement do not constitute loss. Nevertheless, the court also observed that Genzyme, through the share exchange, conferred a benefit on existing General Division shareholders at the expense of Biosurgery Division shareholders. It then reasoned that, "Genzyme should not be able to divide the benefits of equity ownership among its shareholders one way, redistribute those benefits, and then demand indemnification from its insurer for the redivision." Accordingly, the court granted Federal's motion to dismiss, holding that, as a matter of public policy, the settlement amount was not an insurable loss.

The court also held that coverage was precluded by the relevant Federal policy's bump-up exclusion, which provided that Federal was not liable for "the actual or proposed payment by any Insured Organization of allegedly inadequate consideration in connection with its purchase of securities issued by any Insured Organization." In so holding, the district court rejected Genzyme's argument that the bump-up exclusion was limited by its own terms to the policy's entity coverage, and applied it to claims against individual officers and directors as well to avoid permitting Genzyme to sidestep a limitation in the entity coverage.

The First Circuit Decision

Genzyme appealed to the 1st Circuit. There, a three-judge panel reversed in part and remanded the action. The court saw "no basis in Massachusetts legislation or precedent for concluding that the settlement payment is uninsurable as a matter of public policy."

The 1st Circuit also held that the bump-up exclusion precluded coverage for the settlement but noted that, based on its terms, the exclusion applied only to the policy's entity coverage. Thus, the court found, there was no reason to apply the exclusion to the coverage for the entity's officers and directors. Moreover, the court observed that the Federal policy's allocation provision expressly accounted for the possibility that there could be circumstances under which the bump-up exclusion barred entity coverage but other insurance grants would provide coverage. If part of the Genzyme payment represented indemnification of officers and directors, the settlement, pursuant to this rationale, would fall under the corporate reimbursement coverage, and an allocation would be required. The court therefore remanded for consideration of the allocation question.

Public Policy Considerations

Federal's policy carved out from the definition of loss "matters uninsurable under the law pursuant to which [the policy] is construed." Expressing concerns that Genzyme had transferred value from the biosurgery shareholders and improperly given it to the General Division shareholders, the district court found that, as a matter of Massachusetts public policy, the settlement payment was not an insurable loss under any of the policy's insuring clauses. The court reasoned that the plaintiff shareholders would receive the settlement amount while the General Division shareholders would benefit from cancellation of the tracking shares and would receive a windfall by having a portion of the price for acquiring the tracking shares subsidized by the insurer.

The 1st Circuit, however, citing its own precedent, held that, "Massachusetts law only proscribes coverage of acts committed with the specific intent to do something the law forbids." *Andover Newton Theological Sch. v. Cont'l Cas. Co.*, 930 F.2d 89, 92 n.3 (1st Cir. 1991) (emphasis altered). The court found no such contention in the *Genzyme* case. In addition, because the district court cited no authority in support of its determination of Massachusetts' public policy, its holding also was in violation of the Supreme Court's directive that "a public policy … must be well defined and dominant, and is to be ascertained 'by reference to the laws and legal precedents'" to invalidate a contract.

Moreover, the 1st Circuit believed that the public policy rationale adopted by the district court would render coverage for damages awards unobtainable in routine securities litigation charging the corporation with unfair or unlawful treatment of a class of securities holders, even when the insurance contract clearly contemplates such coverage, as the Federal policy did. The court stated that if the parties had wanted to exclude such coverage, they should have included limiting provisions. Absent such provisions, Massachusetts has "no clear public policy that would prevent the parties from including securities litigation coverage in policies, or any basis to assume that policies are designed to exclude such coverage, particularly where, as here, securities litigation is specifically mentioned in the policy" while one class of claims arising from such litigation is specifically excluded.

The 1st Circuit, like the district court, also rejected Federal's argument that the settlement was uninsurable because it represented restitution of ill-gotten gains or benefits to which Genzyme was not entitled. In making this argument, Federal relied on *Level 3 Communications v. Federal Insurance Co.*, 272 F.3d 908 (7th Cir. 2001). *Level 3* held that the restitutionary settlement of a claim that Level 3 had paid too little to acquire the underlying plaintiffs' business interests was not a loss. The settlement there was not insurable because the 7th Circuit held that the plain meaning of the term loss in an insurance contract does not include the restoration of an ill-gotten gain. Federal argued that *Level 3* should govern this case. The district court rejected the argument because Genzyme received no "material benefit" in the share exchange that was capable of being disgorged. The 1st Circuit agreed, noting that Genzyme was not unjustly enriched because issuance of additional shares of stock to Biosurgery Division shareholders neither benefits nor harms a corporation.

Finally, both the district and circuit courts rejected Federal's contention that Genzyme's payment of the settlement was uninsurable as a matter of public policy because it derived from the fulfillment of an existing obligation. The case Federal cited in support of this argument, *Pacific Insurance Co. Ltd. v. Eaton Vance Management*, 369 F.3d 584 (1st Cir. 2004), involved payments made to fulfill an explicit preexisting contractual

obligation to another party, whereas here Genzyme had no explicit contractual obligation. Instead, its liability stemmed, at least partially, from an alleged breach of fiduciary duty to its biosurgery shareholders.

Commentary

The 1st Circuit decision may be subject to criticism in several respects. First, it confined its analysis of the term loss to the public policy carveout from that definition. Given the structure of the definition, the meaning of the term loss should not be determined solely by reference to its carveouts, but the court made no attempt to construe the plain meaning of the term. Moreover, although Massachusetts public policy may not preclude coverage for the corporate transaction at the heart of the case, the plain meaning of the term loss has been held by numerous courts to require that the insured experience some financial detriment. Indeed, the 1st Circuit recognized that redistribution of Genzyme's equity ownership among different groups of shareholders was essentially neutral to Genzyme. In that event, the company should hardly be deemed to have suffered a loss it if must later readjust the ratio for that redistribution to achieve the fair exchange it must have intended all along. The district court appears to have recognized this. The 1st Circuit's decision, however, appears to miss this point due to the court's focus solely on public policy.

The same problem exists with respect to the court's analysis of the *Level 3* decision, which focused solely on that court's discussion of restitution, and whether the underlying plaintiffs' claims sounded in contract or tort. Both lines of analysis miss the larger point that the transaction at the heart of the case involved a redistribution of the corporate pie and a subsequent attempt by the company to readjust the size of the slices. The cash paid to biosurgery owners simply meant that the shares of the General Division were then worth what they should have been if the company and its board had gotten the exchange ratio right in the first instance.

The Bump-Up Provision

Notwithstanding the 1st Circuit's rejection of Federal's public policy arguments, the court did determine that the Federal policy's bump-up exclusion provided a basis for denying coverage for the entity. The bump-up exclusion provided:

> [Federal] shall not be liable under Insuring Clause 3 for that part of Loss, other than Defense Costs… 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 [Genzyme].

On its face, then, the clause barred recovery for losses (other than defense costs) under Insuring Clause 3, which addresses claims against the company. Therefore, both courts recognized the validity of the exclusion as a basis for Federal's denial of coverage for the claims against Genzyme. Genzyme itself acquired the tracking stock in exchange for General Division shares, and the consideration was allegedly "inadequate or excessive," which led to a payment by Genzyme. Although Genzyme had exchanged the tracking stocks for General Division shares, this was still a "purchase of securities," because such transactions are commonly referred to – and, indeed, were referred to in Genzyme's own Articles of Incorporation – as a purchase or payment.

The 1st Circuit, however, reversed the district court's application of the bump-up exclusion to the claims against the individual officers and directors. The district court had expressed the concern that a corporation could sidestep coverage limitations by claiming a settlement payment was made to indemnify officers and directors. The 1st Circuit ruled that under the Federal policy's own terms, the exclusion applied only to the entity coverage, and therefore could not bar Genzyme from recovery for any amount it paid to indemnify its officers and directors. The court turned to the Federal policy's allocation clause for additional support. The allocation provision stated:

> If a Securities claim covered, in whole or in part, under Insuring Clauses 2 or 4 results in any [director or officer] under Insuring Clause 2 or [Genzyme] under Insuring Clause 3 incurring both Loss covered hereunder and loss not covered hereunder, because such Securities Claim includes both covered and uncovered matters, [the parties] shall allocate such amount to Loss as follows: … [the parties] shall allocate that part of Loss subject to [certain exclusions, including the bump-up clause] based upon the relative legal exposure of the [directors and officers and Genzyme].

Thus, the court determined that the Federal policy specifically contemplated circumstances under which the bump-up clause might bar entity coverage but permit coverage for individual officers and directors. Acknowledging the district

court's concern that a shareholder can often bring claims against both a corporation and its officers and directors, the 1st Circuit rejected the contention that the corporation could sidestep limitations on the entity coverage by claiming that any payments made were for the indemnification of executives. The court reasoned that such a construction would deny the insured the benefit — coverage for the individuals — for which it had paid and would deny the plain language of Insuring Clause 2. The 1st Circuit then remanded the action to the district court to determine whether and how to allocate the settlement between the parties.

The 1st Circuit's adherence to the precise wording of the policy is to be expected, especially given that it was construing an exclusion.

Conclusion

Although the *Genzyme* decision favored the Insured in that case, it may provide a roadmap by which insurers may protect themselves from similar unintended consequences in future cases.

Although the circuit court's decision limited the application of the bump-up exclusion to the entity coverage, it did so only to the extent of the provision's own language. Nevertheless, the 1st Circuit recognized the validity of the exclusion. Moreover, the court stated no reason why the bump-up exclusion, with appropriate modification, could not apply to directors and officers. The court merely sought an express provision so stating.

Going forward, insurers may want to consider modifying their policy language to include the express provision that the 1st Circuit sought but did not find in *Genzyme*. Bump-up exclusions such as the one in *Genzyme* could be drafted to apply to all insuring agreements. Alternatively, insurers might carveout from the definition of loss payments representing allegedly inadequate or excessive consideration for a transaction. Indeed, a carveout from the definition of loss might be preferable to amending the exclusion. Because policy definitions delineate the scope of coverage, it is arguably the insured's burden to establish that its claim is within that scope, unlike exclusions on which the insurer usually bears the burden of proof.

Additionally, insurers may still attempt to argue that the plain meaning of the term loss does not include relief measured by an inadequacy in the consideration given to acquire stock. Such relief simply amounts to a readjustment of the price of the transaction regardless of how the underlying plaintiff styles its claim. Federal appears to have argued this point, but the district court conflated it with the public policy issue and the court of appeals addressed only the public policy question.

Emphasizing the plain meaning of loss at all stages of a coverage dispute, especially regarding older policies lacking a bump-up provision, may distinguish future cases from *Genzyme* as well as provide a firmer foundation than fleeting public policy considerations carved out from the definition.