Seeking Shelter

Investigations of investment bank practices likely will trigger a wave of D&O claims.

by Alan Rutkin

There has been a great deal of interest recently in the new wave of lawsuits against investment banks, especially those relating to financial products tied to the repayment of mortgages.

Some complaints have alleged that the risks associated with these products were not disclosed accurately. New York State Attorney General Andrew Cuomo reportedly is investigating whether investment banks misled the rating agencies to inflate the ratings of financial products.

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The proceeding that has received the most attention is a suit by the Securities and Exchange Commission against Goldman Sachs & Co. and a Goldman Sachs employee. (Goldman settled with the SEC July 15 for a record $550 million. The settlement did not apply to the employee.)

Private lawsuits are already following the filing of the SEC's action. Two shareholder derivative suits have been filed against Goldman Sachs in a New York state court in Manhattan, and at least one putative class action complaint has been filed against Goldman Sachs and some of its officers.

Key Points

- **The Situation:** Lawsuits against Goldman Sachs have set the stage for potential D&O claims by top-level executives.
- **The News:** Other top Wall Street investment banks may also be targets of ongoing investigations.
- **The Next Step:** Two exclusions in D&O coverage, for dishonesty or personal gain, will be front and center as these complaints undergo due process.

Ultimately, the directors and officers named in all such suits will seek coverage under their directors and officers insurance policies, and the list of defendants will almost surely go beyond Goldman Sachs (the SEC is also reportedly investigating J.P. Morgan's transactions).

Because the complaint against Goldman Sachs is filed and available, it provides a useful reference point for reviewing and identifying some of the insurance coverage questions that will arise.

SEC Complaint vs. Goldman

The SEC's civil securities fraud lawsuit against Goldman Sachs, filed in mid-April in the U.S. District Court for the Southern District of New York, alleged that Goldman Sachs and an employee made materially misleading statements and omissions concerning a synthetic collateralized debt obligation titled Abacus 2007-AC1. CDOs are debt securities collateralized by debt obligations such as subprime residential mortgage-backed securities, known as RMBS.

According to the SEC's 22-page complaint, the Abacus CDO was tied to the performance of RMBS and was structured and marketed by Goldman Sachs in early 2007, when the U.S. housing market and related securities markets were beginning to show signs of distress.

The SEC alleged that Goldman Sachs' marketing materials for Abacus 2007-AC1—including the term sheet, flip book and offering memorandum for the CDO—all represented that the reference portfolio of RMBS underlying the CDO was selected by ACA Management LLC, a third party with experience analyzing credit risk in RMBS.

However, the SEC alleged, undisclosed in the marketing materials and unbeknownst to investors, a large hedge fund, Paulson & Co. Inc., with economic interests directly adverse to investors in the Abacus CDO, played a significant role in the portfolio selection process. (As part of its SEC settlement, Goldman admitted no wrongdoing but acknowledged its marketing materials for Abacus "contained incomplete information.")

As alleged in the SEC's complaint, Paulson effectively shorted the RMBS portfolio it helped select by entering into credit default swaps with Goldman Sachs to buy protection on specific layers of CDO's capital structure.

Given its financial interests, the SEC contends, Paulson had an economic incentive to choose RMBS that it expected to experience credit events in the near future. Goldman Sachs did not disclose Paulson's adverse economic interests or its role in the portfolio selection process in the term sheet, flip book, offering memorandum or other marketing materials provided to investors.

In sum, the SEC charges, Goldman Sachs arranged a transaction at Paulson's request in which Paulson heavily influenced the selection of the portfolio to suit its economic interests, but failed to disclose to investors, as part of the description of the portfolio selection process contained in the marketing materials used to promote the transaction, Paulson's role in the portfolio selection process or its adverse economic interests.

The SEC's claim against Goldman Sachs may implicate one or more restrictions on D&O coverage.

The deal closed April 26, 2007. Paulson paid Goldman Sachs approximately $15 million for structuring and marketing the Abacus 2007-AC1. By Oct. 24, 2007, 83% of the RMBS in the Abacus portfolio had been downgraded and 17% were on negative watch. According to the SEC, by Jan. 29, 2008, 99% of the Abacus portfolio had been downgraded.

As a result, investors in the CDO—specifically referenced in the complaint as IKB Deutsche Industriebank AG, a commercial bank headquartered in Dusseldorf, Germany; and ABN AMRO Bank N.V., which at the time was one of the largest banks in Europe—lost more than $1 billion. Paulson's opposite CDS positions yielded a profit of approximately $1 billion for Paulson, the SEC contends.

Accordingly, as alleged by the SEC, Goldman Sachs directly or indirectly engaged in transactions, acts, practices and a course of business that violated Section 17(a) of the Securities Act of 1933; Section 10(b) of the Securities Exchange Act of 1934; and Exchange Act Rule 10b-5. The SEC's complaint also seeks injunctive relief, disgorgement of profits, prejudgment interest, civil penalties and other appropriate and necessary equitable relief from the defendants.

Moreover, federal prosecutors may bring criminal charges against Goldman Sachs, and perhaps against individual executives as well.

The federal government seemingly has begun a criminal investigation of alleged securities fraud stemming from Goldman Sachs' mortgage trading, not necessarily including the Abacus CDO.

Insurance Issues

The SEC's claim against Goldman Sachs may implicate one or more restrictions on D&O coverage:

The Dishonesty Exclusion. A dishonesty exclusion may preclude coverage for claims "based upon, arising from, or in any way related to any deliberately dishonest, malicious, or fraudulent act or omission or any willful violation of law by any insured if a judgment or other final adjudication adverse to the insured establishes such an act, omission or willful violation." Importantly, the "adjudication" requirement is not always in a policy, and some policies are tied instead to dishonesty "in fact." This can be an important distinction, especially with respect to the reimbursement of defense costs. Generally speaking, the dishonesty exclusion will apply where there is a claim involving dishonesty; a judgment entered on that claim; and proof of intent that is material to the cause of action.

Personal Profit Exclusion. Financial product claims, such as those asserted by the SEC regarding the Abacus CDO, may very well require the parties or the court to consider the "personal profit" exclusion. Such an exclusion takes different forms but, generally speaking, it excludes losses "arising out of the gaining in fact of any personal profit or advantage to which the insured is not legally entitled."

The purpose of this exclusion is to bar coverage for losses incurred in returning something that did not properly belong to the insured.

In many cases, whether or not a personal profit exclusion applies can be determined by analyzing whether there are disputed sums that involve profits that the insured is not "legally entitled" to receive; the evidence establishing that the insured is "not entitled" to receive those sums; and, if the evidence establishes a wrongful profit, whether its receipt by a third party supports the application of the exclusion.

This exclusion certainly does not require a criminal conviction associated with the conduct. However, if there is a conviction, coverage is likely to be barred.

Consequently, the potential criminal actions against Goldman Sachs, and against company executives, may have important insurance coverage ramifications.

Who Did What?

Courts face the same important issue when considering the personal profit exclusion as when they analyze the dishonesty exclusion: namely, whether a profit had been gained "in fact."

Most policies' personal profit exclusions apply to a profit gained "in fact." Some policies require an "adjudication" that the insured was not entitled to the profit. In contrast, no adjudication is necessary with the "in fact" language.

Moreover, it is important to consider who received the profit and whether the exclusion's requirements therefore were demonstrated. The parties must review the policy language and the facts to assure that the personal profit was received by the appropriate actor.

Consider, for example, a situation where a corporate officer or director is an insured. Whether the personal profit was received by an officer or director will affect application of the personal profit exclusion. The approach to this issue—who must do it—can be pivotal to the claim.

By all measures, claims relating to investment banks represent a major business issue.

Soon they will become a significant insurance issue.

Resolving the anticipated claims will require careful examination of the facts, policies, and case law involved in each claim. BR