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Sam Bankman-Fried Case Provides Lessons on Fraud and D&O Insurance

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Sam Bankman-Fried's criminal trial started this week; and on the same day, he sued one of his director & officer insurers. And a lot of people are asking, why? Is the timing a coincidence or on purpose? Shouldn't he be focused on the criminal trial? The answer is: he is.

Imagine you're an executive of a high flying, rapidly growing company. It could be a public company, or a private one. In the process of raising capital and breaking paradigms, you're accused of also breaking the law and committing financial fraud. To the surprise of many, you can often turn to the directors & officers insurance (that the company's investors paid for) to defend the criminal case against yourself. It could be the story of Enron (Kenneth Lay and Jeff Skilling), WorldCom (Bernie Ebbers), Tyco (Dennis Kozlowski), Stanford Financial Group (Allen Stanford), Theranos (Elizabeth Holmes and Sunny Balwani). Today, it's the story of SBF and FTX.

This strikes a lot of people as odd. D&O policies pay for the legal costs incurred by directors and executives for alleged wrongdoing. Specifically, D&O includes the cost of defending criminal charges, which can be a big part of the fees. Particularly when the stakes are high (up to life in federal prison), and the trials can require teams of attorneys working around the clock for months. After the collapse of Enron, it was reported that half of the $300 million in legal fees went to white collar criminal defense costs (for multiple defendants in multiple cases). Elizabeth Holmes's defense apparently cost more than $30 million.

And most D&O policies are eroding or wasting policies; the payment of defense costs under the policies erodes the amount of coverage left over to pay civil settlements or judgments. SBF has stated he's the defendant in over a dozen cases (civil, regulatory, criminal, and the as a participant in the FTX bankruptcy case). The payment of $10 million in defense costs to lawyers and expert witnesses means there is $10 million less to pay the victims of a fraud.

Insurance is supposed to be about fortuity; insuring against an unknown risk (like a future oil spill) or an unpredictable future occurrence (like a life insurance policy; the death is certain to occur but unpredictable when it will happen). But a key element of fraud and criminal cases is the certain mental intent to commit the fraud or crime. What strikes people as strange is: why can an accused fraudster use the company's D&O insurance (purchased with investor money) to pay tens of millions to white collar defense attorneys? Shouldn't the policy have a fraudster exclusion?

Insurance is supposed to be about fortuity; insuring against an unknown risk or an unpredictable future occurrence. But a key element of fraud and criminal cases is the certain mental intent to commit the fraud or crime. Why can an accused fraudster use the company's D&O insurance (purchased with investor money) to pay tens of millions to white collar defense attorneys?

Yes, D&O policies have a fraud exclusion. But the fraud exclusion usually only applies following a "final adjudication" or "judicial determination." The insurer cannot deny coverage on the basis of fraud or a criminal act, until a court actually determines that there has been fraud or a crime. Until then, the insurer must pay the defense costs. And this is particularly important when the company itself may be insolvent and unable to pay the executive's defense costs, or unwilling because it concludes the executive a fraudster.

Some policies go farther. They pay defense costs even after the criminal conviction, until the final appeal. This prevents the insurer from refusing to cover the costs of a lengthy and expensive appeals process. By requiring a final adjudication or a final, non-appealable determination before the exclusion applies, the directors and officers are protected (and can pay their attorney's fees) including the exhaustion of all appeals. This language has been pushed by the market – the buyers of D&O insurance – because most lawsuits that trigger D&O insurance claims contain claims of criminal conduct, self-dealing, and fraud. Criminal complaints and indictments obviously raise allegations that, if proven, amount to criminal misconduct. But if the simple allegations of fraud triggered the D&O policy's fraud or crime exclusion, then the policy would fail to provide the essential coverage that was sold when it is particularly needed. As a result, the exclusion requires that the fraud or criminal conduct must be proven in court before the exclusion applies. The strongest policies include language that requires a "final, non-appealable" judicial determination of fraud or criminal act before coverage is excluded.

Most D&O policies require a director who is convicted or pleads guilty to a serious crime to pay the insurer back. Of course, in most cases by the time they are found guilty, they are also facing crushing civil liability and the insurer is rarely repaid. But SBF's policy from Continental does not contain a claw back provision.

Also, a corporation usually has a stack of different D&O policies with different tiers or layers of coverage in $5 million or $10 million increments, all from different insurers. This allows the insurers to spread the risk amongst themselves, rather than having the entire loss concentrated in one insurer. SBF's lawsuit against Continental indicates that Beazley, the primary (first) insurer had $5 million of coverage, followed by QBE with the second $5 million in coverage. Continental's $5 million layer kicks in (attached, in insurance lingo) after the first $10 million was exhausted.

What happens next? Unlike in most coverage cases, SBF's lawsuit includes claims for a preliminary injunction. He will likely file a motion with the court within the next few days or weeks, seeking a preliminary hearing and an order that Continental continue to advance his defense costs during the pendency of this coverage case – i.e., while his criminal trial is taking place. This would effectively leave Count 2, the claims for insurance bad faith, to be litigated at a later date.

It's unclear what Continental's defenses will be. It will file something outlining them, eventually. Certainly it will argue that SBF is the mastermind at the center of a multi-billion dollar criminal enterprise, but under the terms of most D&O policies, that isn't enough to avoid a defense obligation until after the criminal trial. But it's possible that Continental will try to prove that FTX or SBF made misrepresentations in the insurance application, or specifically made misrepresentations of things that happened before the policy's inception. The

best example – and perhaps this will apply – would be if SBF knew of illegal activities when the application was made, but lied on the application. This could allow Continental to void or rescind the policy, as if it was never issued.

Bloomberg's Matt Levine has a theory that changes in public company securities law has resulted in the outcome that "everything is securities fraud." An extension of that is that shareholder lawsuits work as a very complicated dividend, except that they are a transfer of money from D&O insurers to shareholders (with plaintiff's lawyers taking a cut). A further extension of this theory would be that D&O insurance is also a way that fraudsters convert investor money into pre-funding their own white collar defense attorney's fees.

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