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Securing Insurance Coverage in the Face of 'Restitution' and 'No Covered Loss' Defenses

By Joshua Gold

Directors and officers and errors and omissions insurance coverage is routinely contested by insurance companies arguing that certain claims do not constitute "loss" as defined in the insurance policy. The insurance company arguments may differ somewhat, but the typical theme involves these slight variants: (1) the amounts sought by the underlying plaintiffs supposedly seek the return of ill-gotten gains or "restitution"; (2) the amounts sought supposedly seek a disgorgement or refund; and (3) the amounts sought by the underlying plaintiffs supposedly seek breach-of-contract damages that will result in a windfall to the policyholder if coverage is available for the violation of contractual promises.

If confronted with these arguments, policyholders should be aware that there are several cases from a number of jurisdictions that can undermine and otherwise defeat them. For example, last year, in *Peerless Insurance Company v. Pennsylvania Cyber Charter School,* 2014 U.S. Dist. LEXIS 65406, a federal trial court rejected the insurance company's argument that there could be no coverage under an E&O policy for an underlying suit claiming conversion and restitution. The decision involved litigation against a charter school by certain Pennsylvania school districts that alleged that the charter school collected money for the enrollment of students to which it was not entitled. The charter school's E&O insurance company argued that the damages sought by the plaintiff school districts were really restitution of an ill-gotten gain and therefore coverage was unavailable. The court ruled that:

> PA Cyber necessarily incurred expenses in educating the students from the plaintiff school districts who enrolled at PA Cyber. Monies derived from the school districts' payments or redirected state subsidies under the Charter School Law presumably helped to offset those expenses. If ordered to repay the funds, PA Cyber would be placed in the position of having expended at least some resources to educate four-year-old students from the plaintiff school districts without

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> any compensation or benefit in return. Pursuant to the Seventh Circuit's reasoning in Level 3 (also cited in *Southcentral Emp't Corp. v. Birmingham Fire Ins. Co. of Pa.*, 2007 PA Super 156, 926 A.2d 977, 982 (Pa. Super. Ct. 2007)), that would arguably qualify as a "loss."

Thus, because the charter school had used its resources and incurred expenses in exchange for the amounts that it allegedly should not have collected, the court ordered the insurance company to defend it — and left open the possibility for indemnity coverage too, since such circumstances could qualify as a loss under the E&O policy.

Public Policy Defenses Rejected

In another case where the insurance company argued that there was no covered loss, but rather restitution, *Chubb Custom Insurance Company v. Grange Mutual Casualty Company,* Slip Copy, 2011 WL 4543896, the court rejected the insurance company's restitution argument and held in relevant part that:

> Chubb's reliance on Level 3 Communications and other similar cases is misplaced. Level 3 Communications applied a public policy exclusion for restitutionary relief from the definition of loss in an insurance contract. This exclusion only applies in limited circumstances, i.e., in circumstances involving the insured being "required to restore to the plaintiff that which was wrongfully acquired."

The court went on to hold that:

> Here, although they requested restitutionary relief, the plaintiffs in the [. . .] actions were in substance seeking damages for the alleged harm caused to them due to the allegedly wrongful conduct of Grange. Indeed, Grange allegedly received "some benefit" from using the software, in the form of retained money, but it did not "wrongfully acquire" this money — it simply retained it. Stated differently, the substance of the plaintiffs' claim in the Hensley and Gooding actions was for damages, not restitution.

In a third case where the insurance company argued against coverage by stating that breach of contract claims do not constitute loss under D&O insurance policies, *Verticalnet, Inc. v. U.S. Specialty Ins. Co.,* 492 F.Supp.2d 452, a federal court rejected that argument, holding that no public policy barred coverage of a settlement under a D&O policy for breach of contract claims. Because the D&O policy in this case had no contract claim exclusion, the insurance company ended up arguing that there was no insurable "loss" under the policy because breach of contract claims are "uninsurable" and pose underwriting and "moral hazards." The *Verticalnet* court rejected the insurance company's defense.

Fiduciary Liabilities Covered

In *Genzyme Corp. v. Federal Ins. Co.,* 622 F.3d 62, a federal appeals court rejected the insurance company's argument that the breach of fiduciary duty and breach of contract underlying claims against the policyholder constituted unjust enrichment/ill-gotten gains. The court held that "the underlying complaint made clear that the alleged cause of the injury was in fact the breach of Genzyme's applicable fiduciary duties and/or contractual obligations" and "does not support a conclusion of uninsurability."

In light of these decisions, policyholders should closely examine insurance company arguments that breach of contract claims from clients or customers or breach of duty claims from investors constitute uninsurable loss. Policyholders can also seek to purchase insurance policies that expressly define "wrongful acts"

to include allegations of breach of contract. Further, coverage can be purchased that expressly defines "loss" to include claims under Sections 11, 12 and 15 of the Securities Act of 1933 as amended. While this coverage should be included even absent the express definitions noted above, policyholders are benefited by enhanced clarification of coverage. These additional steps can strengthen the prospect of an insurance recovery. ▲

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