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Insurance Industry's Disgorgement Defense Hits A Wall

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Law360, New York (May 4, 2017, 11:50 AM EDT) -- For decades, and especially since the turn of the millennium, policyholders seeking claims under directors' & officers' and professional liability insurance policies have been bedeviled by insurance companies invoking the "disgorgement" defense against coverage of a wide array of claims that involve allegations of wrongdoing. Insurance companies use this defense to assert that a given judgment or settlement involves restitution, or the return of ill-gotten gains rather than a loss per se, and so is not covered.

On this front, policyholders won a major victory with the decisions in U.S. Bank N.A. v. Indian Harbor Insurance Co., 68 F. Supp. 3d 1044 (D. Minn. 2014), where the court twice rejected an insurance company's attempt to limit coverage based on a phantom "disgorgement" exclusion not found anywhere in the professional liability insurance policy at issue. Taken together with several other recent decisions rejecting similar "disgorgement" defenses, the court's decision in U.S. Bank marks a turning point in the efficacy of the coverage defense — which has been misused by insurance companies for decades to escape their obligations under the insurance policies that they sell. Recent decisions include one by the New York Supreme Court issued on April 17 reiterating a finding of coverage for Bear Stearns' alleged facilitation of late trading and deceptive market timing, as discussed below.

Level 3 and the "Disgorgement" Defense

The "disgorgement" defense has been cherished and expanded by the insurance industry since the Seventh Circuit's watershed decision in Level 3 Communications Inc. v. Federal Insurance Co., 272 F.3d 908 (7th Cir. 2001). In Level 3, Judge Richard Posner likened the settlement of a securities fraud case to a situation where a thief was required to return stolen money, deeming both situations "restitutionary in nature" and bluntly concluding it "can't be right" for insurance to cover such losses. Id. at 911. There is a gut-level appeal to this logic, but it has limits. Indeed, the subsequent coverage cases that rely on Level 3 share a common factual background: the underlying actions involved either: (1) the return of money to which the policyholder was not entitled; or (2) unlawful acts by the policyholder.

Since Judge Posner's instinctual pronouncement, insurance companies have sought seek to stretch Level

3's application to cases where plaintiffs merely allege that a policyholder was not entitled to the money at issue, even where there is never a finding of any ill-gotten gains. Generally, this "disgorgement" defense is advanced based on two common professional services liability policy provisions: carve-outs from the definition of "loss" for matters that are "uninsurable" as a matter of law and exclusions for underlying claims involving "ill-gotten gains."

The Spectrum of "Disgorgement" Exclusions

The promises made in D&O and E&O policies have evolved over the years, including the years since Level 3. The evolution of the terms relevant to the "disgorgement" defense has been favorable for policyholders. On one end of the spectrum of "disgorgement" exclusions are those triggered by mere allegations of ill-gotten gains, whether those allegations are substantiated or not. Since it is not unusual for underlying plaintiffs to make such allegations — though they often are groundless — insurance products with exclusions that are triggered by mere allegations are not commercially attractive to policyholders.

Accordingly, the insurance industry designed and marketed a broader provision, under which claims involving ill-gotten gains are only excluded where there is a showing that the policyholder had "in fact" received ill-gotten gains. In litigation over the meaning of such provisions, insurance companies have argued that a finding "in fact" of ill-gotten gains merely requires something more than sheer allegations of such gains.[1]

The uncertainty created by such insurance company arguments led to the creation of "final adjudication" language, which was designed and marketed to policyholders as a coverage enhancement whereby a final adjudication of the alleged ill-gotten gains was required before coverage would be excluded. After coverage disputes ensued where the insurance companies themselves sought to establish the "ill-gotten" nature of alleged gains via a "final adjudication" in coverage litigation, further enhancements to that policy wording were marketed and sold, under which the ill-gotten gains exclusion would only apply where the ill-gotten nature of the alleged gains was proved via a final adjudication "in the underlying action."

But despite this express promise, the temptation to deploy the disgorgement trap has proved too tempting for insurance companies. All too often, insurance companies cry "disgorgement" in a wide array of cases involving allegations of ill-gotten gains or where a settlement resolving claims for alleged damages possibly can be characterized as "disgorgement." This tactic runs counter to the whole reason policyholders buy enhanced coverage requiring a "final adjudication" before applicable exclusions kick in. Allegations of ill-gotten gains are common. So are settlements of disputes that make such allegations, and most insurance policies give the insurance company a say — if not control — in whether to enter into such settlements. Thus, policyholders have paid for the promise that amounts paid to settle such claims are covered loss, even if the claim involves allegations of ill-gotten gains.

Courts Confront the "Disgorgement" Defense

Unfortunately for many policyholders, the disgorgement trap has worked too well for too long. Until now. Since about 2013, a series of important decisions have shown that the "disgorgement" defense has very real limits.

In William Beaumont Hospital v. Federal Insurance Co., No. 11 Civ. 15528, 2013 U.S. Dist. LEXIS 35558 (E.D. Mich. Mar. 13, 2013), the district court declined to rule that so-called "disgorgement" is

uninsurable as a matter of law, holding that any "passing reference" to the unlawful retention of monies in a complaint is insufficient to constitute uninsurable "disgorgement." Id. at *39. The court's holding relied in no small part on the fact that the insurance company "failed to identify any ... case holding that these remedies [i.e., the supposed disgorgement] are not insurable under Michigan law, or adopting an 'interpretive principle' of the sort applied in Level 3 Communications." Id. at *32-33.

In J.P. Morgan Securities Inc. v. Vigilant Insurance Co., 992 N.E.2d 1076 (N.Y. 2013), the policyholders sought coverage for a $160,000,000 settlement with the SEC pursuant to a cease and desist order. Significantly, the settlement amount expressly was labeled "disgorgement" in the SEC's order, which also described the policyholders' securities law violations as "willful." Id. at 1081. Nevertheless, New York's highest court declined to hold that the settlement was uninsurable disgorgement and noted that only two remedies are uninsurable under New York law: punitive damages and intentionally harmful conduct. Id. Despite the fact that the policyholder clearly had engaged in wrongdoing and confessed to a judgment that specifically was labeled "disgorgement," the court nonetheless remanded the case to the trial court to determine whether the policyholder's conduct was intentionally harmful, as that would be the only basis for deeming the settlement uninsurable as a matter of law. Id. at 1082-83.

On April 17, 2017, the trial court referred back to the Court of Appeals' decision and rejected the insurance companies' "disgorgement" defense once again, noting that even where a $140 million payment to the SEC specifically is labeled as "disgorgement," it still falls within the plain meaning of the standard E&O insurance policy definition of "loss" and is covered so long as the $140 million payment was not predicated on profits that the policyholder improperly acquired.

Likewise, in Fidelity Bank v. Chartis Specialty Insurance Co., No. 12 Civ. 4259, 2013 U.S. Dist. LEXIS 110935 (N.D. Ga. Aug. 7, 2013), the district court "hesitat[ed] to purport to announce a 'new' Georgia rule" concerning the insurability of disgorgement. Id. at *10. Instead, the court based its holding on a fee exclusion.

The U.S. Bank Court Rejects the "Disgorgement" Defense

The decision in U.S. Bank was the first to address the fact that the "disgorgement" defense is undermined by the express terms of liability insurance policies that have been enhanced beyond the "in fact" wording at issue in Level 3. In granting summary judgment for the policyholder, the court recognized that the insurance company expressly promised to cover underlying claims involving alleged ill-gotten gains unless there is a final adjudication, and correctly held that the insurance contract clearly covered the defense and settlement of such claims where there was no such adjudication.

The court in U.S. Bank considered whether the settlement of lawsuits seeking damages for the way in which the bank charged overdraft fees was restitution. The court held that a settlement for allegedly unlawful conduct is not per se restitution, regardless of how plaintiffs in the underlying actions pleaded their claim for damages. U.S. Bank, 68 F. Supp. 3d at 1051. The court "emphasize[d] that it will not automatically presume — as the Insurers do — that the settlement constitutes restitution because it resolved claims alleging ill-gotten gains and seeking disgorgement of those gains." Id.

The court also addressed the significance of U.S. Bank's enhanced ill-gotten gains exclusion — which barred coverage for claims involving ill-gotten gains, but only where such gains are "determined by a final adjudication in the underlying action." Id. at 1049. The court found this unambiguous language to mean that "[w]hen an underlying action alleging ill-gotten gains and seeking disgorgement of those gains settles before trial, there is no final adjudication in that action determining that the gains were ill-

gotten and ordering the return of those gains." Id. at 1050. Because there was no final adjudication of ill-gotten gains, the insurance company could not rely on the "disgorgement" defense — including a provision in the policy that excluded coverage for matters that were "uninsurable as a matter of law" — to deny coverage.

Several months after the court's rulings in U.S. Bank, the Superior Court of Delaware published a decision involving a coverage dispute strikingly similar to the facts in that case. Gallup Inc. v. Greenwich Insurance Co., 2015 Del. Super. LEXIS 129 (Del. Super. Ct. Feb. 25, 2015). While not explicitly holding that disgorgement is insurable under Delaware law, the court in Gallup considered and rejected the same arguments that the insurance companies made in U.S. Bank — and held that insurance policies with "final adjudication" clauses provide coverage for the settlement of underlying claims alleging ill-gotten gains where there is no final adjudication that the gains were ill-gotten. Id. at *26-31.

Rejecting another attempt to raise the "disgorgement" defense, and citing favorably to U.S. Bank, the appellate court in Burks v. XL Specialty Insurance Co., No. 14-14-740-CV, 2015 Tex. App. LEXIS 11610 (Tx. Ct. App. Nov. 10, 2015), held that settlement of a claim for "disgorgement" was a covered loss. As in U.S. Bank and in Gallup, the Burks court declined to hold that disgorgement was uninsurable as a matter of Texas law. Id. at *20. Even if the settled amounts constituted disgorgement, the court found, the settlement of the underlying action was not a "final determination in the underlying action" sufficient to trigger the ill-gotten gains exclusion. Id. at *19.

Conclusion

Insurance companies steadily have enhanced their promises that mere allegations of ill-gotten gains are covered unless and until there is a final adjudication against the policyholder. Where no such final adjudication exists, the insurance company cannot renege on its promise. In Judge Posner's words — "that can't be right." The court in U.S. Bank clearly understood this point, and its straightforward application of the insurance policy terms at issue is a roadblock against further attempts to use "disgorgement" as an excuse to avoid otherwise covered claims.

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DISCLOSURE: The authors represented U.S. Bank in U.S. Bank N.A. v. Indian Harbor Ins. Co.

[1] Contrary to such litigation positions, the internal guidance created by at least one major American insurance company show that the "in fact" requirement was only met where there was a judicial determination of the conduct at issue.
