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From *Level 3* to *Genzyme*: Evaluating Insurance Coverage for Disgorgement of Profits



CARLTON FIELDS

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Although disgorgement and restitution have long been remedies available at law and in equity, the impact of claims for such relief on coverage determinations under directors and officers (D&O) and other professional liability insurance policies has received renewed focus over the past decade. Consideration of these issues began in earnest following the Seventh Circuit's decision in *Level 3 Communications, Inc. v. Federal Insurance Company*.[1] An understanding of Judge Posner's reasoning in that case—as well as an awareness of how his analysis has been applied or rejected by courts since—is critical to any evaluation of insurance coverage for claims that a company or its officers and directors received an improper benefit due to misrepresentation, fraud, or breaches of fiduciary duty.

Definitions of Insured 'Loss' and 'Damages' Under Professional Liability Policies

Few policies expressly exclude disgorgement or restitution payments. Rather, the issue typically arises under the definitions of "loss" or "damages." Policies providing coverage for an insured's "loss" often define the term as the total amount which an insured becomes legally obligated to pay on account of a claim made against it for "wrongful acts" for which coverage applies, including but not limited to damages, judgments, settlements, costs, and defense expenses. Many policies specifically exclude from the definition of "loss" matters "uninsurable under the law" pursuant to which the policy is construed.

For policies in which loss is not a defined term, coverage is often provided for "damages" that an insured becomes legally obligated to pay, as the result of claims made against it for wrongful acts. "Damages" often are defined as a monetary amount for which the insured may be held legally liable, including judgments, awards, or settlements. These policies often exclude from the definition of "damages" any fines, sanctions, taxes, penalties, or awards deemed uninsurable pursuant to any applicable law.

Although the concepts and definitions of "loss" and "damages" are closely related, the operative term may affect an insurer's—and a court's—analysis of whether coverage is provided for restitutionary relief, as discussed below.

Level 3 and its Subsequent Application

The leading case on the issue of whether restitutionary damages, including disgorgement, are a covered loss is *Level 3*.[2] In this case, the plaintiffs in the underlying litigation alleged that they sold shares in their corporation to Level 3 based on fraudulent representations regarding, among other things, a planned initial public offering, such that Level 3 gained control under "false pretenses."[3] The plaintiffs alleged that the impending initial public offering made the shares that they had sold to Level 3 worth more

than what Level 3 had paid for them. The underlying plaintiffs sought to recover the difference between the value of the stock at the time of trial and the price they had received for the stock from Level 3.[4] The Seventh Circuit found the alleged damages claim to be restitutionary in nature because it "seeks to deprive the defendant of the net benefit of the unlawful act, the value of the unlawfully obtained stock minus the cost to the defendant of obtaining the stock."[5]

The court agreed with the "interpretive principle" argued by the carrier–that a "loss" within the meaning of an insurance contract, does not include the restoration of an ill-gotten gain–finding that argument "clearly right."[6] The court concluded that "[a]n insured incurs no 'loss' within the meaning of the insurance contract by being compelled to return property that it had stolen, even if a more polite word than 'stolen' is used to characterize the claim for the property's return."[7]

The court found that its holding could be distinguished, albeit tenuously, from two Eleventh Circuit cases in which coverage was found under policies that paid for "damages." The court reasoned that the operative policy term, "damages," was broader as defined than the term "loss."[8] Subsequent cases have relied on this distinction.

For example, in *Nutmeg Insurance Company v. East Lake Management & Development Corp.*,[9] the insurer argued that an insured property manager's return of security deposits and interest he had wrongfully withheld was not covered because it constituted the return of wrongfully withheld funds, rather than out-of-pocket loss. Finding the claim covered, the court distinguished *Level 3* on the basis that the operative term in the policy was the broader "damages" term, and the insured was not required to suffer a "loss." On the other hand, the Northern District of Illinois (where the *Level 3* case originated) has held that *Level 3* controlled despite the fact that the policy at issue covered "damages" rather than "loss."[10] Notably, the Seventh Circuit's holding in *Level 3* does not turn on any particular policy wording. Rather, the opinion and analysis are rooted in the common understanding of the word "loss" and the basic concept that the return of "stolen" property does not, under the plain meaning of the word, result in a loss.

What Is 'Uninsurable,' and the 'Public Policy' Analysis

In a number of later opinions, the court's analysis has been rooted in a public policy argument that often derives from the policy language itself. Typical policy wording excludes from "loss" matters that would be "uninsurable under applicable law."[11] In some cases, courts have focused on this wording as defining a public policy argument, applying that analysis to reach a conclusion as to whether the damages sought fall within the policy's definition of a covered "loss." The strength of a coverage argument grounded in public policy considerations varies; some jurisdictions refuse to accept a public policy argument absent an express legislative or judicial mandate.[12]

Similarly, courts also have used distinctions as to which party received the direct financial "benefit" of the alleged acts of fraud or misrepresentation in deciding whether the principles of *Level 3* apply. In those cases, the question becomes whether an improper benefit was received by the insured for its alleged misconduct. If not, then the carrier's argument that the damages sought are restitutionary in nature is less likely to be successful.

For example, in *Genzyme Corporation v. Federal Insurance Company*,[13] suit was brought under a D&O policy to recover costs of settling a shareholder class action arising out of the company's elimination of two "tracking stocks" through an exchange of shares. The company had invoked a share exchange provision to eliminate the tracking stocks, in which holders of two of the tracking stocks would exchange their shares for a certain number shares of the remaining tracking stock of the company's general division, which would become the sole common stock of the company. Holders of one of the tracking stocks sued the company and its directors and officers in multiple suits. A $64 million settlement was reached, for which the insurer denied coverage.

The First Circuit rejected the insurer's argument (which the lower court had accepted on its motion to dismiss) that the settlement payment was not an insurable "loss" as a matter of public policy (*i.e.*, the company "stole" from one group of shareholders and conferred an improper benefit on another), as Massachusetts recognizes only a limited public policy exception.[14] Moreover, the court also held that the case did not fit within the framework of *Level 3*, because Genzyme alleged in its complaint that it received no material benefit from the stock exchange and, thus, in the context of a motion to dismiss, where the pleaded allegations are accepted, the case did "not present an unjust enrichment situation."[15] The court reasoned that the insured company was neither benefited nor harmed by issuing additional shares of stock, which had no affect on the company's assets or liabilities. Because the insured received no "material benefit" in the share exchange, there was "nothing that could be disgorged through a restitutionary remedy."[16]

Thus, according to *Genzyme*, even in situations in which a company is alleged to have participated in the misrepresentations or other conduct, the *Level 3* rationale would not apply to bar coverage where the company received no material benefit from its alleged wrongful acts. Stated another way, where the defendant company (or its officers and directors) do not gain from their alleged misdeeds, then the damages sought cannot fairly be categorized as restitutionary or the return of "stolen" property and, thus, potentially are covered.

The Importance and Effect of Settlement Agreements

Courts frequently examine the terms of the pleadings, motions, and settlement agreements to determine the nature of the relief being sought or paid, relative to evaluating coverage under the policy (*e.g.*, a payment to reimburse claimants for securities losses as traceable to misleading information or non-disclosure rather than to insider trading). Where a settlement shows that it

relates to restitution or disgorgement, it is likely to be excluded from coverage by the insurer as not being a "loss" or as being uninsurable as a matter of law or public policy. Nevertheless, labels are not dispositive, and courts may look to the substance of the transaction before making a decision

For example, in *Chubb Custom Insurance Co. v. Grange Mutual Casualty Co.*,[17] the U.S. District Court for the Southern District of Ohio held recently that even though the underlying plaintiffs explicitly requested restitution in their complaint, the substance of their claim was for damages.[18] The court distinguished *Level 3* by focusing on the nature of the relief sought, noting that in a disgorgement situation, the insured "is asked to return something [it] wrongfully received; [it] is not asked to compensate the plaintiff for injury suffered as a result of his conduct."[19] Thus, "[t]he fundamental distinction is not whether the insured received 'some benefit' from a wrongful act, but whether the claim seeks to recover only the money or property that the insured wrongfully acquired."[20] Under the court's view of the relief actually sought by the underlying plaintiffs, the removal from insured "loss" of matters "uninsurable under the law" was inapplicable.

Similarly, rejecting labels in pleadings as form over substance, compare the analysis in *Ryerson, Inc. v. Federal Insurance Company*,[21] decided in favor of the insurer. The underlying plaintiff had filed suit against the insured alleging that it purchased the insured's subsidiary at a higher price than it was actually worth based on material misrepresentations by the insured. The parties' settlement agreement provided the underlying plaintiff with an $8.5 million "post-closing price adjustment to the Stock Purchase Agreement."[22] The insurer, relying on *Level 3*, argued that the price adjustment was restitution for ill-gotten gains and therefore not an insurable loss.[23] The insured attempted to distinguish *Level 3* on the basis that, unlike in *Level 3*, at the time the underlying case settled, the underlying plaintiff was seeking only compensatory and punitive damages.[24] The court rejected this argument, noting that it "focuses on damages labels and not on the nature of the relief sought by" the underlying plaintiffs.[25] The insured in *Ryerson* also argued against the veracity of its settlement agreement, claiming (with a supporting affidavit) that the sums paid were termed price adjustment solely as a means to avoid taxes. Unimpressed, the court rejected the insured's attempt to contravene its own settlement agreement. [26]

At least one court has refused entirely to engage in any analysis that attempted to characterize the nature of the underlying settlement for which coverage was sought as either restitutionary or compensatory because the parties had "foregone the right to a finding of culpability."[27] In *Virginia Mason Medical Center v. Executive Risk Indem. Inc.*, where the policy defined "loss" as "any monetary damages or settlements which an insured is obligated to pay as a result of any [c]laim, including but not limited to punitive or exemplary damages . . . where insurable under applicable law," the court concluded that the underlying settlement was a covered "loss" simply because it resulted from a claim alleging that the insured had committed a wrongful act.

Conclusion

In summary, the basic principle of *Level 3*–that the restoration of an ill-gotten gain is not a "loss" within the meaning of a professional liability policy–remains in full effect. Thus, when faced with a lawsuit in which the plaintiff is seeking restitution, or the relief sought is in the nature of disgorgement, the insurer, the court, or both may contend that there is no insurable loss, either under the plain meaning of the term or as a matter of public policy. A careful analysis of how the relief sought is described in the pleadings, motions, and even settlement agreements, as well as whether the insured actually received a "material benefit" from the alleged wrongful acts, is necessary to determine whether such a coverage position is subject to challenge by the insured company.

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[1] 272 F.3d 908 (7th Cir. 2001).

[2] This case is the second Seventh Circuit opinion on a case that originated in the Northern District of Illinois, *Kiewit Diversified Group, Inc. v. Federal Ins. Co.*, 999 F. Supp. 1169 (N.D. Ill. 1998). Applying Nebraska law, the district court held that the unambiguous "insured v. insured" exclusion precluded coverage but did not address whether the settlement amount constituted a "loss." *Id.* at 1176-78. On appeal in *Level 3 Communications, Inc. v. Federal Ins. Co.*, 168 F.3d 956 (7th Cir. 1999), the Seventh Circuit upheld the "insured v. insured" exclusion, but held that the settlement must be allocated between covered and noncovered losses, and remanded the case to the district court for further consideration of the allocation issue. The district court addressed the allocation issue in *Level 3 Communications, Inc. v. Federal Ins. Co.*, No. 96-cv-5346 (N.D. Ill. July 31, 2000). In a separate opinion, the district court first addressed the disgorgement issue, holding that the settlement constituted a covered "loss" under the policy at issue, and declining to ignore the plain language of the policy in favor of a policy determination.

Level 3 Communications, Inc. v. Federal Ins. Co., No. 96-cv-5346 (N.D. Ill. Aug. 18, 1999). The disgorgement issue was then appealed to the Seventh Circuit. *Level 3 Communications, Inc. v. Federal Ins. Co.*, 272 F.3d 908 (7th Cir. 2001).

[3] 272 F.3d at 910.

[4] *Id.*

[5] *Id.* at 910-911.

[6] *Id.* at 910.

[7] *Id.* at 911.

[8] *Id.* at 910.

[9] No. 05 C 1328, 2006 BL 120233 (N.D. Ill. Nov. 22, 2006).

[10] *Cont'l. Cas. Co. v. Duckson*, No. 11 C 459, 2011 BL 306850 (N.D. Ill. Nov. 15, 2011).

[11] *See, e.g.*, *CNL Hotels & Resorts, Inc. v. Houston Cas. Co.*, 505 F. Supp. 2d 1317 (M.D. Fla. 2007), *aff'd in part sub nom. CNL Hotels & Resorts, Inc. v. Twin City Fire Ins. Co.*, 291 F. App'x 220 (11th Cir. 2008) (noting that under New York law, restitution of ill-gotten funds does not constitute damages or a loss, as those terms are used in an insurance policy, in holding that settlement was not covered); *Executive Risk Indem. Inc. v. Pacific Educational Services*, Inc. 451 F. Supp. 2d 1147 (D. Haw. 2006) (stating that "[a] conclusion that restitution is insurable would contravene the express purpose of restitution recognized by Hawaii courts, which is to deter wrongdoers from benefiting or otherwise profiting from their improper actions" in holding that restitutionary damages were not a covered "loss"); *Alanco Techs., Inc. v. Carolina Cas. Ins. Co.*, No. CV 04-789-PHXDGC, 2006 BL 61010 (D. Ariz. May 17, 2006) ("Because rescissory damages are uninsurable under the law, and defense costs are recoverable only for covered losses, Plaintiffs have suffered no loss under the policy."); *Liss v. Federal Ins. Co.*, No. L-1845-01 (N.J. Sup. Ct. June 29, 2004) (holding that "[b]ecause the claim against Federal is restitutionary in nature, it runs afoul of prevailing public policy and thus is uninsurable and does not fall within the policy's definition of loss"; *Vigilant Ins. Co. v. Credit Suisse First Boston Corp.*, 782 N.Y.S.2d 19 (2004) (noting that "restitution of ill-gotten funds is not insurable under the law" in holding that insured could not recover settlement amount). *See also*, *American Medical Security Inc. v. Executive Risk Specialty Ins. Co.*, 393 F. Supp. 2d 693 (E.D. Wis. 2005) (explaining that the clear language of the policy, which contained an exclusion for "profit, remuneration or advantage to which the insured was not legally entitled," "as well as the more general public policy considerations underlying cases such as *Level 3*," compel the result that the portions of the settlement agreement representing restitutionary damages are excluded from coverage).

[12] *See, e.g.*, *Bank of America Corp. v. SR Intern. Business Ins. Co.*, No. 05-cvs-5564 (N.C. Dec. 19, 2007) (noting that the underlying complaint did not seek restitutionary damages and that there is no North Carolina judicial or statutory authority that damages for the alleged Section 11 violations are uninsurable loss); *Genzyme Corp. v. Federal Ins. Co.*, 622 F.3d 62 (1st Cir. 2010) (rejecting the insurer's argument that the settlement payment was not an insurable loss as a matter of public policy, as Massachusetts recognizes only a limited public policy exception).

[13] 622 F.3d 62 (1st Cir. 2010).

[14] Although the insurer argued in its motion to dismiss that the settlement payment was not an insurable "loss," either because it did not fall within the commonly accepted definition of the term or because it was uninsurable as a matter of public policy, the district court viewed these distinct concepts as "hairsplitting distinctions."

[15] *Id.* at 70 (The carrier's position under a separate, "Bump-Up" exclusion, not directly relevant to this discussion, was sustained as to the allocated portion of the settlement that would be attributable to the entity, using a "relative legal exposure" test. The additional problems that arise in determining a proper allocation for indemnity in light of the court's other rulings in the case are beyond the scope of this article).

[16] *Id.* (quoting *Genzyme Corp. v .Federal Ins. Co.*, 657 F. Supp. 2d 282, 289 (D. Mass. 2009)).

[17] No. 2:07-cv-1285, 2011 BL 324117 (S.D. Ohio Dec. 20, 2011).

[18] *Id.*

[19] *Id.* (quoting *Unified W. Grocers, Inc. v. Twin City Fire Ins. Co.*, 457 F.3d 1106, 1115 (9th Cir. 2006)).

[20] *Id.*

[21] 796 F. Supp. 2d 911 (N.D. Ill. 2010).

[22] *Id.* at 912.

[23] *Id.*

[24] *Id.* at 913.

[25] *Id.*

[26] *Id.* at 913-914.

[27] *Virginia Mason Medical Center v. Executive Risk Indem. Inc.*, No. c07-0636MJP, 2007 BL 174270 (W.D. Wash. Nov. 14, 2007).