CARLTON FIELDS

In the Seventh Circuit, Moral Hazard Does Not Create Moral Clarity

December 01, 2013

The defendant in *Carolina Cas. Ins. v. Merge Healthcare Solutions* was insured under a D&O policy that excluded coverage for the "multiplied portion of multiplied damages." In an underlying securities suit, the court awarded attorneys' fees to the insured's shareholders, using a lodestar amount and increasing it with a multiplier. The U.S. Court of Appeals for the Seventh Circuit held that the "multiplied portion" exclusion did not apply to the fee multiplier, and, therefore, that the insurer was liable for the entire fee award. The decision rested on a finding that attorneys' fees do not constitute "damages" under governing law. But the court also used the case as an occasion for further reflection on the concept of moral hazard. Courts in the Seventh Circuit have increasingly relied on that concept to provide a rule of decision, but the impact of the concept remains hard to predict. As discussed in the Winter 2013 issue of *Expect Focus*, Judge Posner relied on the doctrine last year in *Ryerson Inc. v. Federal Ins. Co.*, in which the insured seller of a business settled a claim for rescission, based on alleged fraudulent inducement. Federal's policy defined a covered "loss" to include "settlements" of "claims" based on "misleading statement[s]," but the court ruled against coverage for the settlement, on the ground that "[y]ou can't … sustain a 'loss' of something you … shouldn't … have." This year, in *OneBeacon America Ins. Co. v. City of Granite City*, a federal court in Illinois decided a dispute over coverage for a state court suit challenging a local ordinance, under which the owners of impounded vehicles had to pay the City an administrative fee to get them back. The underlying class action contended the fee was an unlawful "taking" under the Illinois Constitution. The City's liability policy applied to suits seeking recovery of "damages," and it expressly covered sums the insured became obligated to pay as "damages" for public officials' errors and omissions and/or law enforcement wrongful acts. The district court, however, found *Ryerson* "clear" in holding "that restitution of monies wrongfully taken does not constitute 'damages' within the meaning of an insurance policy." It absolved OneBeacon not only of responsibility for indemnifying the City, but also of the duty to defend the underlying suit. Thus, it implicitly held that a suit involving "the potential 'restoration of an ill-gotten gain'" does not even *potentially* fall within the coverage of any liability policy. What these bright-line rulings fail to do is clearly explain what will count as "restitution" or "ill-gotten gain" in future cases. Judge Posner's elaboration in *Schlueter v. Latek* didn't help matters: "Damages are measured by the plaintiff's loss, restitution by the defendant's gain. Often they're equivalent … [b]ut not always." In *Granite City*, it was arguable that the $400 fee at issue produced something less than a $400 "gain" to the City; yet the court's ruling meant that no part of the plaintiffs' case constituted a claim for "damages." Judge Easterbrook's opinion in *Merge Healthcare* only muddied these already murky waters. The court said the exclusion provision listed penalties "that insurers regularly exclude to curtail moral hazard—the fact that [the availability of coverage] induces the insured to take extra risks." It then asserted that "attorneys' fees in commercial litigation are not remotely like punitive damages" and other remedies that punish risky or unethical behavior. But the defendants in *Merge Healthcare* allegedly used false statements to win approval of a sale of their company for less than its actual value, and the amount of the attorneys' fees was intended to reflect the additional value that shareholders ultimately realized. It is far from clear why a moral hazard argument against coverage for treble damages would not also apply to fees based on the amount by which management allegedly underpriced its own shares.

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