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Insureds Take Note: Insurance Coverage Is Generally Unavailable for Lawsuits Involving Money or Property Wrongfully Acquired By the Insured

By: Monique M. Fuentes and Negar Azarfar for the DRI Commercial Litigation Committee *Business Suit*

Lawsuits are often brought involving allegations that the defendant retained the fruits of its wrongdoing and the plaintiff is entitled to restitution or disgorgement of that which was wrongfully obtained. A defendant often tenders such a lawsuit to its insurance carrier seeking a defense and indemnity from the insurance carrier for the matter. However, insurance coverage is generally unavailable under an insurance policy in connection with allegations of money or property wrongfully acquired or retained by the insured.

A liability insurance policy, subject to its other terms and conditions, typically provides insurance coverage to the insured for "Loss" or "Damages." Insurance policies, either explicitly or implicitly, exclude from the definition of covered "Loss" or "Damages" matters which are "uninsurable under the law." Restitution, disgorgement, or restoration of money or property wrongfully acquired or retained is generally uninsurable as a matter of law and public policy.

In one of the most oft-cited cases on this issue, *Level 3 Communications, Inc. v. Federal Insurance Co.*, 272 F.3d 908 (7th Cir. 2001), the insured paid millions to settle a lawsuit alleging that the insured bought shares in MFS Telecom from the plaintiffs at an unfairly low price. The Seventh Circuit determined that the settlement payment to the securities plaintiffs did not constitute "loss" under the directors and officers liability policy at issue, as "[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." *Id.* at 911. Numerous courts across the country have embraced this proposition and held that the payment of amounts to which an insured was not legally entitled does not constitute "loss" under an insurance policy. *See, e.g., Stanley v. U.S. Bank Nat'l Ass'n*, 597 F.3d 298, 310 (5th Cir. 2010) (a "[p]ayment[] fraudulent as to creditors that must therefore be repaid due to bankruptcy court order" is not an insurable "loss" because it is "a disgorgement of ill-gotten gains and a restitutionary payment"); *St. Paul Fire & Marine Ins. Co. v. Vill. of Franklin Park*, 523 F.3d 754, 756 (7th Cir. 2008) ("loss" does not encompass the return of an ill-gotten gain*); Pan Pac. Retail Props., Inc. v. Gulf Ins. Co.*, 471 F.3d 961, 968 (9th Cir. 2006) (a claim for increased consideration paid to shareholders in a merger "would necessarily seek to divest money that was improperly obtained or withheld"; consequently, "[a]ny payments intended to settle these claims would be uninsurable as seeking to recover the net benefit of the alleged wrongful acts . . ."); *Executive Risk Indem. Inc. v. Pac. Educ. Servs., Inc.*, 451 F. Supp. 2d 1147, 1162 (D. Haw. 2006) ("[r]estitution is uninsurable under Hawaii law and therefore not covered by the [p]olicy"); *Nortex Oil & Gas Corp. v. Harbor Ins. Co.*, 456 S.W.2d 489, 494 (Tex. Ct. App. 1970) ("[a]n insured . . . does not sustain a covered loss by restoring to its rightful owners that which the insured, having no right thereto, has inadvertently acquired").

In reaching its decision in *Level 3*, the Seventh Circuit relied on *Bank of the West v. Superior Court*, 2 Cal. 4th 1254 (1992), in which the California Supreme Court stated:

> It is well established that one may not insure against the risk of being ordered to return money or property that has been wrongfully acquired. Such orders do not award "damages" as that term is used in insurance policies. (citations omitted).

2 Cal. 4th at 1266. The rationale behind this principle is simple: if one is ordered to give up what it never had the right to possess in the first place, it suffers no compensable loss. To permit someone to obtain insurance in such circumstances is contrary to public policy, as it would eliminate any incentive to obey the law and would allow the wrongdoer to retain the fruits of his wrongdoing. Indeed, this is precisely the California Supreme Court's holding in *Bank of the West*:

> The public policy rationale that underlies these holdings, explicitly or implicitly, is this: When the law requires a wrongdoer to disgorge money or property acquired through a violation of the law, to permit the wrong-doer to transfer the cost of disgorgement to an insurer would eliminate the incentive for obeying the law. Otherwise, the wrongdoer would retain the proceeds of his illegal acts, merely shifting his loss to an insurer.

Id. at 1269. In *Bank of the West*, a class of consumers sued a bank based upon a financing program the bank had developed for automobile insurance premiums. Allegedly, the bank did not disclose the true nature of its financing program to enrollees. The bank ultimately settled with the class plaintiffs and sought coverage for the settlement from its insurer, arguing that the settlement amount constituted damages arising under the California's Unfair Business Practices Act, Section 17203, and that all forms of monetary relief, including disgorgement orders under Section 17203, were damages for insurance purposes. The California Supreme Court rejected the bank's argument and held instead that "damages" were not recoverable under Section 17203, recognizing that "[i]f insurance coverage were available for monetary awards under the Unfair Business Practices Act, a person found to have violated the act would simply shift the loss to his insurer and, in effect, retain the proceeds of his unlawful conduct." *Id.* at 1267.

In its analysis, the court discussed an earlier appellate decision, *Jaffe v. Cranford Insurance Co.*, 168 Cal. App. 3d 930 (1985), wherein the insured was required to return Medi-Cal overpayments it had received from the government and then sought to recover from his insurer. The *Jaffe* court found that the amounts the insured was required to repay were restitutionary in nature, and such amounts were uninsurable as a matter of law because "the defendant [was] required to restore to the plaintiff that which was wrongfully acquired." *Id.* at 935. The court in *Bank of the West* restated the public policy recognized by *Jaffe*, and specifically noted that, had the lower court correctly applied the rule that "*insurable damages do not include costs incurred in disgorging money that has been wrongfully acquired,*" it would have concluded that the settlement amount the bank paid to the consumer class was uninsurable. *Bank of the West*, 2 Cal. 4th at 1268.

The principle articulated in *Bank of the West*, *Level 3* and their progeny - that restitutionary relief is not an insurable loss - was recently followed again in *Ryerson, Inc. v. Federal Insurance Co.*, No. 09 C 4173 (N.D. Ill. Sept. 30, 2010). In *Ryerson*, the insured sought insurance coverage for costs incurred in defending and settling an underlying lawsuit concerning the purchase by the claimant of the insured's subsidiary. The claimant alleged that the insured made material misrepresentations and concealed information regarding the true value of its subsidiary at the time of purchase by the claimant. The insured settled with the claimant for the value of

the inflated price that the claimant paid for the insured's subsidiary. The district court in *Ryerson*, relying on *Level 3*, held that the insured paid the claimant "damages that accounted for the inflated price for" the insured's subsidiary, and thus that "relief was restitutionary in nature, and therefore not an insurable loss." *Id.*, Slip Op. at 7.

Further, in determining whether an insured may obtain coverage for a loss stemming from an ill-gotten gain, an insured should also be aware that courts generally hold that the "label" applied to the claim asserted, or the "characterization" of the remedy sought, may not govern the outcome of the analysis. Instead, the courts evaluate the nature of the claim and the nature of the relief to determine whether a particular loss is insurable. *See, e.g., Cunningham v. Universal Underwriters*, 98 Cal. App. 4th 1141, 1148 (2002) (labels given to causes of action are irrelevant for determining coverage); *Ryerson*, No. 09 C 4173, at 4-5 (in determining coverage, focus is on the relief sought by the claimant and not the damages labels). As stated by the court in *Level 3*, "[h]ow the claim or judgment order or settlement is worded is irrelevant." 272 F.3d at 911. *See also Unified W. Grocers, Inc. v. Twin City Fire Ins. Co.*, 457 F.3d 1106, 1115 (9th Cir. 2006) ("The label of 'restitution' or 'damages' does not dictate whether a loss is insurable. . . . 'How the claim or judgment order or settlement is worded is irrelevant.'") (internal citation omitted); *Pan Pac. Retail*, 471 F.3d at 966 (citing *Bank of the West*, 2 Cal. 4th at 1270) ("[i]n deciding whether a certain remedy is insurable, we must look beyond the labels of the asserted claims or remedies").

In sum, while any defendant who is obligated to pay a settlement or judgment might consider his payment to constitute a "Loss" or "Damage," the parties must consider whether that payment is actually in the nature of restitution or disgorgement of ill-gotten gains. As a matter of law and public policy, insurance coverage typically is not available fort such payments, however they may be labeled.

About the Authors

Monique M. Fuentes is a partner and **Negar Azarfar** is an associate in the Orange County, California office of Troutman Sanders LLP, where they represent insurance companies in coverage and bad faith litigation and provide pre-litigation counseling and advice to insurance clients regarding complex coverage and claims-handling issues. They can be reached at 949.622.2700 or monique.fuentes@troutmansanders.com or negar.azarfar@troutmansanders.com.