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Practice Group:

Insurance Coverage

U.S. Bank v. Indian Harbor: Insurers Face Another Restitution/Disgorgement Setback

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In a recent decision, the United States District Court for the District of Minnesota held that insurers could not use the so-called restitution/disgorgement defense to avoid covering amounts that their insured bank agreed to reimburse to its customers as part of a settlement of claims alleging excessive overdraft fees in *U.S. Bank National Association et al. v. Indian Harbor Insurance Company*.[1] *U.S. Bank* is the most recent in a number of recent decisions that have curtailed insurers' use of the restitution/disgorgement defense. In this Alert, we discuss the *U.S. Bank* decision following a brief overview of the restitution/disgorgement defense.

The Restitution/Disgorgement Defense

By way of background, insurers frequently rely on the restitution/disgorgement defense to deny coverage for a wide variety of otherwise-covered claims under directors and officers (D&O) and professional liability insurance policies, among others. The defense is based on the theory that the policies purportedly do not cover judgments or settlements comprising relief (or even, in some cases, defense costs) that may be characterized as "restitutionary" in nature or that requires an insured to "disgorge" sums of money. Insurers asserting the defense point to language typically contained in D&O and professional liability policies that excludes matters that are "uninsurable" from the definition of a "loss" or "damages." Insurers may also assert that where the insured returns sums of money that it allegedly improperly obtained, the insured has not suffered an economic loss. The decision perhaps most often cited by insurers in support of the restitution/disgorgement defense is *Level 3 Communications, Inc. v. Federal Insurance Co*.,[2] in which the Seventh Circuit held that a D&O policy did not cover a settlement of shareholder claims alleging that the plaintiffs had sold shares in their corporation to the insured "because of fraudulent representations that [the insured] had made."[3] Although the Court acknowledged that the relief sought (the difference between the value of the stock at the time of trial and the price the plaintiffs had received for the stock) was "standard damages relief in a securities-fraud case," the Court found as a matter of law that the settlement at issue was not covered because "a 'loss' within the meaning of an insurance contract does not include the restoration of an ill-gotten gain."[4] The *Level 3* Court reasoned 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."[5]

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[1] No.: 12-cv-3175 (D. Minn. July 3, 2014).

[2] 272 F.3d 908 (7th Cir. 2001)

[3] Id. at 910.

[4] Id.

[5] Id. at 910-11.

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In the wake of *Level 3*, in what appeared to be a troubling trend for insureds, other courts accepted increasingly aggressive coverage denials based on the restitution/disgorgement defense.[6]

More recently, however, courts, including the District of Minnesota in *U.S. Bank*, have properly curtailed insurers' attempts to avoid coverage through the restitution/disgorgement defense.

The Facts Of *U.S. Bank*

Beginning in 2009, three class actions were brought against U.S. Bank, allegedly that the bank overcharged overdraft fees to its customers.[7] In particular, the class actions alleged that U.S. Bank "re-ordered customers' debit-card transactions from highest amount to lowest amount (instead of chronologically), posted the transactions to customers' checking accounts in that order, and allowed the accounts to be overdrawn—thereby creating the most overdrafts and maximizing the overdraft fees assessed on its customers."[8] The class actions asserted a variety of common-law and statutory claims and sought the return of the excess overdraft fees collected by U.S. Bank.[9] U.S. Bank settled the class actions in 2013 for $55 million.[10]

U.S. Bank sought coverage for the settlement from its professional liability insurers, Indian Harbor Insurance Company and ACE American Insurance Company. The professional liability policies at issue provided coverage for a "Loss", which was defined to include "the total amount which [U.S. Bank] becomes legally obligated to pay on account of each Claim … made against [U.S. Bank] for Wrongful Acts … including, but not limited to, damages, judgments, settlements, costs, pre-judgment and post-judgment interest and Defense Costs."[11] However, the policies excluded from the definition of "Loss" "[m]atters which are uninsurable under the law pursuant to which this Policy is construed."[12] The *U.S. Bank* Court referred to this exclusion from the "Loss" definition as the "Uninsurable Provision." The policies also contained an express exclusion for claims "brought about or contributed in fact by any … profit or remuneration gained by [U.S. Bank] or to which [U.S. Bank] is not legally entitled … as determined by a final adjudication in the underlying action."[13] Both the exclusion, which the Court referred to as the "Ill-Gotten Gains Provision," and the Uninsurable Provision are contained in some form in virtually all professional liability and D&O insurance policies.

The insurers denied U.S. Bank's coverage claim on the basis of the restitution/disgorgement defense, citing principally to the Uninsurable Provision and relying on the *Level 3* decision and its progeny. In particular, the insurers argued that the settlement was not a covered

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[6] *See, e.g., Conseco, Inc. v. National Union Fire Ins. Co*., 2002 WL 31961447, at *6-7 (Ind. Cir. Dec. 31, 2002) ("It is axiomatic that insurance cannot be used to pay an insured for amounts an insured wrongfully acquires and is forced to return, or to pay the corporate obligations of an insured … [A]n insured is not allowed to profit from its wrongdoing through insurance.").

[7] *U.S. Bank*, No.: 12-cv-3175, Slip Op., at 1.

[8] Id.

[9] Id. at 2.

[10] Id.

[11] Id. at 2-3.

[12] Id. at 3.

[13] Id.

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"Loss" because the Uninsurable Provision "encompassed the settlement as legally uninsurable restitution."[14] According to the Insurers, "the settlement is restitutionary, and restitution is uninsurable as a matter of law."[15]

U.S. Bank sued the Insurers for breach of contract and a declaratory judgment, and the insurers moved for judgment on the pleadings.

The *U.S. Bank* Court's Ruling

Applying Delaware law, the Court in *U.S. Bank* considered the insurers' restitution/disgorgement defense based on the Uninsurable Provision. Noting that "[t]he Insurers highlight several court decisions

that have rejected insurance coverage for restitution on the basis that returning money or

property to which one is not legally entitled can never constitute a loss," the Court nevertheless found that "[t]wo aspects of the policies' clear language … contradict the Insurers' argument."[16]

First, the Court ruled that "the settlement is not uninsurable under Delaware law because no Delaware authority has held that restitution is uninsurable as a matter of law," noting that the insurers "have failed to cite, and the Court cannot locate, any Delaware authority deeming restitution uninsurable."[17]

Second, the Court found that the Ill-Gotten Gains Provision, which as noted is contained in some form in virtually all professional liability and D&O policies, in fact evidenced that restitution/disgorgement was specifically contemplated, and was excluded only where there is, as required by the exclusion, a "final adjudication" as to the conduct at issue. As explained by the Court:

> [T]he policies exclude from coverage restitution resulting from a final adjudication and by implication include within coverage restitution stemming from a settlement. The Ill-Gotten Gains Provision excludes from coverage money to which U.S. Bank "is not legally entitled" only "as determined by a final adjudication in the underlying action." This provision shows not merely that the parties contemplated the possibility of coverage for restitution, but that they agreed coverage would exist unless the restitution was imposed by a final adjudication. When an underlying action alleging ill-gotten gains settles before trial, there is no final adjudication in that action. So here, where the class actions alleging ill-gotten gains were settled before trial, there is no final adjudication and the settlement is not excluded from coverage.[18]

The Court further reasoned that "[b]ecause the parties expressly excluded any restitution resulting from a final adjudication through the Ill-Gotten Gains Provision, they must have intended to include any restitution not resulting from a final adjudication (say, a settlement) within the definition of 'Loss'" and to "interpret the Uninsurable Provision to always preclude

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[14] Id.

[15] Id. at 5.

[16] Id.

[17] Id.

[18] Id. at 6 (citing Clarendon Am. Ins. Co., No. 04C-11-167, 2008 WL 2583007, at *7 (Del. Super. Ct. June 25, 2008)).

coverage for restitution would nullify the Ill-Gotten Gains Provision, which plainly says that only a final adjudication precludes coverage for restitution."[19]

The court distinguished *Level 3* and its progeny on the basis that those decisions did not, in contrast to the policy at issue in *U.S. Bank*, contain any exclusion requiring a "final adjudication":

> The Court acknowledges the rule of Level 3 and its progeny that restitution is generally uninsurable ... But virtually all cases the Insurers cite that follow Level 3 are distinguishable because they involved policies without a specific provision requiring a "final adjudication." The parties here agreed that the Level 3 rule would only control if a final adjudication—not a settlement—resolved that U.S. Bank was not legally entitled to the overdraft fees and must return them. The parties knew about the Level 3 decision when they executed the policies and still decided to cover a settlement constituting restitution absent a final adjudication.[20]

The Court concluded that "Delaware law does not prohibit insurance for restitution and the parties agreed that restitution is insurable when, as here, the underlying allegations of ill-gotten gains were not finally adjudicated."[21]

The Takeaways

The *U.S. Bank* decision is an important decision for insureds seeking to recover settlement payments labeled by insurers as "restitution" or "disgorgement" and, importantly, appears to be part of a trend against permitting insurers to avoid coverage based on vague extra-contractual "public policy" type arguments that undermine the purpose of professional liability and D&O insurance coverage.

U.S. Bank and other recent decisions, including the decision of the New York Court of Appeals in *J.P. Morgan Securities Inc. v. Vigilant Insurance Co.,*[22] which we discuss here, have rejected insurers' attempts to avoid coverage through the restitution/disgorgement defense.

Insureds approaching professional liability and D&O insurance policy placements and renewals are well advised to pay close attention to their insurance policies, including the definitions of "loss" or "damages," as well as the policy exclusions and other key terms and conditions, so that they are in the best possible position to maximize coverage if and when a claim that may be characterized by insurers as seeking "restitution" or "disgorgement" materializes.

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[19] Id. at 7.

[20] Id. at 8-9.

[21] Id. at 9.

[22] 992 N.E.2d 1076 (2013).

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