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U.S. Bank v. Indian Harbor: Another Blow to the Restitution/Disgorgement Defense

By Peter Gillon and Vernon Thompson

In recent years, purchasers of D&O and professional liability insurance have been stunned to learn that their carriers have denied coverage for a wide range of claims on the theory that their policies do not cover loss that could be characterized as restitutionary in nature or where a judgment or settlement requires the insured to "disgorge" a sum of monies. Now, however, the tide may be turning against this overreaching practice. Although it is far too early to administer last rites to the "restitution/disgorgement defense," a compelling opinion penned by Judge Paul Magnuson of the District of Minnesota, in U.S. Bank v. Indian Harbor Insur. Co.*, along with other recent court rulings, suggest that its expanding use has been severely curtailed. Applying Delaware law, the court flatly rejected insurers' arguments that the defense precluded coverage under a professional liability policy for amounts the insured bank agreed to reimburse customers in a settlement over claims that the bank charged excessive overdraft fees.* U.S. Bank v. Indian Harbor Insur. Co.*, Civ. No. 12-cv-3175 (PAM/JSM) (D. Minn. July 3, 2014).*

The restitution/disgorgement defense usually rests on standard policy language defining covered "Loss" to exclude amounts that are uninsurable as a matter of law, and the argument that applicable State law does not permit insurance companies to indemnify an insured for the payment of restitution or the disgorgement of ill-gotten gains. In many instances, insurers assert this defense even when there is no case or statute declaring restitutionary payments uninsurable. The defense may also include a secondary argument that when a policyholder is ordered to return monies it has obtained unlawfully, there is no basis for coverage because the insured has suffered no economic loss. This argument was articulated most forcefully in an opinion by Judge Richard Posner in *Level 3 Communications, Inc. v. Federal Insurance Co.*, 272 F.3d 908 (7th Cir. 2001).

Insurers have asserted the defense in order to escape liability for matters otherwise covered, such as claims against directors and officers under Section 11 of the Securities Act of 1933, claims for civil penalties under the Foreign Corrupt Practices Act, insider trading claims, bankruptcy trustee fraudulent transfer claims, and even standard securities fraud claims.

The facts of the Minnesota case are straightforward. U.S. Bank was sued in a consumer class action for allegedly excessive overdraft fees charged to its customers' accounts. The bank settled the action in 2013 for $55 million, and it sought coverage for defense costs and damages. Insurers disclaimed coverage on the basis of the restitution/disgorgement defense. On insurers' motion for judgment on the pleadings, Judge Magnuson focused in on two key provisions of the professional liability policy: (1) the definition of "Loss," which excluded "matters which are uninsurable under the law pursuant to which this Policy is construed," and (2) the "ill-gotten gains" exclusion, which excluded coverage for claims resulting from "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." (Both clauses, in one form or another, are found in current D&O and Professional Liability policies.) The court denied the insurers' motion based upon this policy language. Turning first to the "Uninsurable Provision," as the court dubbed it, the court quickly concluded that there was no Delaware authority declaring restitution uninsurable, and it declined to speculate as to what the State courts might conclude.

Of equal importance, the Court cited the presence of the ill-gotten gains exclusion as further support for its finding that the policy did not bar coverage for restitution or disgorgement. "The Ill-Gotten Gains 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." (Slip Op. at 6). The court said it was compelled to read the "uninsurable provision" and the "ill-gotten gains provision" consistently as a whole. In that light, "[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.'" (Slip Op. at 7). In other words, the Court read the two provisions to mean that insurers must look to the personal conduct exclusion and meet its burden to prove the applicability of that exclusion, including establishing the ill-gotten gains by a final adjudication, before it can deny coverage on the basis that restitution is "uninsurable."

This interpretation makes perfect sense. Carriers desiring to exclude coverage should be required to bear the burden of proving an exclusion; and where the policy already incorporates an exclusion shielding insurers from liability for an insured's illegal activities or for the benefits reaped by the insured's illegal activities, courts should do no more than respect the contractually negotiated provision. *See Federal Ins. Co. v. Continental Casualty Co.,* 2006 WL 3386625 (W.D. Pa. Nov. 22, 2006 (upholding coverage for fraudulent transfers to former directors and officers in light of strict liability scheme under Bankruptcy Code, holding that Illegal Profit Exclusion provided ample protection to carriers against insureds reaping a windfall from their illegal acts and refusing to second-guess an express policy term on vague public policy grounds.) Insurers and brokers talk a lot about "contract certainty" – eliminating the vagaries inherent in insurance policies by ensuring that the parties' expectations are clearly expressed. The U.S. Bank ruling, like other recent rulings, properly elevates the explicit terms of the contract over vague notions of public policy and other phantom defenses.

In a final note, the *U.S. Bank* court rejected the secondary basis of the restitution/disgorgement defense – the argument announced in *Level 3 Communications* that payment of restitution or disgorgement is not covered because the insured has not incurred any economic loss by returning something that was not its property. *Level 3 Communications* and its progeny, the court held, are

> distinguishable because they involved policies without a specific provision requiring 'final adjudication' . . . 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. Without governing Delaware law or controlling policy language requiring otherwise, the parties' agreement must be enforced. (*U.S. Bank*, Slip Op. at 9)

The takeaway here is that *U.S. Bank* and other recent cases (See *J.P.Morgan v. Vigilant Insur. Co.,* discussed here) reflect courts' reluctance to thwart coverage for restitution/disgorgement based upon an unstated exclusion or vague public policy grounds when the policy contains an express exclusion that addresses the same claims. Likewise, it appears that, at least for now, Delaware law does not hold that restitution or disgorgement damages are uninsurable.

Policyholders are well advised to take full advantage of these trends by clarifying that the "uninsurable" provision in the definition of "Loss" is to be construed according to the law of the State of the insured's incorporation or domicile, corporate headquarters, place of contracting or other applicable jurisdiction, whichever most favors coverage. Likewise, in light of *U.S. Bank's* holding that the "uninsurable" provision must be construed in conjunction with the "final adjudication" clause of the personal conduct exclusions, policies should expressly reference the exclusion in the definition of "Loss." That is, policies should clarify that insurers agree not to assert the uninsurability of conduct except to the extent expressly precluded under the conduct exclusions, including establishing such conduct by "final adjudication."

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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