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Fighting Back Against the Insurance Industry's 'Restitution'/'No Covered Loss' Defenses

By Joshua Gold

Over the last several years, D&O and E&O insurance companies in particular have contested scores of insurance claims by arguing that the claims do not constitute "loss" as defined in the insurance policy. The insurance company arguments vary a bit but usually involve one or more assertions: 1) the amounts sought by the underlying plaintiffs supposedly seek the return of ill-gotten gains or "restitution," 2) the amounts sought supposedly seek a disgorgement or refund and 3) the amounts sought by the underlying plaintiffs supposedly seek breach-of-contract damages that will result in a windfall to the policyholder if it gets coverage for the contract performance it breached.

While certain aspects of these anti-coverage arguments have been made in other types of insurance policies from time to time, insurance companies most often invoke them under D&O and E&O coverage. If confronted with these arguments, policyholders should be aware that there are several cases from a number of jurisdictions that can undermine and otherwise defeat these insurance company positions.

For example, in a very recent case, *Peerless Ins. Co. v. Pa. Cyber Charter Sch.*, 2014 U.S. Dist. LEXIS 65406, a federal trial court rejected the insurance company's argument that there could be no coverage under an E&O policy for an underlying suit claiming conversion and restitution. The decision involved litigation against a charter school by certain Pennsylvania school districts that alleged that the charter school collected money for the enrollment of students to which it was not entitled. The charter school's E&O insurance company argued that the damages sought by the plaintiff school districts were really restitution of an ill-gotten gain and therefore coverage was unavailable. The court ruled that:

> PA Cyber necessarily incurred expenses in educating the students from the plaintiff school districts who enrolled at PA Cyber. Monies derived from the school districts' payments or redirected state subsidies under the Charter School Law presumably helped to offset those expenses. If ordered to repay the funds, PA Cyber would be placed in the position of having expended at least some resources to educate four-year-old students from the plaintiff school districts without any compensation or benefit in return. Pursuant

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> to the Seventh Circuit's reasoning in Level 3 (also cited in *Southcentral Emp't Corp. v. Birmingham Fire Ins. Co. of Pa.*, 2007 PA Super 156, 926 A.2d 977, 982 (Pa. Super. Ct. 2007)), that would arguably qualify as a "loss."

Thus, because the charter school had used its resources and incurred expenses in exchange for the amounts that it allegedly should not have collected, the court ordered the insurance company to defend and left open the possibility for indemnity coverage too since such circumstances could qualify as a loss under the E&O policy.

Public Policy Defenses Rejected

In another case where the insurance company argued that there was no covered loss, but rather restitution, *Chubb Custom Ins. Co. v. Grange Mut. Cas. Co.*, Slip Copy, 2011 WL 4543896, the court rejected the insurance company's restitution argument and held in relevant part that:

> Chubb's reliance on Level 3 Communications and other similar cases is misplaced. Level 3 Communications applied a public policy exclusion for restitutionary relief from the definition of loss in an insurance contract. This exclusion only applies in limited circumstances, i.e., in circumstances involving the insured being "required to restore to the plaintiff that which was wrongfully acquired."

The court went on to hold that:

> Here, although they requested restitutionary relief, the plaintiffs in the […] actions were in substance seeking damages for the alleged harm caused to them due to the allegedly wrongful conduct of Grange. Indeed, Grange allegedly received "some benefit" from using the software, in the form of retained money, but it did not "wrongfully acquire" this money — it simply retained it. Stated differently, the substance of the plaintiffs' claim in the Hensley and Gooding actions was for damages, not restitution.

In another case where the insurance company argued against coverage by stating that breach of contract claims do not constitute loss under D&O insurance policies, *Verticalnet, Inc. v. U.S. Specialty Ins. Co.*, 492 F.Supp.2d 452, a federal court rejected that argument, holding that no public policy barred coverage of a settlement under a D&O policy for breach of contract claims. Because the D&O policy in this case had no contract claim exclusion, the insurance company ended up arguing that there was no insurable "loss" under the policy because breach of contract claims are "uninsurable" and pose underwriting and "moral hazards." The *Verticalnet* court rejected the insurance company's defense.

Lending and Fiduciary Liabilities Covered

In *Cincinnati Ins. Co. v. Stonebridge Financial Corp.*, 797 F.Supp.2d 534, a federal court held that an E&O policy covered breach of contract damages, despite the presence of an exclusion for contractual liability, because of the special nature of the lending business and policies marketed to insure its risks. The court, in considering the policyholder's position, held:

> We find this interpretation compelling, particularly in the context of an E&O policy designed to insure against the special risks inherent in the lending business. Here, the policy not only insures errors, omissions, or acts committed by Stonebridge in the performance of professional services — defined to encompass all of Stonebridge's activities on behalf of its clients — it also specifically covers "claims arising out of any 'wrongful lending act' related to an extension of credit or refused extension of credit to a 'borrower.'" Stonebridge points out that as "all lender liability actions arise out of a contractual relationship" (Doc. No. 25, p. 18), it reasonably expected the policy to cover "all lender liability practices," whether asserted in negligence or breach of contract. *Id*.

In *Genzyme Corp. v. Federal Ins. Co.*, 622 F.3d 62, a federal appeals court rejected the insurance company's argument that the breach of fiduciary duty and breach of contract underlying claims against the policyholder constituted unjust enrichment/ill-gotten gains. The

court held that "the underlying complaint made clear that the alleged cause of the injury was in fact the breach of Genzyme's applicable fiduciary duties and/or contractual obligations" and "does not support a conclusion of uninsurability."

Accordingly, policyholders often will have plenty of ammunition to fend off insurance company arguments that breach of contract claims from clients or customers, or breach of duty claims from investors, constitute uninsurable loss. Policyholders can often improve their position further by purchasing insurance policies that expressly recognize coverage for breach of contract claims and include within the definition of "loss" coverage for claims under Sections 11, 12 and 15 of the Securities Act of 1933 as amended.

About Anderson Kill

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