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By David C. Parisi

Directors and Officers liability claims

Insurers often misapply a Public-Policy "Exclusion"

Most companies purchase Direc-tors and Officers Liability insurance policies ("D&O policies") to protect their officers and directors from personal liability. One would assume that merely reading the D&O policy will be sufficient to determine whether coverage exists when a potential claim arises. Unfortunately, in this post-Enron environment, and perhaps due to the large number of ensuing securities suits, D&O carriers now more than ever rely on a public policy "exclusion" to deny coverage.

This "exclusion" is the California public policy prohibiting insurance coverage for claims for ill-gotten gains, *i.e.*, restitution. While this public policy exclusion is not necessarily new, it has caused a trend of denials and litigation in the D&O arena, though most of the controlling decisions on the issue are from out of state and/or unpublished. Though this public policy "exclusion" may justify denials in some claims, it is not applicable to all claims as asserted by many carriers.

A short primer on D&O policies

D&O policies are designed to protect directors and officers so that qualified individuals will be encouraged to take such positions and freely perform their duties without fear of personal liability. In some circumstances, corporations agree to indemnify their directors and officers for defense costs, settlements, judgments, or similar costs incurred in their capacity as officers and directors. Such agreements are typically in the corporate bylaws or charter.

However, indemnification by the corporation is not always sufficient to make directors and officers whole because some statutes may prohibit indemnification in certain circumstances, and a corporation may become insolvent. Accordingly, D&O policies typically include two insuring clauses, one providing direct coverage for directors and officers, and one providing reimbursement to the corporation should it indemnify directors and officers. These are generally referred to as Coverage A and Coverage B, or Side A Coverage and Side B Coverage.[1]

D&O policies are not written on forms standardized among the carriers.[2] However, Coverage A generally provides coverage for any alleged wrongful acts of the corporate directors or officers where the company is not indemnifying the directors or officers. A typical Coverage A insuring clause provides as follows:

> This policy shall pay the Loss of each and every Director or Officer of the Company arising from any claim or claims . . . for any alleged Wrongful Act in their respective capacities as Directors or Officers of the Company, except for and to the extent that the Company has indemnified the Directors or Officers

Coverage B, which insures the company to the extent it indemnifies its directors and officers, may provide as follows:

> This policy shall reimburse the Company for Loss arising from any claim or claims which are first made against the Directors or Officers and reported to the Insurer . . . for any alleged Wrongful Act in their respective capacities as Directors or Officers of the Company, but only when and to the extent that the Company has indemnified the Directors or Officers.

Unlike an ordinary liability insurance policy in which the insured company obtains primary protection from lawsuits, an insured company does not generally enjoy direct coverage under a D&O policy. The company is insured indirectly for its indemnification obligations. In other words, the proceeds of the D&O policy essentially belong to the directors and officers. (*See In re Louisiana World Exposition, Inc.* (5th Cir. 1987) 832 F.2d 1391, 1399.) However, the benefits are generally not available until the amount of loss has been fixed, which may occur by a payment or the creation of the legal obligation to make payment. In this respect, the insuring clauses generally define a "Loss" as "damages, judgments, settlements and Defense Costs . . ."

A review of the case law in the area will quickly reveal that few California decisions have interpreted D&O policies. (*ML Direct, Inc. v. TIG Specialty Ins. Co.* (2000) 79 Cal.App.4th 137, 144 [93 Cal.Rptr.2d 846, 852].) Additionally, choice of law issues often arise with D&O policies, which results in the application of the laws of other states despite a California venue. For these reasons, federal and out-of-state cases are often relied upon when interpreting the policies. One trend in D&O insurance is that insurance carriers appear to be more aggressively attempting to avoid coverage based on a restitution argument.

See Parisi, Next Page

Journal of Consumer Attorneys Associations for Southern California
ADVOCATE
August 2007 Issue

Bank of the West: Claims that seek restitution of an ill-gotten gain are generally not insurable

D&O insurance carriers argue that restitution and disgorgement are uninsurable as a matter of law. The carrier will likely cite *Bank of the West v. Superior Court* (1992) 2 Cal.4th 1254 [10 Cal.Rptr.2d 538]. *Bank of the West* arose from a coverage argument under a comprehensive general liability insurance policy. In *Bank of the West* the insured sought coverage for restitution ordered pursuant to the Unfair Business Practice Act, Business and Professions Code sections 17200, *et seq.* The court found no coverage was available because the only relief available for the violation alleged was disgorgement. (*Id.* at 1266.) The court held 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." (*Id.* at 1266.)[3] D&O insurers often refer in their denial letters to their policies which often exclude from the definition of loss "matters uninsurable under the law pursuant to which this policy is construed."

Level 3 Communications v. Federal Ins. Co.

The first significant case to address restitution in the context of D&O policies is the Seventh Circuit's *Level 3 Communications, Inc. v. Federal Ins. Co.* (7th Cir. 2001) 272 F.3d 908. It is also the case most relied on by insurers when denying claims because of "restitution."

In *Level 3*, the court held that no coverage existed for the settlement of a securities fraud suit because "loss" within the meaning of the policy does not include ill-gotten gain. In the underlying litigation, shareholders filed a securities fraud action against the officers and directors of Federal's insured alleging that Level 3 obtained the plaintiffs' company under false pretenses. The shareholders sought the difference between what they were paid and the true price. Level 3 settled the underling litigation on behalf of its officers and directors because it had an obligation to indemnify them for liability in their capacity as officers and directors. Level 3 then sought to recover its $10 million settlement from Federal under Coverage B of the D&O policy. Federal denied the claim, contending that no part of the settlement was a "loss" within the meaning of the policy because the settlement was "restitutionary in nature." (*Id* at 909-910.) The Federal policy defined loss to mean "the total amount which any Insured Person becomes legally obligated to pay . . . including, but not limited to . . . settlements." (*Id* at 909.)

The Seventh Circuit agreed with Federal. The 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." (*Id.* at 911.)[4]

While *Level 3* arises from securities litigation, egregiously fraudulent conduct and restitutionary damages resulting from such conduct, D&O carriers now frequently try to extend the argument to any case which involves the payment or forfeiture of profits or which even simply involves some alleged wrongdoing by the insured. It is now not unusual to see a D&O insurer deny a claim pursuant to *Level 3* because the underlying lawsuit asserts causes of action for replevin, account stated, conversion or fraud.

Published Cases following *Level 3*

Most recently, the Ninth Circuit reversed a summary judgment in favor of insurers where there were genuine issues of fact over whether a class action settlement included only uninsurable restitutionary payments. (*Pan Pacific v. Gulf Ins. Co.* (9th Cir. 2006) 466 F.3d 867, *opinion amended and superseded on rehearing*, (9th Cir. Dec. 2006) 471 F.3d 961 (applying California law). In *Pan Pacific*, as with *Level 3*, the policyholders, Pan Pacific and Western, were denied coverage under D&O policies for an underlying shareholder class action. The policyholders proposed a merger which was challenged by a shareholder in a class action against both companies and their directors and officers. The gist of the complaint was that Pan Pacific and Western "breached their fiduciary obligations to the shareholders by failing to negotiate the highest possible price" and by "failing to disclose all material information to the shareholders before they voted" to approve the merger. (*Id.* at 964.) The underlying lawsuit was settled for $990,000.00 and Pan Pacific and Western sued both carriers for failure to pay benefits. Coverages B and C were at issue in *Pan Pacific*. The D&O carriers for both companies denied coverage asserting that the settlement was restitutionary in nature. (*Id.* at 965.)

The trial court, relying on *Level 3*, granted the insurers' motions for summary judgment finding in part that the underlying settlement "was, as a factual matter, restitutionary relief that was uninsurable under California law." (*Id.* at 965.)

Though the Court of Appeals in *Pan Pacific* recognized that insurers are "not required to provide coverage for claims seeking return of something wrongfully received," it agreed that the insurers "must still indemnify for claims that seek compensation for injury suffered as a result of the insured's conduct." (*Id.* at 966-967 *citing Bank of the West*, *supra*, 2 Cal.4th at 1268.) The court further noted that it "must look beyond the labels of the asserted claims or remedies" and determine whether any portion of the settlement was to settle non-restitutionary claims. (*Id.* at 966-967.)

Significantly, before the settlement was approved in the underlying action, "all derivative claims that sought relief on behalf of the corporation" had been dismissed. (*Id.* at 967.) These derivative claims sought relief based on "the decreased consideration paid for the shareholders' shares," which would have sought to divest money improperly

See Parisi, Next Page

Journal of Consumer Attorneys Associations for Southern California
ADVOCATE
August 2007 Issue

obtained. (*Id*. at 967-968.) Accordingly, the derivative claims would have been uninsurable under a *Level 3* analysis. Only certain claims which alleged violation of the corporations' disclosure duties remained at the time of settlement. (*Ibid*.) The *Pan Pacific* Court noted that though the claims which sought restitutionary relief had been dismissed at the time of the settlement, the settlement could have been motivated by concerns of the corporation and their officers and directors about exposure on appeal of the dismissed, and uninsurable, claims.

The *Pan Pacific* court recognized that the policyholders provided a theory of damages available at the time of settlement of the underlying action which would provide compensation and not return of money wrongfully obtained. (*Id.* at 968-969.)[5] The court noted that there had been no trial regarding what was settled in the underlying action and there "was no expert testimony provided concerning the exposures for defendants" in the underlying action on the dismissed claims or pending claims at the time of settlement. (*Id*. at 970.)

Based on these findings, *Pan Pacific* held that it was not convinced that "the claims and exposures settled were entirely 'of the narrow type identified by these cases as not a proper subject of coverage by insurance.'" (*Id*. at 970 *quoting AIU Ins. Co. v. Superior Court* (1990) 51 Cal.3d 807, 836-837 [274 Cal.Rptr. 820, 836-837].) The court held that the existence of the damage theory that the settled claims were covered, with the prior dismissal of uninsurable claims, created a "genuine issue of fact as to whether the settlement contained non-restitutionary amounts." (*Id*. at 969.) The Ninth Circuit therefore held that the district court erred when it found that the *entire* settlement was for uninsurable relief. (*Ibid*.)

Unified Western Grocers

The other Ninth Circuit opinion to address the *Level 3* issue is *Unified Western Grocers v. Twin City Fire Ins. Co.* (9th Cir. Aug. 2006) 457 F.3d 1106 (applying California law). As with *Pan Pacific*, the Ninth Circuit held that where the allegations asserted against the insured in the underlying action "do not necessarily restrict all potential recovery to restitution" and damages may exist not based on the amount wrongfully acquired, coverage may exist. (*Id*. at 1115.) In the case, a genuine issue of material fact remained as to the extent the underlying action sought restitution of money wrongfully acquired. Also, because there were covered and non-covered claims, "the insurer is obligated to allocate the reimbursement of funds between the two types." (*Ibid*.) Accordingly, because a "genuine issue of material fact remains as to the extent that the Underlying Complaint sought restitution of money wrongfully acquired," summary judgment was denied. (*Ibid*.)

One of the other recent citable cases which relies on *Level 3* is *American Medical Security, Inc. v. Executive Risk Specialty Ins. Co.* (E.D. Wis. 2005) 393 F.Supp.2d 693. In *American Medical*, the court noted that a "party may not use insurance to put itself in a better position than it would have been absent in its wrongdoing." (*Id*. at 709.) However, even though restitutionary claims were not covered under an errors and omissions policy, an insurer is not entitled to summary judgment where several allegations and claims against the insured give rise to non-restitutionary, covered, damages. (*Id*. at 1115-1116 (summary judgment in favor of insurer reversed where underlying complaint contained mixture of covered and uncovered losses; genuine issue of material fact existed as to extent that underlying complaint sought restitutionary relief which was deemed uninsurable).)

The most recent case to address *Level 3* is *CNL Hotels & Resorts, Inc. v. Houston Cas. Co.* (M.D. Fla. March 2007) 2007 WL 788361. In *CNL*, excess carriers over the D&O policies denied coverage on the ground that the "settlement payments represented disgorgement, rather than an actual loss," and that losses from violation of Section 11 of the Securities Act of 1933 are uninsurable. (*Id*. at *1.) The District Court in *CNL* followed *Level 3* and gave a somewhat positive analysis of *Level 3* with respect to innocent officers and directors. The insured argued that "it would be unfair to preclude individual directors and officers from recovering" certain payments where "such individuals can be held liable even if they did not receive any money" from the plaintiffs in the underlying action. (*Id*. at *7.) The *CNL* Court agreed and stated that "the *Level 3* line of cases would not preclude" such relief. (*Ibid*.) (This may be dicta because, as the court stated, no individual was seeking such recovery in the instant case.)

When an Insurer Denies Coverage based on a *Level 3* Analysis

The *Level 3* decision did not distinguish between coverage for the company, *i.e.*, entity coverage, and for the individual officers and directors. A reasoned analysis should consider whether the directors and officers realized some personal gain from the plaintiffs in the underlying lawsuit. If the directors and officers realized no gain and yet the underlying lawsuit was settled by them or a judgment was entered against them, such a resolution should not be considered the return of some ill-gotten gain. It cannot be said that a settlement can be restitution or disgorgement where the directors and officers received no money or ill-gotten gains in the first place. In such a case, coverage for the directors and officers should not be excluded on the public policy grounds announced by the Supreme Court in *Bank of the West*. There is also no public policy justification to preclude the company from recovering those same sums under the indemnification insuring clause just because the company indemnified its officers and directors as obli-

See Parisi, Next Page

Journal of Consumer Attorneys Associations for Southern California
ADVOCATE
August 2007 Issue

gated. No published California decision has explicitly addressed this issue yet.

The *Level 3* Court relied in part on the fact that the underlying suit was settled for a large sum, $12 million. (*Level 3*, *supra*, 272 F.3d at 911-912.) As one commentator noted, in *Level 3* the "insured did not contend that the settlement was paid to avoid the cost of getting rid of a nuisance lawsuit. As a result, the settlement had to have been paid because of the plaintiffs' restitution claim, which was not covered." (4 Windt, Allan D., *Insurance Claims and Disputes: Representation of Insurance Companies and Insureds*, § 6.31, n. 3, (4th Ed. with 2002 Cum. Supp.) (emphasis added).) The *Level 3* court chose not to decide whether, had the underlying lawsuit been groundless and the size of the settlement been very small, there would have been no ill-gotten gain and therefore coverage under the policy. (*Id*. at 912.) This implies that the court looked to the size of the settlement and then concluded that the claims against the insured had at least some merit. This leaves the door open to an insured to argue that (1) the insurer has not produced sufficient evidence that the allegations were true; (2) the amount of the settlement was small indicating that the allegations were not true; and (3) *Level 3* therefore stands nothing more than that restitutionary damages are not a covered loss, but a small settlement which is not restitutionary may be covered.

The *Level 3* Court noted that some types of payments would be covered: "[a]n example would be a fraudulent statement by a corporate officer that inflated the price of the corporation's stock without conferring any measurable benefit on the corporation." (*Level 3*, *supra*, 272 F.3d at 911.) Or, the court explained, an officer stole property for his own benefit and, not knowing this, the insured company "defended against a suit seeking the return of the property and incurred heavy legal expenses in that defense." (*Ibid*.) In such situations, coverage would exist because those "expenses would be a loss to the company not offset by any benefit to it . . . ." (*Ibid*.)

One could also very reasonably argue on behalf of an insured that the *Bank of the West* case, upon which D&O insurers base their restitution arguments, addressed coverage under a comprehensive general liability policy which only insured for "damages." (*Bank of the West, supra*, 2 Cal.4th at 1262.) D&O policies, on the other hand, obligate insurers to pay for losses, which are generally more broadly defined to include "damages, judgments, settlements and Defense Costs." (*See, e.g., Commercial Capital Bankcorp. Inc. v. St. Paul Mercury Ins. Co.* (C.D. Cal. 2006) 419 F.Supp.2d 1173, 1176.)

Where an insured company settles an underlying action and the settlement can be broken out into different types of remedies, unless the D&O insurer can prove which portion of a settlement is clearly for restitution, it may not be able to obtain a summary judgment of no coverage. This is because *Pan Pacific* teaches that the portion of a settlement payment that constitutes something other than disgorgement of ill-gotten gains is recoverable under a D&O policy. Where there is the instance of covered and non-covered acts, it is the duty of the insurer to make the allocation and prove its right to reimbursement from the insured. (Rutter, *Cal. Practice Guide: Insurance Litigation*, ch. 7B, § 7:767.8 (2007).) And, where the character of an insurance payment is disputed, summary judgment is not proper. (*Pan Pacific*, *supra*, 471 F.3d at 969-970; *Unified Western Grocers, supra*, 457 F.3d at 1115.) Moreover, as the *Pan Pacific* court found, to the extent that a trier of fact finds that "the settlement should not be characterized in full as reflecting uninsurable restitutionary relief and finds that the insurers must reimburse ... for any part of the settlement, then the defense costs reasonably related to these covered claims must also be reimbursed." (*Pan Pacific, supra*, 471 F.3d at 971.)

The simple label "restitution" or "damages" does not control whether a loss is covered. "Whatever technical distinctions we and other courts have drawn between restitution and compensatory damages in other contexts, in ordinary terms both concepts are within the definition of 'damages.'" (*AIU Ins. Co., supra,* 51 Cal.3d at 836.) Simply because a plaintiff in an underlying action characterizes the relief they sought as restitution does not make it so. The most common example is the class action by employees against their employers for overtime pay. (*See, e.g., Murphy v. Kenneth Cole Productions* (2007) 40 Cal.4th 1094 [56 Cal.Rptr.3d 880].) At times these employees characterize the relief as restitution under Section 17200, *et seq.* of the Business and Professions Code. However, the California Supreme Court "has held that wrongfully withheld salary payments are 'damages' . . . ." (*Cortez v. Purolator Air Filtration Products Co.* (2000) 23 Cal.4th 163, 174-175 [96 Cal.Rptr.2d 518, 526].)

It must also be remembered that the public policy exclusion for restitution only applies in limited circumstances. "Although the concept of 'restitution' may have a broader meaning in other contexts, we limit our reference to it here to situations in which the defendant is required to restore to the plaintiff that which was wrongfully acquired." (*Bank of the West*, *supra*, 2 Cal.4th at 1266 *citing Jaffee, supra*, 168 Cal.App.3d at 934-935.) The exclusion applies where the "defendant is asked to return something he wrongfully received . . . ." (*Ibid*.) The exclusion *does not* apply where the defendant is "asked to compensate the plaintiff for injury suffered as a result of his conduct." (*Ibid*.) As the Supreme Court held, "[t]o emphasize the distinction between what is insurable and what is not, we noted that *Jaffe* bars coverage only in situations in which *the defendant is required to restore to the plaintiff that which was wrongfully acquired*." (*Id*. at 1270 (emphasis in original, internal quotation marks omitted).)

See Parisi, Next Page

One issue which has not been addressed, except in dicta in a footnote in *CNL*, is whether the portion of a settlement of an underlying action which is for attorneys fees is something other than restitution, and therefore covered. This can be a significant issue – in *CNL* it was $7 million of potential coverage. In *CNL*, with no analysis, the district court stated that the attorney fees were "a part of the sum that CNL disgorged to settle" the class action and was "clearly restitutionary." (*CNL, supra*, at *8.) The CNL court made these statements because it found the "fact that the plaintiffs had to use some [of the settlement proceeds] to pay their attorneys does not alter the character of CNL's payment . . ." (*Ibid.*) However, in California, *Bank of the West* only held that "one may not insure against the risk of being ordered to return money or property that has been wrongfully acquired." (*Bank of the West*, *supra*, 2 Cal.4th at 1266.) To the extent that the attorneys fees in a settlement are paid by the insured company, pursuant to the terms of the settlement agreement or pursuant to the private attorney general statute, California Code of Civil Procedure section 1021.5[6], a strong argument can be made that coverage should exist.

Finally, even if coverage is precluded for one insured, the carrier may still have an obligation to provide coverage for other co-insureds. In California, where several persons or entities are insured under a liability policy, the "innocent" insured is entitled to be indemnified and defended against vicarious liability for a co-insured's willful acts unless the insurance policy clearly provides otherwise. (*American States Ins. Co. v. Borbor by Borbor* (9th Cir. 1987) 826 F.2d 888, 892-895.)

Conclusion

Clearly, the public policy "exclusion" for "restitution" does not apply to all amounts commonly referred to as "restitution." Even the insurer's much touted case, *Level 3*, does not purport to lay down a rule of general application. (*Level 3*, *supra*, 272 F.3d at 911 ("We can imagine situations in which there would be a covered loss.").) To the extent that the plaintiffs in the underlying action seek some type of compensatory damage, a complete denial based on a restitution argument should fail. While this may seem like common sense, perhaps not surprisingly, D&O insurers still try to avoid coverage where there is even a hint of restitution in the underlying action.

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Notes:

[1] Some policies also provide additional coverage for losses incurred by the corporation for its own exposure in securities claims. This additional type of coverage is referred to as Coverage C, or Side C Coverage.

[2] (*August Entertainment, Inc. v. Philadelphia Indemnity Ins. Co.* (2007) 146 Cal.App.4th 565, 573-574 [52 Cal.Rptr.3d 908, 912] ("unlike general liability insurance, which is typically written on standard forms, D&O policy provisions often vary depending on a number of factors, including the nature of the insured's business, the insured's financial condition, and [the] insured's status as a public or private company.").)

[3] D&O carriers also tend to point to *Jaffe v. Cranford Ins. Co.* (1985) 168 Cal.App.3d 930, 935 [214 Cal.Rptr. 567, 570-571], where the court held that recovery of funds overpaid to a healthcare provider involved restitutionary relief outside the scope of covered damages in an insurance policy.

[4] The Seventh Circuit distinguished two similar opinions that held to the contrary. In *Limelight Productions, Inc. v. Limelite Studios, Inc.* (7th Cir. 1999) 60 F.3d 767, the court explained that when the insurers had issued the policies, they "were on notice plaintiffs could recover ill-gotten profits, and must be held to have intended to cover these damages because they did not exclude them." (*Id.* at 768.) Similarly, in *International Ins. Co. v. Johns* (11th Cir. 1989) 874 F.2d 1447, 1452, the court analyzed an insurance policy that defined the "term 'Loss' [as] any amount which the insureds are legally obligated to pay for a claim or claims made against them for wrongful acts, and shall include but not be limited to damages, judgments, settlements and costs." The *Johns* court held that the settlement, despite arguably being restitutionary, was a covered loss because it "fits within the plain language of the policy's definition of loss." (*Id.* at 1454-55.) The *Level 3* Court distinguished these cases in a sentence stating that "the operative term in the insurance policy was 'damages' rather than 'loss,' and so was broader." (*Level 3, supra*, 273 F.3d at 910.)

[5] The alternative damage theory was based on the "value of information" allegedly withheld in the failure to disclose material facts. (*Pan Pacific*, *supra*, 471 F.3d at 969.) Therefore, damages could be awarded to "reflect the intrinsic value of specific information withheld, as opposed to the impact of such information on the marketplace." (*Ibid.*)

[6] California Code of Civil Procedure section 1021.5 provides in part as follows: "Upon motion, a court may award attorneys' fees to a successful party against one or more opposing parties in an action which has resulted in the enforcement of an important right affecting the public policy" if certain criteria are met.