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Coverage for Ill-Gotten Gain under D&O Policies: The Legacy of *Level 3*

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I. Introduction

One of the most common points of dispute between Directors' and Officers' Liability insurers[1] and their insureds is the question of coverage for an insured's payment to resolve a claim for wrongful acquisition of a financial asset or wrongful failure to pay a financial obligation. Judge Richard Posner's November 26, 2001 opinion in *Level 3 Communications, Inc. v. Federal Insurance Co.*, 272 F.3d 908 (7th Cir. 2001) ("*Level 3*") continues to have extraordinary influence on that issue. This paper takes a fresh look at *Level 3* and cases that have applied or distinguished *Level 3* in the 16 years since, including recent decisions that have addressed *Level 3* in the context of changes to D&O policy wording. The paper's broad conclusion is that the principles of *Level 3* are alive and well in spite of wording changes that have been argued by some to limit its effect.

This paper organizes its analysis around three principle questions:

1. **Is a *Level 3* analysis based on policy interpretation or public policy?**
2. **What are the characteristics of settlements or judgments to which the *Level 3* coverage principle[2] applies?**
3. **Have changes to D&O policy forms reduced the impact of *Level 3*?**

[1] The issue is not unique to D&O insurance, and indeed some of the cases discussed in this paper involve GL, professional liability or E&O, and other coverages.

[2] A precise statement of the "*Level 3* coverage principle" is elusive. It has been expressed in many different and often contradictory ways by insurers, insureds and courts, and its boundaries are the subject of debate. For purposes of this paper, Judge Posner's expression is at least the starting point: "a 'loss' within the meaning of an insurance contract does not include the restoration of an ill-gotten gain." *Id*. at 910.

II. The *Level 3* Opinion

Level 3 arose out of a 1994 securities fraud lawsuit filed against Kiewit Diversified Group Inc. (subsequently known as Level 3 Communications, Inc. ("Level 3 Inc.")), its subsidiary MFS Communications, Inc. ("MFSCC"), and James Crowe (the CEO of MFSCC), by former minority stockholders of an MFSCC subsidiary, Metropolitan Fiber Systems, Inc. ("MFS Telecom"). MFSCC had purchased the stockholders' MFS Telecom shares in 1992, just a year before taking MFS Telecom public in an IPO. The former stockholders asserted claims for securities fraud under the Securities and Exchange Act of 1934 and for related torts, alleging that the defendants failed to disclose material information about the value of their MFS Telecom shares, including plans for the IPO.

Level 3 Inc. reported the securities claim to its D&O carrier, Federal Insurance Company. Since the policy covered only the loss of the individual insured Crowe, Federal originally reserved rights and stated that it would pay an 80% allocation of Defense Costs excess of the $2.5 million retention. *See Kiewit Diversified Group v. Federal Ins. Co.*, 999 F. Supp. 1169 (N.D. Ill. 1998). Level 3 Inc. eventually settled the case for $11.8 million, at least part of which was as indemnification of Crowe. Federal denied coverage, based in part[3] on the argument that the settlement was not a covered loss. Level 3 Inc. sued Federal in the Northern District of Illinois, and the issue of coverage for the settlement reached the 7th Circuit in 2001.

In a brief decision under Nebraska law,[4] the 7th Circuit ruled in favor of Federal and found that the settlement was not covered under the Federal policy.

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[3] Federal also denied on the basis of an "insured v. insured" exclusion, but that issue was resolved in another decisions in the same coverage litigation. *See Level 3 Communs. v. Fed. Ins. Co.*, 168 F.3d 956 (7th Cir. 1999).

[4] Although Judge Posner does not cite any Nebraska law in *Level 3*, it is clearly stated in the other Posner decision in the case, *Level 3 Communs. v. Fed. Ins. Co.*, 168 F.3d 956, 957, that the coverage litigation was governed by Nebraska law.

Judge Posner initially noted that Federal raised two alternative coverage arguments. The first was that the settlement had not resulted in a "loss" within the meaning of the policy, because the relief sought was restitutionary in nature. The second was that even if the parties intended that such a settlement would be insured under the policy, coverage would be unenforceable as against public policy. *See Level 3*, 272 F.3d at 909-910.

The court rested its decision solely on the first argument[5], which Judge Posner called the "interpretive principle" and summarized as follows.

> The interpretive principle for which Federal contends–that a "loss" within the meaning of an insurance contract does not include the restoration of an ill-gotten gain–is clearly right.

Id. at 910 (citations omitted.)

Judge Posner noted that the securities plaintiffs in the underlying class action had been seeking "the difference between the value of the stock at the time of the trial and the price they had received for the stock from Level 3," which is "standard damages relief in a securities-fraud case." Such relief is "restitutionary in character," he explained, when

> [it] seeks to divest the defendant of the present value of the property obtained by fraud, minus the cost to the defendant of obtaining the property. In other words, it seeks to deprive the defendant of the net benefit of the unlawful act, the value of the unlawfully obtained stock minus the cost to the defendant of obtaining the stock. ….An 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.

The court acknowledged that the Federal policy defined "loss" as "the total amount which an Insured Person becomes legally obligated to pay … including, but not limited to…

[5] The New York Court of Appeals acknowledged that Judge Posner's decision was based on "contract interpretive principles," as opposed to public policy, in *J.P. Morgan Sec. Inc. v. Vigilant Ins. Co*., 21 N.Y.3d 324, 335-336 (2013).

settlements," *id.* at 909, but rejected Level 3 Inc.'s argument that the insured is covered by any settlement regardless of the nature of the claim against it or the remedy sought.

> That can't be right. *Reliance Group Holdings, Inc. v. National Union Fire Ins. Co.*, 594 N.Y.S.2d 20, 25 (App. Div. 1993) ("determination of this appeal should not hinge on the circumstance that Reliance made restitution by way of settlement instead of in satisfaction of a judgment after trial"). It would mean, as Level 3's lawyer confirmed at argument, that if Level 3, seeing the handwriting on the wall, had agreed to pay the plaintiffs in the fraud suit all they were asking for…, Federal would still be obligated to reimburse Level 3 to retain the profit it had made from a fraud.

Id. at 911.

Judge Posner made it even clearer that his ruling was based on an interpretation of policy language rather than on public policy, when he stated:

> As the interpretive principle controls this case, we need not consider the issue of enforceability, though the two issues are intertwined, since obviously an insurance policy wouldn't be presumed to have been drafted in such a way as to make it unenforceable.

Id. at 910 (citing *Central Dauphin School District v. American Casualty Co.*, 493 Pa. 254, 426 A.2d 94, 1996 Pa. LEXIS 732 (1981).[6]

III. Subsequent Treatment of *Level 3* Generally

The *Level 3* decision remains "good law," and is as influential now as it was in the first years after its publication. A recent Shephard's® report for *Level 3*, as published by LexisNexis®, shows citations in 52 cases between 2002 and 2009, and 54 between 2010 and

[6] In practice, certain details of *Level 3* are often overlooked. For example, the coverage question was in the context of the policy's "company reimbursement coverage" for Level 3 Inc.'s indemnification of the individual insured defendant, Mr. Crowe. *Id*. at 909. But the fact that the actual insured liability was that of Mr. Crowe, who obviously was not an actual party to the underlying transaction, did not affect Judge Posner's determination that Level 3 Inc. was the insured whose alleged "loss" had to be evaluated. Level 3 Inc. had underpaid for the MFS Telecom stock, and through its payment of the settlement as indemnification of Crowe, Level 3 Inc. had made restitution of its ill-gotten gain.

2017. Shepard's® categorizes 20 of the citing decisions as "Positive," while only 18 are denoted with "Caution." There is no apparent trend favoring one category over the other. None of the citing decisions is denoted with "Warning" or "Questioned."

Although *Level 3* applied state law (Nebraska), federal courts – especially in the 7th Circuit (22 times) and the 9th Circuit (18 times) – have cited the decision more often than state courts. New York (7) and Texas (5) are the states whose courts have cited Level 3 the most often.

This author's review of the decisions denoted with "Caution" finds no decisions that expressly reject *Level 3*, but reveals a number of themes that some courts have relied on, correctly or otherwise, to distinguish the decision. Many of the decisions are subject to criticism because the courts have failed to observe Judge Posner's clear distinction between policy interpretation and public policy, a distinction that can be outcome-determinative.

IV. Policy Interpretation or Public Policy?

As noted above, Judge Posner's expressly based his *Level 3* opinion on policy interpretation and did not decide the issue of whether coverage was prohibited as a matter of Nebraska public policy. Other courts, including the 11th Circuit, have cited with approval *Level 3*'s interpretation of the policy term "loss" in accordance with its ordinary meaning, even if the term itself is further defined in the policy to include settlements. See, e.g., *CNL Hotels & Resorts, Inc. v. Twin City Fire Ins. Co.*, 291 F. App'x 220, 223 (11th Cir. 2008) (definition of "loss" was sums insured was "legally obligated to pay..., including… settlement amounts") ; *Republic Western Ins. Co. v. Spierer, Woodward, Willens, Denis & Furstman*, 68 F.3d 347 (9th Cir. 1995) (return of legal fee retainer because of conflict of interest was not covered); *Local 705*

Int'l Bhd. of Teamsters Health & Welfare Fund v. Five Star Managers, 316 Ill. App. 3d 391, 396; 735 N.E.2d 679, 684; 249 Ill. Dec. 75, 80 (Ill. Ct. App.2000) ("The plain and ordinary meaning of "loss" cannot be ignored. [The insured] 'simply cannot lose that to which it was not legally entitled.'"); *Conseco Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 2002 WL 31961447, *12 (Ind. Cir.) ("The definition of "Loss" cannot be read to ignore the word 'Loss' itself, since doing so would completely eviscerate the meaning of the word."); *Pratter v. Reliance Ins. Co.*, 2010 Pa. Commw. LEXIS 733, *14 ("Loss" was defined to include "settlements," but settlement establishing Redress Fund to refund wrongfully charged loan origination fees was not a "Loss").

The distinction between the policy interpretation and public policy approaches is demonstrated in an earlier decision that Judge Posner cited in his opinion.[7] *Central Dauphin Sch. Dist. v. American Casualty Co.*, 493 Pa. 254*, 426 A.2d 94, 1996 Pa. LEXIS 732 (1981) arose out of a taxpayer's successful court challenge of a tax imposed by a school district. A court ordered the school district to refund the taxes, and the school district sought coverage for the refund payments under its School Board Liability Policy. The school board argued that its improper assessment of taxes was the result of negligent conduct, which the policy covered, and that the settlement fell within the policy definition of "loss" because the school board was "legally obligated to pay" it as a result of the taxpayer's lawsuit. The insurer countered that the refunds were not covered "loss" under the policy because the school board had not been entitled to the tax revenues in the first place. The Pennsylvania Supreme Court found there was no coverage for the settlement. Though the court's analysis began with the policy definition of "loss," the court focused on the phrase in the definition that excluded matters "which shall be

[7] As Judge Posner's reliance on earlier case law demonstrates, the principles of *Level 3* had been recognized by other courts well before the issuance of his opinion.

deemed uninsurable under the law pursuant to which this policy shall be construed."[8] *Id*. at *258. With that, the issue became one of public policy. The court's source of public policy was the Pennsylvania Public School Code, which the court read to require any tax refunds to be paid "out of the budget appropriation of public funds." *Id*. at 259. The court stated that government taxation is controlled by constitutional and statutory provisions that must be strictly complied with.

> Because this Commonwealth's public policy does not permit a school district to make unlawful taxation just as revenue-productive as lawful taxation, it must be concluded that a political subdivision's return of tax monies to its taxpayers collected by an unlawful tax is uninsurable. Hence there has been no "loss" within the meaning of the insurance Policy.

Id. The court stated its ruling would be the same even if the school board's conduct were only negligent. *Id.*

The *Central Dauphin* court's rationale is arguably a combination of public policy and policy interpretation, not because of the "uninsurable" wording in the definition of "loss," but because of the court's reliance on the fact that insurance coverage would have allowed the district to effectively keep the tax revenues. In other words, coverage would have given the district a windfall because it really had no loss within the ordinary meaning of the word. In fact, a concurring justice's opinion asserted that the "ordinary meaning of loss" analysis was a specific alternative rationale for the decision: "The school district simply cannot 'lose' that to which it was not legally entitled."[9] *Id*. at 262.

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[8] This clause has been included in D&O policies since well before 1981, and is an indication of the market's long-standing awareness of public policy limitations to insurance coverage.

[9] The concurring Justice Larsen included a convincing counter to a dissenting judge's position that the inclusion of examples such as "damages and settlements" in the policy's definition of "loss" effectively broadened the term beyond its ordinary meaning:

> Despite the broad terms, there is absolutely no indication that a peculiar meaning be given to the word "loss". In fact, the examples which follow the definition are garden-variety "losses": "damages, judgments, settlements and costs, cost of investigation and defense of legal actions . . ." etc. The language of the policy

The majority decision in *Central Dauphin* provides an example of a tendency that many courts interpreting *Level 3* have shown: that of conflating the policy interpretation approach with the public policy approach. That can be a decisive error. As discussed further below, public policy analyses often focus on the nature of the insured's conduct or the particular moral hazard created, while policy interpretations typically stick to analyzing whether the insured has suffered an actual loss. A failure to clearly distinguish the two approaches can cause a presiding court to focus only on broader coverage wording (such as coverage for "Damages" with no specific requirement of actual loss) and find coverage while ignoring a strong public policy defense. Conversely, a court might find coverage for a clear case of returning a mistakenly acquired asset because the conduct was not intentional or egregious enough to trigger public policy concerns.

Judge Posner's awareness of the distinction was made even clearer in a decision issued at nearly the same time as *Level 3*. In *Mortenson v. National Union Fire Ins. Co.*, 249 F.3d 667 (7th Cir. 2001), Judge Posner gave examples of types of insurance coverage that might be forbidden as a matter of Illinois public policy: "taking out a life insurance policy on another person's life without his consent," "insurance against criminal fines [or] punitive damages," and insurance against certain "civil penalties." These are examples of coverage that would raise acute moral hazards or promote willful misconduct. They have nothing to do with whether an insured may have suffered a real "loss."

> does not require that an eccentric meaning be given to the word "loss", and permitting the school district to recover the amount of the refunded taxes from the insurance company would disregard the plain and ordinary meaning rule set forth in *Pennsylvania Manufacturers' Association Insurance Co. v. Aetna Casualty and Surety Insurance Co*., [426 Pa. 453, 233 A.2d 548 (1967)].

Id.

V. What Constitutes the Return of ill-Gotten Gain?

The question of what actually constitutes "return of ill-gotten gain" has been a controversial issue, both in the policy interpretation and public policy contexts. Judge Posner acknowledged that the *Level 3* principle was limited in scope, in part to counter any argument that it rendered coverage "illusory." He noted that a securities claim could assert that an officer's fraudulent statement "inflated the price of the company's stock without conferring any measurable benefit on the corporation," so that a settlement would be a loss to the corporation that is not offset by any benefit. *Level 3* at 911.

J.P. Morgan Sec. Inc. v. Vigilant Ins. Co., 21 N.Y.3d 324 (2013), is a decision that demonstrates the limitations of the ill-gotten gains concept from *Level 3* and is consistent with Judge Posner's decision. The insured in *J.P. Morgan* sought insurance coverage for a $160 million "disgorgement" settlement with the SEC. While the court agreed with the insurer that the portion of the $160 million that constituted a return of the insured's profits from its misconduct was not covered, the court held that the insurer had to reimburse the insured for the portion that represented profits earned by the insureds' clients. That seems uncontroversial and consistent with *Level 3*, in which "[a]ll that the plaintiffs in the underlying suit obtained was the amount they received in settlement of their claim against Level 3, and that amount was part of Level 3's gain from its officers' misbehavior." *Level 3* at 911.

But the contours of what constitutes ill-gotten gain are frequently disputed. There seems to be general agreement that "How the claim or judgment order or settlement is worded is irrelevant." *Id.* But some courts have focused on other factual distinctions in *Level 3* to limit its impact more than Judge Posner may have intended.

a. The Distinction Between Wrongful "Acquisition" and Wrongful "Retention"

In *William Beaumont Hosp. v. Fed. Ins. Co***.,** 552 Fed. Appx. 494 (6th Cir. 2014), the 6th Circuit, applying Michigan law, found that an insured hospital's payment of increased compensation to its nurses in settlement of their claim for violations of the anti-trust laws was a covered loss. It distinguished *Level 3* and some of its progeny[10] by noting that in those cases the insureds were repaying money they had wrongfully "obtained" or "acquired," rather than paying something it had wrongfully "retained." *Id.* at 499. The 6th Circuit found that an insured who settled a claim that it had improperly "retained" something it owed had indeed incurred an insurable "loss" under the terms of the insured's liability policy.

Similar decisions include *Fed. Ins. Co. v. Arthur Andersen LLP*, 2005 U.S. Dist. LEXIS 15706* (N. D. Ill.) (payment of retirement benefits was deemed covered loss because the insured had not improperly acquired the cash used to pay the benefits); *Chubb Custom Ins. Co. v. Grange Mut. Cas. Co.*, 2011 U.S. Dist. LEXIS 111583 (S.D. Ohio 2011) (settlement paid by insured health insurer to customers for underpayments of their claims is covered loss); *Unified W. Grocers, Inc. v. Twin City Fire Ins. Co.*, 457 F.3d 1106, 1115 (9th Cir. 2006) (finding portion of a settlement based on the insured's receipt of "some benefit" might be covered, while the portion based on a claim to "recover… the money or property that the insured wrongfully acquired" would not be covered); *Genzyme Corp. v. Fed. Ins. Co.*, 622 F.3d 62, 70 (1st Cir. 2010) (finding that an insured's settlement was covered loss because by buying back its own shares, the

[10] Namely, *In re TransTexas Gas Corp*., 597 F.3d 298, 310 (5th Cir. 2010) (return of funds due to a fraudulent transfer was not insurable); *CNL Hotels & Resorts, Inc. v. Twin City Fire Ins.Co.*, 291 F. App'x 220, 223 (11th Cir. 2008) (per curiam) (insured acquired money in violation of law so the return of the money was not a covered loss).

insured had not "obtained an identifiable asset" that it was being forced to restore to plaintiffs); and *BLaST Intermediate Unit 17 v. CNA Ins. Cos.*, 544 Pa. 66*, 674 A.2d 687 (Pa. 1996) (the payment of back wages was covered because the court concluded it would not result in a "windfall" to the insured).

Whether viewed as a matter of policy interpretation or public policy, the distinction for coverage purposes between the return of something obtained and the payment of something already owed seems arbitrary. As a matter of policy interpretation, it is unlikely that an insurer would choose to cover an insured for its refusal to pay or perform some obligation, but cover an insured for its decision to take something away from a third party. In either case, the insured has incurred no net loss. The insured is not just "made whole," it is in a better position than it was before the act that gave rise to the dispute. And the public policy issues of fairness and moral hazard seem essentially the same; an insured can choose not to pay wages in order to have them funded by its insurer.

Other courts, even before *Level 3*, have effectively rejected the distinction. In *Safeway Stores v. National Union Fire. Ins. Co. of Pittsburgh, Pa.*, 64 F.3d 1282 (9th Cir. 1995) – more noted as a pro-insured decision for other reasons – an insured acquired in a leveraged buyout settled shareholder class claims by, in part, agreeing to accelerate a dividend payment so that it went to the plaintiff shareholder class rather than the acquiring company, KKR. The insured, Safeway, sought coverage for that part of the settlement as a "loss … which the Insured Person has become legally obligated to pay on account of a claim." The court denied the insured's claim, reasoning that the dividend was an existing obligation and that the payment, "if a 'loss' to anyone, was KKR's, not Safeway's." *Id.* at 1286.

Similarly, in *Town of Brookhaven v. CNA Ins. Cos.*, No. CV-86-3569, 1988 WL 23555* (E.D.N.Y. Feb. 24, 1988), an insured town sought insurance coverage for payments it made to resolve claims that it was obligated to distribute certain tax revenues to school districts. The court found that such payments were not recoverable as loss under the policy because they constituted "the benefit enjoyed by the town by virtue of its improper withholding of money." *Id*. at *3.

Insurers might also argue that a settlement of a claim to enforce an existing obligation does not fall within a policy's insuring agreement. For example, the coverage grant in the *Chubb Custom Ins. Co. v. Grange Mut. Cas. Co.* case was to pay "Loss which the Insures shall become legally obligated to pay as a result of any claim … arising out of any Wrongful Act." 2011 U.S. Dist. LEXIS 111583, *5 (S.D. Ohio 2011.) If an insured is contractually or legally obligated to pay some amount and the payee sues to enforce that obligation, the "Wrongful Act" giving rise to the claim may be the insured's failure to pay, but the insured's legal obligation to pay the payee was the result of the applicable contract or law, not the lawsuit.

In *August Entertainment, Inc. v. Philadelphia Indemnity Ins. Co.*, 146 Cal. App. 4th 565, 52 Cal. Rptr. 3d 908 (2007), the court found that a settlement of a breach of contract claim arising out of a film licensing dispute was "not a loss resulting from a wrongful act within the meaning of" a D&O policy.

> To hold otherwise would make [the insurer] a de facto party to a corporate contract and require it to pay the *full* contract price (plus interest), letting the corporation completely off the hook. Performance of a contractual obligation … is a debt the corporation voluntarily accepted. It is not a loss resulting from a wrongful act within the meaning of the policy.

Id., 146 Cal. App. 4th at 581, 52 Cal. Rptr. 3d at 581. Another example is *American Cas. Co. v. Hotel & Restaurant Empls. & Bartenders Int'l Union Welfare Fund*, 113 Nev. 764, 942 P.2d 172

(finding a claim against trustees for failure to comply with obligations did not result in a "loss" arising out of a "wrongful act").

The Northern District of Illinois took a curious approach on the "Wrongful Act" issue in the *Fed. Ins. Co. v. Arthur Andersen LLP* case discussed above, 2005 U.S. Dist. LEXIS 15706* (N. D. Ill.). As Arthur Andersen was facing financial pressures as a result of the Enron scandal, many of the firm's retired partners sought accelerated distributions of their pension benefits, alleging a contractual right to do so. Some partners submitted letters to Arthur Andersen, and some sued. Arthur Andersen agreed to make the requested distributions pursuant to a settlement agreement and sought coverage under the Fiduciary Liability Coverage portion of its Executive Protection policy.

Among other things, Arthur Andersen's insurer argued that the payment of accelerated retirement plan distributions was not covered under its policy because the distributions did not arise out of alleged Wrongful Acts. The court agreed with Federal's argument only with respect to distributions made to partners who had not sued Andersen but had only submitted letters electing to accelerate, which the court concluded did not actually assert any Wrongful Acts. *Id.* at *48. Benefits paid to partners who sued and alleged Wrongful Acts were deemed covered loss. *Id.*

The Northern District's approach misses the point. Requiring an alleged Wrongful Act – which presumably could include breach of contract – is a low bar and fairly meaningless as a matter of substance. The more appropriate question is whether the payments made by the insured are made *as a result of* a Wrongful Act rather than as a result of an existing commitment.

Claims to enforce contractual obligations may also raise issues under contract or professional liability exclusions, public policy issues in some jurisdictions, and issues regarding

coverage for intentional acts. Whether or not *Level 3* itself stands for the notion that an insurance policy does not cover an insured's settlement of a claim to enforce an existing obligation, the issue remains a significant one.

b. The Egregious Conduct Factor in the Public Policy Context

When a court relies on public policy rather than interpretation of the insurance policy, it typically focuses on the nature of the insureds' alleged conduct. This is not surprising, since public policy decisions in other insurance contexts often relate to intentional or willful misconduct *(see, e.g.,* California Insurance Code §533) or punitive damages. *Fed. Ins. Co. v. Arthur Andersen LLP*, discussed above, 2005 U.S. Dist. LEXIS 15706* (N. D. Ill.), is an example. Federal argued for no coverage under both policy interpretation and public policy rationales. After citing *Mortensen*, the court rejected the public policy rationale, apparently influenced by Andersen's argument that its delay in benefit distributions was a result of its efforts to manage the financial stress caused by sudden demands for accelerated benefits. The court distinguished between a hypothetical repayment of "wrongfully" taken property, on one hand, as opposed to Arthur Andersen's payment of retirement benefits that it had "rightfully" maintained in its possession on behalf of the partners, stating that coverage for the former might violate public policy but coverage for the latter would not. *Id*. at *43, n. 19. While this reasoning also touches on the "return of something acquired" versus "payment of something retained" distinction other courts have made, the Northern District of Illinois' distinction between "rightfully" and "wrongfully" demonstrates its reluctance to assert public policy when the insured's conduct was not egregious.

The association of public policy with egregious conduct is also demonstrated in *Nutmeg Ins. Co. v. East Lake Mgmt. & Dev. Corp.*, 2006 U.S. Dist. LEXIS 85665*, 2006 WL 3408156 (N.D. Ill.). The Nutmeg insured was sued for unlawfully withholding security deposits from tenants, who sought statutory damages equal to twice the amount of the withheld deposits. After settlement, the insurer argued that the statutory damages were not uninsurable under public policy and that the portion equal to the amount of withheld deposits was not a loss to the insured. The court found coverage for the entire amount, rejecting the public policy argument because the damages payable under the statute were not analogous to punitive damages in that they were awardable regardless of whether the landlord's conduct was inadvertent or intentional. *Id.* at *19. (The court rejected the "no loss" argument with respect to the portion attributable to the withheld security deposits because the policy covered "Damages," the definition of which required no actual "loss." *Id.* at *24-25.)

BLaST Intermediate Unit 17 v. CNA Ins. Cos., 544 Pa. 66*, 674 A.2d 687 (Pa. 1996), is an instructive decision that starts out as an analysis of public policy and conduct, but ultimately demonstrates the earlier-discussed tendency of courts to conflate public policy with policy interpretation. The *BLaST* insured sought coverage for its court-ordered payment of back wages under the Equal Pay Act. The insurer apparently only raised, or at least the Pennsylvania Supreme Court only identified, the public policy basis for the argument against coverage. The court found that coverage would not violate public policy, and in doing so attempted to distinguish its earlier ruling in *Central Dauphin Sch. Dist. v. American Casualty Co.*, discussed above, which found no coverage for a school district's refund of improperly imposed taxes. The *BLaST* court seemed to accept the insured's argument that its failure to pay wages in violation of

the Equal Pay Act was a "good faith" mistake, and contrasted that conduct with the "unlawful" imposition of taxes by the *Central Dauphin* school board. Id. at *71-72.

However, apparently straining to justify its conclusion, the court then resorted to an analysis that smacks more of policy interpretation than public policy. The *BLaST* court reasoned that the *Central Dauphin* school board had not suffered a "loss" because the board "would have realized a windfall if allowed to collect from its insurance carrier after refunding the taxes." *Id*. at *73. The *BLaST* insured, on the other hand, would not receive a windfall if its payment of back wages was covered, because the insured would not be placed in a better position than it was in prior to the judgment against it in the Equal Pay Act litigation. *Id.* The decision thus turns out to be more about the "acquisition" and "retention" distinction than about conduct that raises public policy concerns.

Other courts have noted that at least in connection with a policy interpretation analysis, the nature of the insured's conduct is irrelevant. The *Central Dauphin Dauphin Sch. Dist. v. American Casualty Co.* court, for example, noted that whether the school board had or had not been negligent was irrelevant to the issue of whether it had incurred a "loss." 493 Pa. 254*, 259. The 11th Circuit made the same point in *CNL Hotels & Resorts, Inc. v. Twin City Fire Ins. Co.*, 291 F. App'x 220 (11th Cir. 2008), in which it ruled that an insured's settlement of a Section 11 Claim under the Securities Act of 1933 was not a "loss" because the insured had received an inflated purchase price in its public offering of shares.

> The return of money received through a violation of law, even if the actions of the recipient were innocent, constitutes a restitutionary payment, not a "loss." It is immaterial whether CNL committed fraud.

Id. at 223.

VI. Changes to D&O Policy Forms

The most significant recent developments in the treatment of the *Level 3* principle are a result of changes in D&O policy wording over the past 16 years Some of the changes appear to be an attempt in the market – generally a "soft" market – to clarify the impact of *Level3* and its progeny on coverage. The changes that seem most significant from the standpoint of the courts are the narrowing of the ill-gotten gain or conduct exclusions.[11]

This section addresses two recent cases that have relied on the wording of conduct exclusions to limit the impact of the *Level 3* principles.

In *Unites States Bank N. A. v. Indian Harbor Ins. Co*., 68 F. Supp. 3d 1044 (D. Minn. 2014), the coverage claim was asserted by an insured bank in connection with class actions asserting that the bank had collected inflated overdraft fees from its customers. The class actions asserted claims for breach of contract, unconscionability, conversion, and unjust enrichment; and sought return of the excess overdraft fees and damages. The bank settled the claims for $55 million and sought coverage from its professional liability insurers. Putting aside whether some portion of the settlement might have been allocable to covered damages in addition to the repayment of overcharges,[12] this settlement was at least in part a classic case of restitution. But the court found coverage based on policy wording that, according to the court, would override any public policy concern.

[11] The so-called "bump-up" provision is another example of policy wording that has evolved and often affects a *Level 3* analysis in the policy interpretation context. Sometimes written as an exclusion, sometimes as a carve-out of the definition of "loss," the provisions typically address whether, for example, a corporation that acquires another is covered for an increase in purchase price it must pay as a part of the settlement of shareholder litigation arising from an acquisition. There are many different versions, some of which have a broader scope than others. Typically, however, they do not apply to the insurer's obligation to advance Defense Costs.

[12] The court did not reach a decision on that issue.

The policy definition of "loss" excluded matters uninsurable as a matter of law. The federal judge applied Delaware law but did not rule on whether Delaware public policy permitted coverage for the settlement[13]. The judge actually assumed that it would, but found that the policy's "Ill-Gotten Gains" exclusion rendered the public policy issue moot because the exclusion barred coverage for restitution of profits only if a final adjudication found the insured had obtained the profits illegally.

The opinion does not contain a full quotation of the exclusion, but it appears to have been a fairly standard version:

> The provision excludes from coverage a payment for loss connected to a claim resulting from money to which U.S. Bank "is not legally entitled . . . as determined by a final adjudication in the underlying action."

Id. at 1049. The exclusion is often referred to as the "profit" exclusion, and is typically worded to bar coverage for loss in connection with a claim arising from profit or advantage to which an insured was not legally entitled. There are variations, but current D&O policy forms typically limit application of the exclusion to claims which have been found to arise out of illegal profit or advantage in a final adjudication adverse to the insured. The exclusion is often paired with a similar exclusion for claims arising out of fraudulent conduct.[14]

The court distinguished *Level 3* and *CNL Hotels & Resorts, Inc. v. Twin City Fire Ins. Co.* by asserting that the policies in those cases did not contain "ill-gotten gain" exclusions

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[13] The court found no evidence of a Delaware public policy that restitution is uninsurable.

[14] For example, at least one version of the AIG Executive Edge® Broad Form Management Liability Insurance Policy contains a "*Conduct*" exclusion that bars coverage for:

> Loss, other than Crisis Loss, in connection with any Claim made against an Insured… arising out of, based upon or attributable to any:
>
> (a) remuneration, profit or other advantage to which the Insured was not legally entitled; or
>
> (b) deliberate criminal or deliberate fraudulent act by the Insured;
>
> if established by any final, non-appealable adjudication in any action or proceeding other than an action or proceeding initiated by the Insurer to determine coverage under the policy; [proviso with exceptions omitted].

requiring a final adjudication. *Id.* at 1052. It distinguished other decisions that found restitution uninsurable despite similar final adjudication exclusions[15] by criticizing them for failure "to otherwise analyze the impact of the final-adjudication requirement. *Id*.

Gallup, Inc. v. Greenwich Ins. Co., 2015 Del. Super. LEXIS 129, 2015 WL 1201518, is a more recent decision that takes the same approach and largely relies on *U.S. Bank*. The *Gallup* insured sought coverage for settlement of a False Claims Act claim that included the return of overpayments the insured had received as a result of its billing violations. The court found that the settlement constituted "Loss" because the policy definition of "Loss" included settlements, and that since the policy's "Fraud/Ill-gotten Gains Exclusion" required final adjudication, the court did not have to reach the public policy question.

There are at least four significant reasons other courts should be reluctant to follow the *U.S. Bank* and *Gallup* decisions. First, while both courts purport to rely on policy interpretation, it ignores the basic finding of *Level 3:* an insured incurs no "loss" in the ordinary meaning of that word if it is merely returning something it wrongfully obtained. *Level 3* at 911. The *U.S. Bank* court relies on the principle that the policy must be interpreted as a whole, but ignores the ordinary meaning of "loss" and instead refers to the policy's ill-gotten gain exclusion to find a contractual basis for covering the settlement (despite its presumption that coverage would violate public policy).

Second, the *U.S. Bank* court dismisses Judge Posner's concerns about allowing insureds to settle and obtain coverage[16] with a rationale that ignores practical reality and overestimates

[15] Those other cases were *Dobson v. Twin City Fire Ins. Co*., No. 11-cv-0192 (DOC/MLG), 2012 U.S. Dist. LEXIS 93823, 2012 WL2708392 (C.D. Cal. July 5, 2012), which has since been reversed in *Dobson v. Twin City Fire Ins. Co.,* 590 Fed. Appx. 687, 2015 U.S. App. LEXIS 647, 2015 WL 191526; and *Aon Corp. v. Certain Underwriters at Lloyd's of London*, No. 06-16852 (Ill. Cir. Ct. Ch. Div. Dec. 3, 2010)

[16] As noted above, the *Level 3* Court rejected the insured's argument that the bar against coverage for ill-gotten gains does not apply if the case is settled, reasoning:

courts' willingness to allow an insurer simply to say no to a settlement for coverage reasons. The *U.S. Bank* court argues:

> Yet insurance companies can counter that incentive by not consenting to the settlement…. If the Insurers were concerned that the settlement constituted restitution, they could have refused consent or conditioned consent on an admission of liability for wrongdoing or a stipulation that the payment was restitution. The Insurers would have been wiser to refuse or condition consent at the outset rather than consent and later contest coverage in avoidable litigation.

U.S. Bank at 1052. Insurers reading that explanation would immediately hear the ringing of "bad faith" failure-to-settle accusations in their ears. Or at best, and depending on the jurisdiction, an insurer would anticipate the insureds' argument that they were excused from obtaining the insurers' consent because of the insurer's position on coverage for restitution, *see, e.g., TIAA-CREF v. Ill. Nat'l Ins. Co.*, 2017 Del. Super. LEXIS 359, or that the insured's failure to obtain consent was excused because the insurer is unable to prove that it was prejudiced by the settlement. *See, e.g., Hernandez v. Gulf Group Lloyds*, 875 S.W.2d 691 (Tex. 1994).

A third flaw in the *U.S. Bank* decision is its premise that finding that a restitutionary settlement is not covered loss would nullify the Ill-Gotten Gains exclusion as a matter of contract interpretation. *See id*. at 1050. The U.S. District Court for the Southern District of Florida recently rejected that argument in *Phila. Indem. Ins. Co. v. Sabal Ins. Group, Inc*., 2017 U.S. Dist. LEXIS 159508* (S.D. Fla.). The final adjudication limitation in conduct exclusions still serves an important purpose even if indemnification for a settlement is not allowed. It ensures

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> That can't be right…. It would mean, as Level 3's lawyer confirmed at argument, that if Level 3, seeing the handwriting on the wall, had agreed to pay the plaintiffs in the fraud suit all they were asking for…, Federal would still be obligated to reimburse Level 3 to retain the profit it had made from a fraud.

Level 3 at 911 (citing *Reliance Group Holdings, Inc. v. National Union Fire Ins. Co*., 594 N.Y.S.2d 20, 25 (App. Div. 1993).

that even if a claim is a clear-cut effort to obtain restitution or disgorgement, an insurer will advance the insured's defense costs so long as the matter is still being defended. *Id*. at *14-15.

> In fact, the very facts of the instant case bear out this conclusion. "Loss" includes "Defense Costs" as well as "Damages." "Defense Costs" are clearly covered as a "Loss" and do not fall within the exclusionary provisions on "Claims" arising out of the Defendants gaining profit to which they are not legally entitled or "Claims" arising out of a dishonest, fraudulent, or criminal act, unless and until there is a final, nonappealable judgment establishing the Defendants committed such act.

Id. at *15.

Furthermore, as the *Phila. Indem*. court notes,"an exclusionary provision does not apply unless there is coverage in the first instance." *Id.* at *13 (citing *Siegle v. Progressive Consumers Ins. Co*., 819 So.2d 732 (Fla. 2002), and *Amerisure Mut. Ins. Co. v. Auchter Co.*, 673 F.3d 1294 (11th Cir. 2012)). Thus, pursuant to the *Level 3* interpretation, the insured does not even have a "loss" to which an exclusion could be applied.

Finally, though the *U.S. Bank* court strains to try to counter this conclusion, both *U.S. Bank* and *Gallup*, if correct, would allow insurers and insureds to ignore the well-established prohibition against "contracting around public policy." *See, e.g., J.C. Penny Casualty Ins. Co. v. M.K*., 52 Cal. 3d 1009, 1019 n.8:

> [California Insurance Code] Section 533 reflects a fundamental public policy of denying coverage for willful wrongs. (*Tomerlin v. Canadian Indemnity Co.* (1964) 61 Cal.2d 638, 648 [39 Cal.Rptr. 731, 394 P.2d 571].) The parties to an insurance policy therefore cannot contract for such coverage. (Civ. Code, § 1667.) We therefore need not and do not decide whether coverage would be excluded by the explicit policy exclusion in the absence of section 533.); and *CSX Transp., Inc. v. Mass. Bay Transp. Auth*., 697 F. Supp. 2d 213, 229 (D. Mass. 2010) ("Even sophisticated parties cannot contract around public policy.").

The *U.S. Bank* court's attempt to work around that problem fails as a matter of logic. The court assumed that insuring restitution was against Delaware public policy.

> But the Court does not conclude that parties may contract to insure a payment, like restitution, that is uninsurable under public policy. All the Court concludes is

> that parties may agree to ensure that a payment truly fits within a category of matters that are legally uninsurable.

Id. at 1052. That is to say, the state and its courts may establish public policy, but parties to a contract can determine when that policy is violated. It is difficult to imagine a more apt description of parties "contracting around public policy."

Gallup contains a unique error by the court that renders it even more questionable. The court found that the policy was governed by Nebraska law, but then oddly asserts that Judge Posner's decision in *Level 3* did not apply Nebraska law. It did.[17] The *Gallup* court, then, applying the same governing law as Judge Posner, took a completely different approach to interpreting essentially the same policy wording regarding what constitutes "loss."

The *Phila. Indem. Ins. Co. v. Sabal Ins. Group, Inc*. case discussed provides additional reasons to reject *U.S. Bank* and *Gallup*. The coverage claim in *Phila. Indem.* was for a settlement to repay the State of Florida workers' compensation and other payments received based on false claims submitted by the insured. The policy contained a final adjudication profit exclusion, but the court found there was no loss within the meaning of the policy and expressly criticized *U.S. Bank* and *Gallup*. For example:

> I do not find *CNL Hotels* or *Level 3* distinguishable on the basis that the policies at issue did not include exclusionary language requiring a final judgment. While neither case delves deeply into the language of the insurance policies at issue, *Level 3* specifically mentions a final judgment. 'Level 3 acknowledges that if a judgment had been entered in the suit against it on the basis of a judicial determination that it had engaged in fraud, Federal would win; the policy so provides.' *Level 3*, 272 F.3d at 911 (emphasis added).

Phila. Indem. Ins. Co., 2017 U.S. Dist. LEXIS 159508, *14. The court summarized its own conclusion as follows.

[17] *See* fn. 4, *supra*.

> All in all, there is no ambiguity in the Policy and the payments Defendants agreed to pay as part of the Stipulated Settlement Agreement are restitutionary in nature regardless of whether there is an admission of guilt or a final adjudication.

Id. at *16.

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