Ill-Gotten Gains

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Policy Language and Public Policy

Lawsuits seeking to recover wrongfully obtained profits or similar remedies, often referred to as "ill-gotten gains," present unique issues under insurance policies because of the inherently intentional nature of the conduct and the "moral hazard" associated with insuring theft. Various terms and exclusions within insurance policies may preclude coverage for intentional or criminal acts, such as fraud, and some policies include specific exclusions for "ill-gotten gains." Additionally, public policy weighs against insuring the return of money to which an insured was not entitled.

As a general proposition, insurance is not available to permit an insured to recover money to which it had no right but for its wrongful conduct. Nevertheless, policy interpretation issues may arise where the case is settled without a determination that the insured wrongfully obtained profits or that the settlement was meant to disgorge those profits. Additional issues may arise where a suit seeks covered compensatory damages in addition to disgorgement. Courts have resolved these issues by looking at the policy language, the nature of the loss or settlement for which insurance coverage is sought, and, because disgorgement claims usually allege or actually involve wrongful conduct, the public policy against insuring such a loss.

This article will summarize the issues that typically arise in litigation and the most commonly cited cases addressing these issues. It will further highlight very recent decisions demonstrating the application of the general analytical approach employed by courts in ruling on these issues.

The Disgorgement Remedy

The meanings of the terms "disgorgement" and "restitution" are not entirely coextensive, but are similar and often used interchangeably. *Black's Law Dictionary* defines "disgorgement" as "[t]he act of giving up something (such as profits illegally obtained) on demand or by legal compulsion." *Black's Law Dictionary* (9th ed. 2009). Similarly, "restitution" is defined as "[r]eturn or restoration of some specific thing to its rightful owner or status." *Id.* In simplistic terms, an award disgorging profits wrongfully obtained could be used to pay restitution to a plaintiff.

In contrast to compensatory damages, which derive from a plaintiff's loss, and punitive damages, which are designed to punish and deter, courts usually award restitutionary damages as measured by the defendant's unjust enrichment. Specifically, courts may award restitution damages in the form of "disgorgement," which "eliminates the possibility of profit from conscious wrongdoing," and deprives of the defendant of unlawful gain. Restatement (Third) of Restitution and Unjust Enrichment §51 cmt. a & e, §3 cmt. a (2011). In other words, restitution places the defendant in the financial position it would have been but for the wrongful conduct. Restatement (Third) of Restitution and Unjust Enrichment §51 cmt. k (2011). For purposes of this article, the authors refer generally to "disgorgement" or "restitutionary damages" interchangeably.

Disgorgement is an available remedy in multiple contexts. Most commonly, the Securities and Exchange Commission (SEC) will seek disgorgement of illicit investment income in enforcement actions, and, relatedly, shareholders often seek to recover profits wrongfully diverted from one company to another under shared ownership in derivative actions. In the context of a federal trademark action, the Lanham Act, 15 U.S.C. §1051, *et. seq.* (2002), also permits a plaintiff to recover the "defendant's profits" in cases of willful violations. 15 U.S.C. §1117(a). State enactments also recognize the remedy. For instance, Connecticut courts may award disgorgement in a case involving the misappropriation of trade secrets. *E.g.,* Conn. Gen. Stat. §35-53(a)(2016) ("A complainant also may recover for the unjust enrichment caused by misappropriation....").

Policy Language

The Level 3 "Interpretive Principle"

The issue of whether disgorgement is a covered loss most often arises in the context of directors and officers (D&O) and professional liability policies. Consistent with established principles of insurance policy

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interpretation, courts typically look to the definition of "loss" in the first instance, and then for pertinent exclusions, to determine whether there is coverage in a lawsuit seeking disgorgement. Most commonly, courts turn to the "Ill-Gotten Gains" or "Illegal Profits" exclusion.

"Loss" may be defined in an insurance policy as "damages, judgments, settlements, pre-judgment and post-judgment interest… and Defense Costs." Typically, a settlement or judgment meets the requirements of the definition, but the definition of "loss" may also provide exceptions to coverage, such as for "disgorgement by any Insured or any amount reimbursed by any Insured Person." Similar coverage limitations may also be set forth by way of exclusions. For instance, an insurer may exclude itself from providing coverage for "any payment for Loss in connection with any Claim made against an Insured… arising out of, based upon or attributable to the gaining of any profit or advantage to which any final adjudication establishes the Insured was not legally entitled."

Perhaps the most frequently cited case addressing the lack of insurance coverage for disgorgement based on the definition of "loss" is *Level 3 Commc'ns, Inc. v. Fed. Ins. Co.*, 272 F.3d 908 (7th Cir. 2001). Authored by Judge Posner, this decision from the United States Court of Appeals for the Seventh Circuit held that a plaintiff was not entitled to coverage under a D&O policy for amounts paid by the insured corporation to indemnify its officers against a settlement of a lawsuit by shareholders seeking to recover the value of shares purchased based on fraudulent representations made by the insured. The policy there defined "loss" as the "total amount which any Insured Person becomes legally obligated to pay… including, but not limited to… settlements." *Id.* at 909.

The insurer argued that "it's as if… [the insured] had stolen cash from [shareholders] and had been forced to return it and were now asking the insurance company to pick up the tab." *Id.* at 910. Characterizing the relief sought by the shareholders as "restitutionary in nature," Judge Posner wrote that the suit "seeks to deprive the defendant of the net benefit of the unlawful act" and that 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…." *Id.* at 911; *see also Nortex Oil & Gas Corp. v. Harbor Ins. Co.*, 456 S.W.2d 489 (Tex. App. 1970) ("An insured… does not sustain a covered loss by restoring to its rightful owners that which the insured, having no right thereto, has inadvertently acquired…. The insurer did not contract to indemnify the insured for disgorging that to which it was not entitled in the first place…."); *Cf. Limelight Prods., Inc. v. Limelite Studios, Inc.*, 60 F.3d 767 (11th Cir. 1995) ("When Gulf and Select issued these policies they knew of the Lanham Act, 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.").

> Public policy weighs against insuring the return of money to which an insured was not entitled.

The *Level 3* interpretive principle may be the starting point of the analysis of whether a policy covers restitution-like damages, but there are other factors bearing on the determination, including whether the settlement payment made or damages sought can be properly characterized as "disgorgement," whether there is "final adjudication" language, and, most commonly in the context of the duty to defend, whether there are claims for covered compensatory damages in addition to disgorgement.

What Constitutes Disgorgement

Whether a settlement payment constitutes disgorgement is not always clear. Even where the policy language is unambiguous, courts have looked to the nature of the underlying claims and circumstances of the settlement payment to attempt to determine whether it can be classified as disgorgement. In arriving at determinations that coverage may exist, courts usually characterize the loss as something other than disgorgement.

The *Level 3* court recognized that "[h]ow the claim or judgment order or settlement is worded is irrelevant." 272 F.3d at 911 (7th Cir. 2001). Quoting *Reliance Group Holdings, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 188 A.D.2d 47 (N.Y. App. Div. 1993), the court also noted that "determination of this appeal should not hinge on the circumstance that [the insured] made restitution by way of settlement instead of in satisfaction of a judgment after trial." *Id.* This suggests an analysis that is more focused on the true nature of the loss, as opposed to whether it occurs by settlement or judgment, or whether the labels "restitution" or "disgorgement" are applied to the underlying damages.

For instance, the United States Court of Appeals for the Sixth Circuit concluded that a restitutionary settlement was covered, despite that the policy excluded "disgorgement." *William Beaumont Hosp. v. Fed. Ins. Co.*, 552 F. App'x 494 (6th Cir. 2014). The court considered the issue of whether an insured hospital was entitled to coverage for an underlying antitrust suit alleging that it had wrongfully withheld wages, where the hospital had ultimately settled the suit. The policy defined "loss" as the "total amount which any Insured becomes legally obligated to pay on account of each Claim… including, but not limited to, damages, judgments, settlements, costs and Defense Costs." *Id.* at 496. By way of endorsement, the policy excluded "disgorgement by any Insured or any amount reimbursed by an Insured Person." *Id.*

Using the dictionary definitions, the *Beaumont* court noted that "ill-gotten" means "obtains dishonestly or otherwise unlawfully or unjustly" and "gains" means "an increase in or addition to what is of profit, advantage, or benefit… resources or advantage acquired or increased." *Id.* at 499. Reasoning that "[r]etaining or withholding [wages] differs from obtaining or acquiring," the court held that "the damages Beaumont paid in settlement of the claim does not constitute disgorgement." *Id.* Interestingly, the court also found per-

suasive that the policy at issue excluded "disgorgement" but not "restitution," further supporting that it viewed the settlement payment as restitution for withheld wages but not "disgorgement" of wrongfully obtained funds. *Id.* at 498; *see also J.P. Morgan Securities, Inc. v. Vigilant Ins. Co.*, 21 N.Y.3d 324 (N.Y. Ct. App. June 11, 2013) (declining to find that the payment was for the return of improperly acquired funds in the hands of the insured because "the SEC order does not establish that the $160 million disgorgement payment was predicated on moneys that Bear Stearns itself improperly earned as a result of its securities violations. Rather, the SEC order recites that Bear Stearns' misconduct enabled its 'customers to generate hundreds of millions of dollars in profits.'").

Notwithstanding that a settlement may be covered under *Beaumont* and *Vigilant*, which are both heavily cited, a settlement can be excluded from coverage on the basis that it is in the nature of uninsurable disgorgement. This is exemplified by the *Reliance* decision. In *Reliance*, the plaintiffs attempted a hostile takeover of Walt Disney Productions. 188 A.D.2d at 49. To avoid the takeover and settle a derivative action filed by plaintiffs, Disney agreed to purchase plaintiffs' shares at an inflated price. *Id.* at 50. Minority shareholders sued the plaintiffs for breach of fiduciary duty for abandoning a derivative action that plaintiffs had instituted, which actions were settled. *Id.* at 50–51. The plaintiffs sought to collect for the settlement from its insurers. *Id.* at 52.

The court noted that the "settlement [of the derivative action against plaintiff] was essentially equivalent to a determination, reached through agreement of the parties, that [plaintiff] had been unjustly enriched in the amount of $21.1 million through its actions in connection with the Disney takeover attempt." *Id.* at 55. Further, the plaintiffs "sustained no 'loss' as defined in the policy, but rather realized a profit of approximately $74 million in connection with its Disney takeover attempt after the [derivative action] settlement." *Id.* The court looked to the nature of the settlement payment to determine whether it constituted disgorgement. *See also Westport Ins. Corp. v. Hanft & Knight*, 523 F. Supp. 2d 444 (D. Penn. 2007) (despite "in fact" language in the policy exclusion, the court concluded based on the nature of the claims that there was no requirement for a final adjudication to bar coverage, but just required some evidence).

Thus, at least under *Level 3* and *Reliance*, whether the loss for which coverage is sought is a settlement or judgment should not impact the determination of whether a loss is in the nature of disgorgement. Further, labels applied to losses may not be determinative, particularly where the court looks to the circumstances of the settlement and allegations of the claims. *E.g., J.P. Morgan Securities, Inc. v. Vigilant Ins. Co.*, 21 N.Y.3d 324 (loss may be covered despite referring to it as a "disgorgement payment"). However, as is explained below, policies containing "final adjudication" language can put a finer point on whether a settlement payment is in the nature of disgorgement and thus excluded from coverage.

> In other words, restitution places the defendant in the financial position it would have been but for the wrongful conduct.

Final Adjudication Language

In many policies, the definition of "loss" or an exclusion precluding coverage of ill-gotten gains may require that there is a "final adjudication" that the gains were wrongfully obtained. Similarly, policies may include language requiring that the insured was "in fact" not entitled to the funds sought to be disgorged before coverage is barred. In such instances, the language of the settlement document, whether a settlement agreement, stipulation, or consent decree, may come into play.

In *J.P. Morgan Sec., Inc. v. Vigilant Ins. Co.*, the New York Appellate Division considered a case in which the insurer issued a professional liability policy that contained an exclusion for:

> Claim(s)... based upon or arising out of any deliberate, fraudulent or criminal act or omission... provided, however, such Insured(s) shall be protected under the terms of this policy with respect to any Claim(s) made against them in which it is alleged that such Insured(s) committed any deliberate, dishonest, fraudulent, or criminal act or omission, unless judgment or other final adjudication thereof adverse to such Insured(s) shall establish that such Insured(s) were guilty of any deliberate, dishonest, fraudulent or criminal act or omission.

Vigilant, 126 A.D.3d 76, 78 (N.Y. App. Div. 2015).

In the underlying lawsuits, the insured entered a consent decree with the SEC and a stipulation with the New York Stock Exchange (NYSE) in which there were "findings" of misconduct. *Id.* at 80. However, the settlement documents also denied liability by the insured and provided the insured the right to later challenge the "findings." *Id.* at 84. The court held that the exclusion did not apply because "[i]t can hardly be said that the SEC order and NYSE stipulation put Bear Stearns's guilt 'beyond doubt,' when the same documents expressly provided that Bear Stearns did not admit guilt, and reserved the right to profess its innocence in unrelated proceedings." *Id.* at 83; *see also Gallup, Inc. v. Greenwich Ins. Co.*, No. N14-02-136FWW, 2015 Del. Super. LEXIS 129, *29–30 (Feb. 25, 2015) ("The Court finds that this provision shows that Defendant contemplated coverage for restitution and specifically decided that reimbursement for restitution would only be precluded upon a final adjudication that the money Plaintiff received was actually restitution.").

The District Court for the District of Minnesota addressed a settlement agreement in which the insured did not admit liability and did not characterize the settlement payment as restitutionary in nature and reached a conclusion similar to that of the *Vigilant* court. *U.S. Bank Nat'l Ass'n v. Indian Harbor Ins. Co.*, 68 F.Supp.3d 1044, 1050 (D. Minn. 2014). The policy contained

an exclusion for "any payment for Loss in connection with any Claim made against [U.S. Bank]... brought about or contributed in fact by any... profit or remuneration gained by [U.S. Bank] to which [it] is not legally entitled... as determined by a final adjudication in the underlying action." *Id.* at 1047. The case involved a claim for the return of excess overdraft fees. *Id.* at 1050. Reading the policy as a whole, the court considered the exclusion unambiguous and held that:

> [T]he settlement is not a payment that a final adjudication in the underlying action determined is restitution.... In other words, the settlement allegedly constitutes restitution but is not a final adjudication determining restitution.... If a settlement resolves claims alleging unlawful activity but excludes an admission of liability for the activity, it does not establish that the underlying allegations are true or false.

Id. In both *Vigilant* and *Indian Harbor*, the courts found significance in the settlement language denying the allegations that the fund were wrongfully obtained. *Compare Millennium Partners, L.P. v. Select Ins. Co.*, 822 N.Y.S.2d 849 (N.Y. App. Div. 2009), *aff'd* 68 A.D.3d 420 (finding no coverage, the court held that facts in the settlement agreement sufficiently linked the disgorgement settlement to unlawfully acquired money); *Vigilant Ins. Co. v. Credit Suisse First Boston Corp.*, 800 N.Y.S.2d 358, modified 10 A.D.3d 528, 782 N.Y.S.2d 19 (N.Y. App. Div. 2004) (finding no coverage because the decree provided "CSFB shall pay $70 million, representing disgorgement of monies obtained improperly by CSFB as a result of the conduct alleged in the Complaint.").

In a recent decision by the New York Appellate Division, *Soni v. Pryor*, 139 A.D.3d 841 (N.Y. App. Div. 2016), the court reaffirmed that mere allegations of wrongdoing may not suffice to preclude coverage when a policy exclusion requires final adjudication of the underlying claim. The court considered an "ill-gotten gains" exclusion in the context of a legal malpractice claim, where the insureds sued their former attorneys for failing to inform them that they had coverage under a D&O policy in the underlying lawsuit. The former attorneys argued that no coverage existed because the underlying action against the insureds included allegations that the insureds had committed acts of fraud and conversion. *Id.* at 842. In support of its holding, the court cited to *Vigilant*, 126 A.D.3d at 78, and ruled that the lack of final adjudication in the underlying lawsuit against the insureds precluded application of the ill-gotten gains exclusion, where the relevant exclusion required a "final adjudication establish[ing] that [a] criminal, fraudulent or dishonest act occurred," in order to apply. *Soni*, 139 A.D.3d at 843.

Even where the policy language is unambiguous, courts have looked to the nature of the underlying claims and circumstances of the settlement payment to attempt to determine whether it can be classified as disgorgement. In arriving at determinations that coverage may exist, courts usually characterize the loss as something other than disgorgement.

Claims for Other Relief in Addition to Disgorgement

Lawsuits involving claims for both covered and uncovered relief such as disgorgement present an additional challenge. In those cases, whether a settlement payment is for ill-gotten gains as opposed to covered compensatory damages is less clear than where there are only allegations of wrongful conduct. This issue may also arise where the insured seeks a defense for claims that allege wrongful conduct and seek disgorgement of profits, but the complaint also contains covered allegations and claims for relief.

Cases involving covered and uncovered allegations present evidentiary issues concerning the intention behind the settlement. For instance, in *Unified W. Grocers, Inc. v. Twin City Fire Ins. Co.*, 457 F.3d 1106 (9th Cir. 2006), the United States Court of Appeals for the Ninth Circuit addressed a suit containing "other allegations seek[ing] damages proximately caused by the Defendants' actions in an amount greater than the amount of money actually alleged to have been taken by the Defendants." *Id.* at 1115–16. The court denied summary judgment because it found a fact issue as to whether the claims against the insured sought restitution or other relief, reasoning that "[t]he fundamental distinction is not whether the insured received 'some benefit' from a wrongful act, but whether the claim seeks to recover *only* the money or property that the insured wrongfully acquired." *Id.* at 1115 (emphasis added). This suggests that the court would have found no coverage for a claim seeking only restitutionary relief.

"The nature of the damages sought in the underlying action is a critical factor that must be established before the Court can find that the [underlying] claims [] were uninsurable." *Pharos Capital Grp., LLC v. Nutmeg Ins. Co.*, 999 F. Supp. 2d 947, 958 (N.D. Tex. 2014). In *Pharos*, the court considered whether an insured's breach of contract claim against its insurer stated a claim. *Id.* While the court agreed with the insurer that the Fifth Circuit recognizes that "loss" under an insurance contract does not include an "ill-gotten gain," because the underlying plaintiffs did not seek disgorgement or restitution of ill-gotten funds as a remedy against the insured, the court could not conclude that the exclusion applied. *Id.* Because the underlying plaintiffs' claims were based on allegations that the insured wrongfully received millions of dollars from another entity, but did not reveal whether the damages sought were restitutionary in nature, the

court held that it could not conclude at an early stage of the litigation that there was no reasonable basis upon which the insured would be able to recover on its breach of contract claim against the insurer. *Id.; see also Peerless Ins. Co. v. Pa. Cyber Charter School*, 19 F. Supp. 3d 635 (W.D. Pa. May 13, 2014) (the complaint sought "restitution" and "reimbursement," but also sought "damages, interest and costs," which fell within the policy definition of "loss"); *Burks v. XL Specialty Ins. Co.*, No. 14-14-00740-CV, 2015 Tex. App. LEXIS 11610 (Nov. 10, 2015) ("Given that the Burks settled these claims, there is necessarily a fact issue about whether the entire settlement amount represented disgorgement of ill-gotten gains.").

Public Policy

Courts look to the public policy of insuring payments that amount to the return of stolen funds in addition to the policy language. The definition of "loss" or an exclusion may preclude coverage for "matters which may be deemed uninsurable under the law pursuant to which this policy shall be construed." Courts may look to public policy to determine whether disgorgement damages are insurable even where there is no such exclusion. Courts may also look to the public policy relative to the availability of insurance coverage for intentional conduct in light of the intentional nature of conduct giving rise to such claims for relief.

The California Supreme Court succinctly expressed the public policy rationale for precluding coverage for disgorgement damages:

> [W]hen the law requires a wrongdoer to disgorge money or property acquired through a violation of the law, to permit the wrongdoer to transfer the cost of disgorgement to an insurer would eliminate the incentive for obeying the law. Otherwise, the wrongdoer would retain the proceeds of his illegal acts, merely shifting his loss to an insurer.

Bank of the West v. Superior Court of Contra Costa County, 833 P.2d 545, 555 (Cal. 1992). In *Bank of the West*, the court considered a commercial general liability policy in the context of a violation under the California Unfair Business Practices Act, where the plaintiffs' only demand for money damages was for "restitution… of any and all amounts collected by defendants through their unlawful and unfair business practices." *Id.* at 548. Because "[t]he only non-punitive monetary relief available under the Unfair Business Practices Act is the disgorgement of money that has been wrongfully obtained or, in the language of the statute, an order 'restor[ing]… money" the court held that there was no coverage. *Id.* at 552–53.

Courts may look to public policy to determine whether disgorgement damages are insurable even where there is no such exclusion. Courts may also look to the public policy relative to the availability of insurance coverage for intentional conduct in light of the intentional nature of conduct giving rise to such claims for relief.

From state-to-state, the rationale behind the public policy against insuring disgorgement varies little from that stated in *Bank of the West*, and is based on the "moral hazard" of insuring wrongful conduct. Policies expressly excluding from coverage matters "deemed uninsurable under the law pursuant to which this policy shall be construed" may require a court to look to public policy of the state whose law governs the policy when interpreting the exclusion. For instance, Illinois, Pennsylvania, California, and New York have established public policies against insuring disgorgement damages. *See, e.g., St. Paul Mercury Ins. Co. v. Foster*, 268 F. Supp. 2d 1035 (C.D. Ill. 2003) (Illinois); *Central Dauphin School District v. American Cas. Co.*, 493 Pa. 254 (1981) (Pennsylvania); *Bank of the West*, 833 P.2d at 555 (California); *Millennium*, 822 N.Y.S.2d 849 (N.Y. App. Div. 2009), *aff'd*, 68 A.D.3d 420 (New York). In Michigan and Arizona, restitutionary damages may be insurable. *See, e.g., Beaumont*, 552 Fed. Appx. 494 (6th Cir. 2014) (Michigan); *Cohen v. Lovitt & Touche, Inc.*, 308 P.3d 1196 (Ariz. 2013) (insuring restitutionary payments is not contrary to public policy). Some states, such as California, also have statutes against insuring intentional conduct, which may bear on the court's assessment of public policy. *E.g., Unified W. Grocers, Inc. v. Twin City Fire Ins. Co.*, 457 F.3d 1106 (9th Cir. 2006) ("Section 533 [of the California Insurance Code] states: 'an insurer is not liable for loss caused by the willful act of the insured….'").

Conclusion

Due to the complexity of the underlying claims giving rise to disgorgement damages, and the fact-driven determinations that often occur as a result of these claims, courts have not adopted an accepted template for analyzing the insurability of disgorged profits. Compounding the issues that arise with the complexity of such claims, coverage claims for disgorged profits occur with relative infrequency, providing courts with limited opportunity to analyze these issues.

Though there is no widely accepted test for how to analyze the insurability of disgorged profits, courts tend to apply some version of the interpretive principle, as exemplified by *Level 3*, in conjunction with the public policy analysis, as exemplified by *Bank of the West*, when determining whether an insured is entitled to coverage for such claims. In addition to understanding the distinction between the disgorgement remedy and covered damages in complex cases involving financial loss, it is important for insurer and policyholder counsel to be aware of the different analytical approaches. IDQ