Third Quarter 2017 • Vol. XXX • Number 3

PLUS Journal *Reprint*
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Journal
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The Trials and Tribulations of the Definition of "Loss"

by Perry S. Granof

When does a loss under a D&O policy constitute a "Loss?" It is increasingly becoming a more complex question. In March 2005, Richard Bortnick and I published an article in *Mealey's Emerging Insurance Disputes,* entitled: "*When are Settlement And Damage Payments Not 'Loss' Under a D&O Policy?*"

The article focused on the definition of the term "Loss" as considered in several cases and as it applied to the insurability of D&O claims. At that time, the circumstances giving rise to those cases involved four distinct situations. They involved the following:

1. Allegations of restitution of ill-gotten gains (see *Reliance Group Holdings, Inc. vs. National Union Fire Insurance Co. of Pittsburgh, Pa.,* 594 N.Y.S. 2d 20 [App. Div., 1 Dept.] and 82 N.Y. 2d 704 [N.Y. 1993], and *Level 3 Communications, Inc. v. Federal Insurance Co.,* 272 F. 3d 908 [7th Cir. 2001]);
2. An $11.5 million dividend payment, in connection with a leveraged buyout (see *Safeway Stores, Inc. v. National Union Fire Insurance Company of Pittsburgh Pa.,* 64 F. 3d 1282 [9th Cir. 1995]);
3. Restitution of $81.84 million to shareholders in a Section 11 securities case, for purported misrepresentations as to the value of securities sold (see *Conseco Inc. v. national Union Fire Insurance Co. of Pittsburgh, PA.,* No. 49 D 130202CP000348, 202 WL 31961447 [Ind. Cir. Ct. Dec. 31, 2002]); and
4. The disgorgement of $70 million that an insured agreed to pay as part of a settlement with the SEC (*Vigilant Insurance Co. v. Credit Suisse First Boston Corp.,* No. 600854/02 (N.Y. Supreme Ct., New York County July 13, 2003, aff'd 782 N.Y.S. 2d 10[N.Y. App. Div. 2004]).

The courts that addressed the insurability of "Loss" in those instances focused on the issues of whether ill-gotten gains, rescissory or disgorgement remedies, and stock or dividend payments constituted insurable "Loss (es)."

Since the publication of our article in *Mealey's*, the industry has seen insurance companies assert the definition of "Loss" to preclude coverage in additional circumstances, and courts addressing these matters created new considerations, impacting the application of the term "Loss."

For example, in the case of *J.P. Morgan Sec. Inc. vs. Vigilant Ins. Co.* 21 N. Y. 3d. 324 (2013), Morgan Stanley on behalf of Bear Stearns (as a successor in interest) sought indemnification from its insurer Vigilant, for a $160 million disgorgement payment to the SEC in connection with its facilitation of "late trading and deceptive market timing on behalf of certain customers." The insurer had disclaimed coverage, for among other reasons, because the disgorgement payments did not constitute a "Loss" under the subject policy, as a matter of public policy. The case was ultimately appealed to the highest state court in New York, which determined that Bear Stearns' conduct did not lead to any ill-gotten gains directly to itself. Therefore: "...the Insurers (had) not met their heavy burden of establishing as a matter of law…that Bear Stearns (was) barred from pursuing insurance coverage under its policy."

Another example of a case where the definition of "Loss" has been applied to challenge the insurability of a claim involves the issue of consent judgments, also known as non-recourse settlements. These are settlement agreements where a claimant enters into a stipulation *not* to enforce the judgment against

the insured person. In the case of *Intelligent Digital Sys, LLC. Vs. Beazley Ins. Co.,* 2016 U.S. Dist. Lexis 129027, the United States District Court for the Eastern District of New York, applying New York state law, ruled that: "As a matter of law consent judgments against insured persons are covered 'Losses' under the policy."

In the *Intelligent Digital* case, the Eastern District observed that its ruling follows the majority of courts that have ruled on this issue, and noted that the term "Legally obligated to pay" encompassed consent judgments, regardless of whether the judgment included a covenant precluding enforcement of the judgment against insured persons. The court in that case observed that had the underwriter intended to preclude coverage for non-recourse settlements, it could have expressly done so by adding a non-recourse settlement exception to the definition of "Loss." However, it is noteworthy that in at least one jurisdiction, an appellate court ruled that a consent judgment was precluded from coverage by virtue of the policy's definition of "Loss." That is the Eight Circuit of the U.S. Court of Appeals, in the case of *U.S. Bank Nat. Assn. v. Federal Ins. Co.,* 664 F3d. 693 (8th Cir. 2011).

Currently, one can find D&O insurance policies within the industry that have expressly included non-recourse settlements as an exception to the definition of "Loss." For example, underwriters have, in certain instances, modified the definition of "Loss" to preclude coverage for: "any amounts for which an **Insured** is not financially liable or which are without legal recourse to an **Insured**…." The definition of "Loss" has been amended in other ways to clarify an underwriting intent with respect to the scope of the "Loss." For example, certain D&O policies contain language modifying the definition of "Loss" to expressly preclude coverage for stock related "bump-up" claims. This is intended to address the availability of coverage in certain Section 11 securities class and individual actions, especially in situations where a loss payment represents an increase in the consideration paid for the purchase of securities or assets.

Notwithstanding the evolution of issues triggering the application of the definition of "Loss," some courts continue to maintain a bright line test in evaluating its application. That is, unless the definition of "Loss" is expressly modified, in the listing of exceptions, the "Wrongful Act" at issue constitutes a "Loss." Further, in certain jurisdictions, there are only two exceptions where one can successfully argue "public policy" considerations as a bar to coverage, which is typically found as an exception in the definition of "Loss." Those being: (1) One may not insure a punitive damage award; and (2) Insurance cannot cover conduct designed to cause injury. Therefore, in those jurisdictions, unless the conduct at issue falls squarely within one of these exceptions, it cannot be considered to fall outside the definition of "Loss."

In determining whether the claim in question constitutes a "Loss," it is prudent for claims professionals evaluating the issue to carefully scrutinize the underlying conduct giving rise to the claim, the nature of the loss incurred, the applicable policy language, and any applicable law relevant to the jurisdiction where the coverage issue takes place.