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Coverage for Ill - Gotten Gains? Discussing the (Un)Insurability of Restitution and Disgorgement

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Coverage for Ill-Gotten Gains?: Discussing the (Un)Insurability of Restitution and Disgorgement

Katherine C. Skilling*

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I. Introduction

On June 11, 2013, the New York Court of Appeals ruled in favor of Bear Stearns & Co., Inc., a broker-dealer, denying Vigilant Insurance Company’s motion to dismiss Bear Stearns’ complaint.¹ In *J.P. Morgan Securities Inc. v. Vigilant Insurance Co.*,² Bear Stearns³ sought indemnification from Vigilant for approximately \$140 million out of \$160 million that Bear Stearns had paid to the Securities and Exchange Commission (SEC) as “disgorgement” in a settlement of market timing violations claims.⁴ Vigilant argued that, as a matter of public policy, Bear Stearns should not be entitled to indemnification for the \$160 million disgorgement payment “because Bear Stearns enabled its

1. See *J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 992 N.E.2d 1076, 1078 (N.Y. 2013) (reversing and reinstating the insured’s complaint).

2. 992 N.E.2d 1076 (N.Y. 2013).

3. See *id.* at 1080 n.4 (“In 2008, Bear Stearns merged with J.P. Morgan. After the merger, Bear Stearns & Co., Inc. became J.P. Morgan Securities Inc. and Bear Stearns Securities Corp. was renamed J.P. Morgan Clearing Corp.”).

4. See *id.* at 1078–79 (providing the details of the SEC order issued after Bear Stearns agreed to pay \$160 million as “disgorgement”).

customers to make millions through its trading tactics.”⁵ The court rejected the insurer’s public policy argument because Bear Stearns “did not share in the profits or benefits from the late trading, from which it received only \$16.9 million in commissions.”⁶ Because the SEC order did not conclusively refute Bear Stearns’s allegations that approximately \$140 million of the disgorgement payment represented the improper profits of its hedge fund customers, the insurers were not entitled to a dismissal of Bear Stearns’s coverage claim.⁷ Arguably, *J.P. Morgan Securities Inc. v. Vigilant Insurance Co.* narrows the ability of insurers to rely on the public policy rationale to deny coverage for claims or payments labeled as restitution or disgorgement. The rejection of the insurer’s public policy argument in *J.P. Morgan Securities* represents a potential victory for insureds if other courts follow suit in limiting the ability of insurance companies to rely on the public policy rationale.

Deciding whether there is insurance coverage for restitution and disgorgement is especially problematic because the restitution remedy is subject to misunderstanding by both lawyers and judges.⁸ *J.P. Morgan Securities* highlights the uncertainty surrounding the meaning of disgorgement and how it should be measured.⁹ Courts must look at the nature of the claim

5. *Id.* at 1080.

6. *Id.* at 1078.

7. *See id.* at 1083 (“Hence, at this . . . stage, the documentary evidence does not decisively repudiate Bear Stearns’ allegation that the SEC disgorgement payment amount was calculated in large measure on the profits of others.”).

8. *See* Doug Rendleman, *Measurement of Restitution: Coordinating Restitution with Compensatory Damages and Punitive Damages*, 68 WASH. & LEE L. REV. 973, 977 (2011) (discussing the confusion surrounding the restitution remedy); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1 cmt. c (2011) (“Employed to denote liability based on unjust enrichment, the word ‘restitution’ is a term of art that has frequently proved confusing.”); *id.* § 51 cmt. e (“While its purpose is easily stated and readily understandable, the application of the [disgorgement] remedy involves well-known, sometimes intractable difficulties.”).

9. *See J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 922 N.E.2d 1076, 1080 (N.Y. 2013)

[Bear Stearns] acknowledges that it is reasonable to preclude an insured from obtaining indemnity for the disgorgement of its own ill-gotten gains, but contends that it was not unjustly enriched by at least \$140 million of the disgorgement payment because that portion

or payment, rather than the label, to see if it constitutes restitution or disgorgement.¹⁰ However, the problem remains that restitution and disgorgement are not specific terms with universal definitions.¹¹ Thus, it is imperative for courts and lawyers to gain a sound understanding of what these terms mean in the vernacular of remedies.

This Note explores the legal issues surrounding insurance coverage for restitutionary payments and disgorgement of ill-gotten gains. Furthermore, this Note argues that utilizing and adopting the definitions of restitution and disgorgement from the Third Restatement of Restitution and Unjust Enrichment¹² can provide guidance and clarity for both judges and lawyers in determining whether there is coverage for claims or payments labeled as restitution or disgorgement.¹³ Part II provides general background information, including an overview of director's and officer's liability insurance policies, the scope of coverage provided under such policies, and limitations on coverage, as well as an

was attributable to the profits of its customers.

In response to this argument, the insurer contends that, for public policy reasons, it should not be required to indemnify Bear Stearns for the \$160 million disgorgement payment "because Bear Stearns enabled its customers to make millions through its trading tactics." *Id.*

10. See *Pan Pac. Retail Proprs., Inc. v. Gulf Ins. Co.*, 471 F.3d 961, 966 (9th Cir. 2006) ("In deciding whether a certain remedy is insurable, we must look beyond the labels of the asserted claims or remedies." (citation omitted)); *Unified W. Grocers, Inc. v. Twin City Fire Ins. Co.*, 457 F.3d 1106, 1115 (9th Cir. 2006) ("The label of 'restitution' or 'damages' does not dictate whether a loss is insurable." (citations omitted)).

11. Compare *William Beaumont Hosp. v. Fed. Ins. Co.*, No. 13-1468, 2014 WL 185388, at *5 (6th Cir. Jan. 16, 2014) (finding that in order to constitute disgorgement, the hospital would have had to *gain* possession of, rather than *retain*, "the nurses' wages illicitly, unlawfully, or unjustly" (emphasis added)), with *Town of Brookhaven v. CNA Ins. Cos.*, No. CV-86-3569, 1988 WL 23555, at *3 (E.D.N.Y. Feb. 24, 1988) (requiring the town to disgorge the interest it earned on the unlawfully held funds, which represented "the benefit enjoyed by the town by virtue of its improper withholding of money [that] should have been earning interest on behalf of the districts").

12. See generally RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT (2011).

13. See *infra* Part IV.A.1 (explaining why adopting the definitions of restitution and disgorgement from the Third Restatement of Restitution and Unjust Enrichment can help courts gain a sound understanding of these remedies, which will help courts determine whether to grant coverage for restitution or disgorgement on a case-by-case basis).

overview of remedies.¹⁴ Part III addresses the controversies surrounding coverage for restitution and disgorgement and provides a discussion of recent problematic cases.¹⁵ Part IV reiterates the complicated nature of the issues related to the insurability of “restitution” and “disgorgement” and provides several suggested solutions to address these issues.¹⁶ The most promising solution lies in utilizing and adopting the definitions of restitution and disgorgement from the Third Restatement of Restitution and Unjust Enrichment.¹⁷ The Note concludes by emphasizing the importance of courts having an understanding of the terms “restitution” and “disgorgement” as they are used in the vernacular of remedies. If courts adopted the Restatement’s definitions and utilized its guidance when analyzing coverage issues for these misunderstood remedies, then courts would be able to resolve these insurance coverage disputes with some sense of clarity.

II. Background on Insurance Law

A. Insurance Contracts

Because events in life are uncertain, people and entities insure against risks that accompany various activities.¹⁸ Although insurance has been defined in various ways, it is essentially “a contract by which one party (the insurer), for a consideration . . . promises to make a certain payment, usually of

14. See *infra* Part II (providing background on insurance law and discussing the interpretation of insurance contracts).

15. See *infra* Part III (presenting the problem and discussing the applicable law in determining whether an insurer must indemnify its insured for payments that are restitutionary in nature).

16. See *infra* Part IV (proposing several potential solutions to address the issues surrounding the insurability of restitution and disgorgement).

17. See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1 (2011) (“A person who is unjustly enriched at the expense of another is subject to liability in restitution.”); *id.* § 51 cmt. a (“Restitution measured by the defendant’s wrongful gain is frequently called disgorgement.” (internal quotation marks omitted)).

18. See ROBERT H. JERRY, II & DOUGLAS R. RICHMOND, UNDERSTANDING INSURANCE LAW 7 (5th ed. 2012) (defining insurance and discussing the nature of risk).

money, upon the destruction or injury of ‘something’ in which the other party (the insured) has an interest.”¹⁹ Two essential characteristics of an insurance contract are “the assumption of a risk of loss and the undertaking to indemnify the insured against such loss.”²⁰ Insurance can be characterized as first-party or third-party insurance.²¹ In first-party insurance, the insurance contract “indemnifies the insured for a loss suffered directly by the insured,” whereas in third-party insurance, “the interests protected by the contract are ultimately those of third parties injured by the insured’s conduct.”²²

Liability insurance, which is the focus of this Note, is a quintessential example of third-party insurance because “it protects the insured against liability to others.”²³ Of primary concern here is professional liability insurance, which “covers members of various professions, with both the premium and the articulation of coverage based on the specific profession involved.”²⁴ Several different coverage options are available within professional liability insurance, including errors and omissions (E&O) coverage and directors and officers (D&O) liability coverage.²⁵ Errors and omissions coverage protects “against liability based on the failure of the insured, in his or her professional status, to comply with what can be considered in simplistic terms to be the standard of care for that profession.”²⁶

Directors and officers liability coverage protects “against both liability based on official actions of corporate officers and directors, and the expense of defending actions that seek to establish liability.”²⁷ A common D&O policy “offers indemnification to the corporation for loss arising from a claim made against an officer or director of the corporation acting in his

19. 1 STEVEN PLITT ET AL., COUCH ON INSURANCE § 1:6 (3d ed. 2013).

20. *Id.* § 1:9.

21. JERRY & RICHMOND, *supra* note 18, at 45.

22. *Id.*

23. *Id.*

24. PLITT ET AL., *supra* note 19, § 1:35.

25. *See id.* (providing that under modern practice two of the more common coverages within professional liability insurance are E&O coverage and D&O liability coverage).

26. *Id.*

27. *Id.*

or her capacity as such.”²⁸ To be within coverage, the officer or director must be sued as an officer or director of the corporation, and the alleged wrongful conduct must have occurred while the officer or director was discharging her corporate duties.²⁹

B. D&O Policies

Most D&O policies offer three types of coverage: “Side-A,” “Side-B,” and “Side-C.”³⁰ Side-A coverage protects individual directors and officers, typically providing that the insurer will indemnify directors and officers for loss resulting from any claim made against them for a wrongful act.³¹ Side-B coverage generally provides reimbursement to entities that indemnify individual directors and officers that are sued in their capacities as directors and officers.³² The corporate insured is generally not covered for its own losses as a defendant in litigation unless the policy provides “entity” coverage.³³ The insured entity may choose

28. *Id.*

29. See 9A PLITT ET AL., *supra* note 19, § 131:31 (providing that a typical D&O policy “defines ‘director and officer’ to include any past, present, or future duly-elected or appointed director or officer of the company”).

30. See MICHAEL R. DAVISSON ET AL., DIRECTORS & OFFICERS LIABILITY INSURANCE DESKBOOK 29 (3d ed. 2011) (explaining three types of coverage included in most D&O policies).

31. See *id.* at 30 (providing a typical definition of Side-A coverage).

32. See *id.* at 29 (discussing the protection afforded under Side-B coverage).

33. See, e.g., Clark v. Gen. Accident Ins. Co., 951 F. Supp. 559, 561 (D.V.I. 1997) (“These provisions have been interpreted to mean exactly what they purport to state, i.e. that the named insured is not covered except to the extent that it may indemnify its directors and officers for covered loss incurred by them.”); Farmers & Merchs. Bank v. Home Ins. Co., 514 So. 2d 825, 829 (Ala. 1987) (“The second insuring clause very plainly provides primary insurance coverage to the Bank to the extent the Bank has indemnified its officers and directors for covered losses incurred by those officers and directors.”); Nat’l Bank of Ariz. v. St. Paul Fire & Marine Ins. Co., 975 P.2d 711, 715–16 (Ariz. 1999) (“NBA’s directors and officers did not face any liability, thus NBA is not entitled to any coverage or reimbursement under its D & O Policy. To find coverage under NBA’s D & O Policy under these circumstances would be to transform it into a corporate liability policy.”); Buckingham Apartments, Ltd. v. Liberty Mut. Ins. Co., 508 N.Y.S.2d 493, 495 (N.Y. App. Div. 1986) (“The policy expressly limits recovery to those instances in which an officer or director is entitled to indemnification from the corporation, or where an officer or director is obligated to pay an amount based upon his legal liability for an actual or asserted wrongful act.”).

to obtain Side-C coverage, commonly referred to as “entity” coverage, for claims against the company itself, provided that the insurer offers such coverage.³⁴

C. Scope of Coverage

In order for the insured to recover under a D&O or an E&O policy, the claim must be covered by the terms of the contract.³⁵ Therefore, to obtain coverage, an insured must make a claim that falls within the coverage provisions of a liability policy.³⁶ Ultimately, the court must determine “whether the claim falls within the policy’s scope of coverage.”³⁷ Typically the concept that insured individuals “are covered only for actions taken in an insured capacity” is included in the definition of “director,” “officer,” or “wrongful acts.”³⁸ In sum, determining whether the insurer will provide coverage under E&O and D&O policies hinges on whether a covered individual, in his or her insured capacity, has committed a negligent act, error, or omission during the coverage period.³⁹ The term “wrongful acts” is typically defined to mean negligent, rather than intentional, conduct.⁴⁰ Most liability policies provide that “loss” does not include

34. See DAVISSON ET AL., *supra* note 30, at 36 (explaining that some D&O policies extend Side-C coverage and that “[s]uch coverage may be optional and extended only upon the payment of an additional premium”).

35. See 9 PLITT ET AL., *supra* note 19, § 126:1 (providing that the insurance contract determines the extent of coverage under a given policy).

36. See *id.* (explaining that no recovery may be had for a claim that falls outside the coverage provisions or that falls within a policy exclusion).

37. See DAVISSON ET AL., *supra* note 30, at 63 (providing several important questions in determining the scope of coverage, such as “who is afforded coverage under the policy terms, and what manner of claims, wrongful acts or losses are covered under the policy?”).

38. See *id.* (noting that “D&O policies do not cover wrongful acts taken in a personal capacity or on behalf of an entity other than the insured”).

39. See 9A PLITT ET AL., *supra* note 19, § 131:1 (discussing protection afforded under E&O and D&O policies).

40. See Donald R. McMinn, *Transactional Lawyers Under Fire: A Look at Coverage Questions Arising in the Context of Securities Class Action Suits Against Legal Professionals*, 38 TORT TRIAL & INS. PRAC. L.J. 999, 1002 (2003) (providing, for example, that policies covering an insured’s liability for “wrongful acts” will “define the term to mean acts that are negligent,” not acts that are intended to cause harm to a third party).

coverage for matters uninsurable under applicable law.⁴¹ Insurance companies often use this limitation to deny coverage for claims that are restitutionary in nature.⁴² Along with explicit policy exclusions, courts and legislatures impose limitations on coverage as well.

D. Limitations on Coverage

1. Restitution and Disgorgement

Although the typical definition of loss does not explicitly exclude payments that are restitutionary in nature, courts in many jurisdictions have held such awards uninsurable based on two rationales.⁴³ First, several courts have held that restitutionary payments, or payments that represent the disgorgement of wrongfully or illegally obtained profits, “are uninsurable because such amounts do not constitute loss” within the meaning of an insurance policy.⁴⁴ Other courts have held

41. See *Cohen v. Greenwich Ins. Co.*, No. C20092552, 2011 WL 8780709, at *3 (Ariz. Super. Ct. Dec. 1, 2011) (quoting the insurance policy as providing that loss does not include “matters which are uninsurable under the law pursuant to which this policy is construed”); *Cent. Dauphin Sch. Dist. v. Am. Cas. Co.*, 426 A.2d 94, 95 (Pa. 1981) (quoting the insurance policy as providing that “loss shall not include fines imposed by the law, or matters which shall be deemed uninsurable under the law pursuant to which this policy shall be construed”).

42. See, e.g., *Zayed v. Arch Ins. Co.*, 932 F. Supp. 2d 956, 965 (D. Minn. 2013) (“Arch argues that Cook’s claim for return of Oxford’s \$2.5 million investment in Mesa is ‘uninsurable under [Minnesota] law,’ and thus the judgment entered against Mesa . . . is not a ‘Loss’ for purposes of the Policy.”).

43. See *infra* Part III.B–C (providing a detailed discussion of cases holding that restitutionary payments are uninsurable, either under the interpretive principles of contract law or under the public policy rationale); *DAVISSON ET AL.*, *supra* note 30, at 70–75 (discussing numerous cases that have found restitutionary payments and disgorgement of ill-gotten profits uninsurable).

44. *DAVISSON ET AL.*, *supra* note 30, at 70; see, e.g., *Safeway Stores, Inc. v. Nat’l Union Fire Ins. Co.*, 64 F.3d 1282, 1286 (9th Cir. 1995) (finding that Safeway’s payment of an \$11.5 million early dividend is not a loss under the terms of the D&O policy because “[n]either the owners of that corporation nor its directors suffered a loss”); *CNL Hotels & Resorts v. Hous. Cas. Co.*, 505 F. Supp. 2d 1317, 1324–26 (M.D. Fla. 2007) (“[I]f the insured is simply being forced to return money to which it was not entitled, the event is not a loss.”); *Vigilant Ins. Co. v. Credit Suisse First Bos. Corp.*, 782 N.Y.S.2d 19, 20 (N.Y. App. Div. 2004) (“Restitution of ill-gotten funds does not constitute ‘damages’ or a ‘loss’ as those terms are used in insurance policies.”).

“that it is against public policy to insure against the risk of being ordered to return money or property that has been wrongfully acquired.”⁴⁵ In some states, it is also against public policy to afford coverage for intentionally harmful or criminal misconduct.⁴⁶ However, some jurisdictions permit coverage for intentional acts.⁴⁷ Insurers can assert a state’s public policy as a defense to coverage under circumstances in which the insured is seeking coverage for restitutionary awards, disgorgement, or intentional acts.⁴⁸

2. Intentional Acts

In the majority of jurisdictions, insurance coverage for intentional wrongdoing is precluded in two situations.⁴⁹ The first

45. DAVISSON ET AL., *supra* note 30, at 70; *see, e.g.*, *Bank of the W. v. Super. Ct.*, 833 P.2d 545, 554 (Cal. 1992) (“At least absent demonstrably unusual circumstances, we have doubts whether an insurance policy which purported to insure a party against payments of a restitutionary nature would comport with public policy.”); *Cent. Dauphin Sch. Dist.*, 426 A.2d at 97 (“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.”).

46. *See, e.g.*, *St. Paul Fire & Marine Ins. Co. v. F.H.*, 55 F.3d 1420, 1423 (9th Cir. 1995) (“It is true, as St. Paul argues, that Alaska recognizes a general public policy against insuring a person against liability for his or her intentional acts.”); *Grumman Sys. Support Corp. v. Travelers Indem. Co.*, 828 F. Supp. 11, 13 (E.D.N.Y. 1993) (“This Court finds that an insurance agreement that indemnifies for liability incurred as a direct result of a violation of an injunction is void as against public policy.”); *Marie Y. v. Gen. Star Indem. Co.*, 2 Cal. Rptr. 3d 135, 153 (Cal. Ct. App. 2003) (providing that California Insurance Code Section 533 codifies California’s public policy, which precludes insurance coverage for willful acts and reads the exclusion into every insurance policy); *Pub. Serv. Mut. Ins. Co. v. Goldfarb*, 425 N.E.2d 810, 814 (N.Y. 1981) (providing that whether insurance coverage for civil liability arising from a criminal act is precluded by public policy “depends upon whether the insured, in committing his criminal act, intended to cause injury”).

47. *See infra* note 56 (discussing cases that have found that it is not against public policy to insure against losses resulting from intentional acts).

48. *See* DAVISSON ET AL., *supra* note 30, at 75 (explaining that in states where it is against public policy to cover certain acts, the state’s public policy becomes a defense to coverage).

49. *See id.* (discussing the two situations in which courts preclude insurance coverage for intentional wrongdoing).

situation is “where the insured acted with the subjective intent to cause harm to a third party.”⁵⁰ To determine whether the insured acted with the requisite subjective intent, courts consider whether the insured intended to inflict the injury.⁵¹ If the insured’s intentional act caused unintended injury, then public policy will not preclude coverage because the insured did not act with the requisite intent.⁵² The second situation is “where the harm is an inherent result of the conduct at issue.”⁵³ In such a situation, regardless of the insured’s subjective intent, courts will infer intent to injure from the nature of the insured’s act.⁵⁴ For example, “courts have inferred intent to harm in claims arising from misconduct including securities fraud, assault, and malicious prosecution.”⁵⁵ However, there are some jurisdictions that permit coverage for intentional acts.⁵⁶ Because courts

50. *Id.*

51. *See id.* (discussing how courts analyze coverage for intentional acts).

52. *See* Pub. Serv. Mut. Ins. Co. v. Goldfarb, 425 N.E.2d 810, 814 (N.Y. 1981) (“One who intentionally injures another may not be indemnified for any civil liability thus incurred. However, one whose intentional act causes an unintended injury may be so indemnified.”).

53. DAVISSON ET AL., *supra* note 30, at 75.

54. *See, e.g.,* Dodge v. Legion Ins. Co., 102 F. Supp. 2d 144, 151 (S.D.N.Y. 2000) (“When the alleged harm is an inherent result of the act, however, intent to injure will be inferred as a matter of law from the intentional character of the conduct.”); Vt. Mut. Ins. Co. v. Malcom, 517 A.2d 800, 802 (N.H. 1986) (“Nor can an insured’s intentional act be an accidental cause of injury when it is so inherently injurious that it cannot be performed without causing the resulting injury.”).

55. DAVISSON ET AL., *supra* note 30, at 76; *see, e.g.,* Dodge, 102 F. Supp. 2d at 150 (finding that the insured’s acts “of kissing, embracing, sodomizing and engaging in intercourse with Dodge during her therapy sessions” are intrinsically intentional); Downey Venture v. LMI Ins. Co., 78 Cal. Rptr. 2d 142, 506 (Cal. Ct. App. 1998) (providing that the harm and injury caused by malicious prosecution to the plaintiff and the judicial process “were both inherent and predictable,” so the insurer was not required to indemnify the insured for a settlement of the malicious prosecution claims).

56. *See* Mo. Pub. Entity Risk Mgmt. Fund v. Investors Ins. Co., 338 F. Supp. 2d 1046, 1051 (W.D. Mo. 2004) (concluding that it is not against public policy to enforce insurance contracts that cover intentional acts of discrimination); Chi. Bd. of Options Exch. Inc. v. Harbor Ins. Co., 738 F. Supp. 1184, 1187 (N.D. Ill. 1990) (finding that there is no Illinois public policy against a corporation insuring against losses stemming from the intentional torts of its directors and officers); Grinnell Mut. Reinsurance Co. v. Jungling, 654 N.W.2d 530, 541 (Iowa 2002) (concluding that freedom of contract for insurance coverage should prevail over the public policy reasons for barring coverage for the

generally hold that it is against public policy to insure against intentional conduct,⁵⁷ punitive damages for those intentional acts are also not within the scope of coverage.⁵⁸

3. Punitive Damages

Punitive damages are damages “awarded against a person to punish him for his outrageous conduct and to deter him and others like him from similar conduct in the future.”⁵⁹ There is a substantial split among courts as to whether punitive damages arising out of an accident, or awarded for gross, malicious, wanton, or reckless conduct, are covered under the terms of a liability policy.⁶⁰ Courts holding that punitive damages are

intentional act of fraud).

57. See *supra* notes 50–55 and accompanying text (discussing situations in which courts prohibit coverage for intentional wrongdoing).

58. See JERRY & RICHMOND, *supra* note 18, at 522 (providing that punitive damages for an intentional tort are not coverable because it would be against public policy to permit such coverage).

59. RESTATEMENT (SECOND) OF TORTS § 908 (1979).

60. Compare *Shelter Mut. Ins. Co. v. Dale*, 914 So. 2d 698, 703 (Miss. 2005) (holding that Mississippi law does not prevent insurers from excluding coverage for punitive damages, but insurers may provide additional coverage for punitive damages), *Collins & Aikman Corp. v. Hartford Accident & Indem. Co.*, 436 S.E.2d 243, 246 (N.C. 1993) (holding that a policy that covered compensatory or nominal damages for bodily injury also covered liability for punitive damages because “[p]unitive damages were recovered because of the recovery for bodily injuries”), *Lazenby v. Universal Underwriters Ins. Co.*, 383 S.W.2d 1, 8 (Tenn. 1964) (allowing coverage for punitive damages and stating that if insurers believe punitive damages protection should not be afforded, then insurers can make a provision in the exclusions section to that effect), *Fluke Corp. v. Hartford Accident & Indem. Co.*, 34 P.3d 809, 816 (Wash. 2001) (stating that the policy at issue provided indemnification for “damages” without limiting payment to compensatory damages or expressly excluding punitive damages, and insurers cannot “raise public policy as a sword to sever the bargain between insurer and insured”), and *Hensley v. Erie Ins. Co.*, 283 S.E.2d 227, 233 (W. Va. 1981) (refusing to find that West Virginia “public policy precludes insurance coverage for punitive damages arising from gross, reckless or wanton negligence”), with *Bohrer v. Church Mut. Ins. Co.*, 12 P.3d 854, 857 (Colo. Ct. App. 2000) (concluding that “an insurer’s promise to pay post-judgment interest on punitive damages and damages for intentional torts is against public policy”), *McCabe v. St. Paul Fire & Marine Ins. Co.*, 914 N.Y.S.2d 814, 817–18 (N.Y. App. Div. 2010) (finding that attorney’s professional liability insurer was not obligated to indemnify him with respect to the award of treble damages because “New York public policy precludes insurance indemnification for punitive

uninsurable focus on the nature and purpose of punitive damages, which is the deterrence of certain kinds of conduct.⁶¹ Permitting insureds to escape liability for punitive damages would frustrate the deterrent effect of such damages.⁶² Insurers try to avoid insuring people against risks that are more likely to occur if they have insurance because this creates the problem of “moral hazard.”⁶³ Typically, insurance policies will state that the insurer will provide coverage for “all sums which the insured is legally obligated to pay as damages.”⁶⁴ Despite this broad language providing coverage for damages, courts have found that punitive damages are not included in the term “damages.”⁶⁵

On the other hand, some courts have held that when there is no provision in the policy specifically excluding punitive damages, there can be coverage for punitive damages.⁶⁶ In terms of

damage awards”), and *City of Fort Pierre v. United Fire & Cas. Co.*, 463 N.W.2d 845, 848–49 (S.D. 1990) (finding that civil penalties requested by the United States in the federal lawsuit were punitive in nature and that the award of punitive damages would violate public policy).

61. See, e.g., *City of Fort Pierre v. United Fire & Cas. Co.*, 463 N.W.2d 845, 848–49 (S.D. 1990) (“Two interests implicated by an award of punitive damages are punishment to the wrongdoer and deterrence of the wrongdoer’s conduct.”).

62. See *State Fund Mut. Ins. Co. v. Enebo*, 458 N.W.2d 161, 163 (Minn. Ct. App. 1990) (“Allowing a person against whom punitive damages are assessed to shift responsibility for paying those damages to an insurer would frustrate the deterrent purpose of punitive damages.”); *City of Fort Pierre*, 463 N.W.2d at 849 (“Were a person able to insure himself against economic consequences of his intentional wrongdoing, the deterrence attributable to financial responsibility would be missing.”).

63. See *Mortenson v. Nat’l Union Fire Ins. Co.*, 249 F.3d 667, 671 (7th Cir. 2001) (“The temptation that insurance gives the insured to commit the very act insured against is called . . . ‘moral hazard’ and is the reason that fire insurance companies refuse to insure property for more than it is worth—they don’t want to tempt the owner to burn it down.”).

64. 12 PLITT ET AL., *supra* note 19, § 172:33.

65. See *Nationwide Mut. Ins. Co. v. Knight*, 237 S.E.2d 341, 345 (N.C. Ct. App. 1977) (concluding that “the inclusive language of the policy does not cover punitive damages that might be assessed against the insured”). Punitive damages do not constitute compensation for injuries sustained. *Id.* Rather, punitive damages are awarded over and above actual damages in an effort to punish the defendant and to deter certain types of conduct. *Id.*

66. See, e.g., *Ridgway v. Gulf Life Ins. Co.*, 578 F.2d 1026, 1029 (5th Cir. 1978) (finding that the unqualified wording of the policy, which provided that the insurer agreed “[t]o indemnify the insured for all sums which the insured shall be obligated to pay by reason of the liability . . . imposed on the insured by law,” includes both actual and punitive damages); *Phila. Indem. Ins. Co. v.*

interpretation of policy language, these courts view punitive damages as covered by the express words of the policy.⁶⁷ In *Meijer, Inc. v. General Star Indemnity Co.*,⁶⁸ the U.S. District Court for the Western District of Michigan permitted coverage for punitive damages because the policy did not explicitly exclude them.⁶⁹ The court reasoned that

[t]o hold that punitive damages are not recoverable would create, in effect, an exclusion for which the parties did not negotiate and allow insurance companies to collect premiums for coverage of a risk that they voluntarily assumed and then escape their obligation to pay on a claim by a mere judicial declaration that the contract is void by reason of public policy.⁷⁰

Some legislatures have passed laws addressing the insurability of punitive damages.⁷¹ In Virginia, for example, the legislature has declared that it is not against the public policy of

Stebbins Five Cos., No. 302CV1279M, 2004 WL 210636, at *3 (N.D. Tex. Jan. 27, 2004) (“Accordingly, the Court finds that the CGL agreement and the Professional Liability agreement unambiguously provide coverage for an award of punitive damages, unless otherwise excluded.”); *Providence Wash. Ins. Co. v. City of Valdez*, 684 P.2d 861, 863 (Alaska 1984) (“Under the terms of the policy Providence has not specifically excluded punitive damages. We therefore conclude that the liability policy Providence issued to Valdez provides coverage for punitive damages.”); *Am. Home Assurance Co. v. Safway Steel Prods. Co., Inc.*, 743 S.W.2d 693, 702 (Tex. App. 1987) (noting that “Texas courts that have interpreted the ‘all sums’ phrase have held that the term encompasses punitive damages” and holding that policy providing coverage for “all sums which the insured shall become legally obligated to pay as damages because of . . . bodily injury” covered punitive damages).

67. See *S.C. State Budget & Control Bd. v. Prince*, 403 S.E.2d 643, 648 (S.C. 1991) (finding that the policy at issue does not limit recovery to actual damages because the policy did not define damages). Because the policy used broad language, providing that “[t]he Fund will pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages,” the policy must be read as encompassing punitive damages. *Id.*

68. 826 F. Supp. 241 (W.D. Mich. 1993).

69. See *id.* at 247 (“Under Michigan law, insurers may limit the risks that they elect to assume, but they must clearly express limitations on coverage and any failure to do so is construed against the drafting insurer and in favor of finding coverage under the policy.”).

70. *Id.* at 247.

71. See *JERRY & RICHMOND*, *supra* note 18, at 525–26 (discussing several states where legislatures have spoken on the matter of insurance coverage for punitive damages).

Virginia “for any person to purchase insurance providing coverage for punitive damages arising out of the death or injury of any person as the result of negligence, including willful and wanton negligence, but excluding intentional acts.”⁷² The Kansas legislature passed a statute providing that it is not against the public policy of Kansas for a person or entity to obtain insurance coverage for punitive damages vicariously imposed.⁷³ At least in the context of automobile insurance, a South Carolina statute defines “damages” as including “both actual and punitive damages.”⁷⁴ When the legislature speaks, the legislative pronouncement is controlling.⁷⁵ Therefore, if a legislature passes a statute specifically providing that punitive damages are uninsurable, then the statute would override an insurance policy provision providing coverage for punitive damages.⁷⁶

In short, to determine whether an award of punitive damages is covered by the insurance policy, the court must first refer to the language of the insurance policy.⁷⁷ If there is an explicit exclusion for punitive damages, then such exclusion is typically enforceable, and no coverage exists.⁷⁸ However, if there is no such

72. VA. CODE ANN. § 38.2-227 (2013).

73. See KAN. STAT. ANN. § 40-2,115 (2013) (providing that a person or entity may obtain insurance coverage for punitive damages vicariously imposed on the insured “without the actual prior knowledge of such insured”).

74. S.C. CODE ANN. § 38-77-30(4) (2013). South Carolina also requires that an automobile insurance policy contain “a provision insuring the persons defined as insured against loss from the liability imposed by law for damages arising out of the ownership, maintenance, or use of these motor vehicles within the United States or Canada.” *Id.* § 38-77-140. This statute requires auto liability insurance for “damages,” which includes actual and punitive damages per Section 38-77-30(4). *Id.*

75. See JERRY & RICHMOND, *supra* note 18, at 526 (discussing legislative pronouncements on the insurability of punitive damages).

76. See 12 PLITT ET AL., *supra* note 19, § 172:38 (providing that if a statute prohibits coverage for punitive damages, then the statute is controlling regardless of what the policy provides).

77. See, e.g., Phila. Indem. Ins. Co. v. Stebbins Five Cos., No. 302CV1279M, 2004 WL 210636, at *3 (N.D. Tex. Jan. 27, 2004) (“First, it must be shown that the policy’s terms provide for and do not exclude coverage of a punitive damages award.”).

78. See, e.g., Massena v. Healthcare Underwriters Mut. Ins. Co., 724 N.Y.S.2d 107, 111 (N.Y. App. Div. 2001) (stating that the policies at issue “expressly exclude claims arising from interference with contract, punitive damages, malicious civil acts or omissions, and defamation”). Because punitive damages were explicitly excluded, the insurer had no duty to indemnify the

exclusion, then the result depends upon the specific court's conception of punitive damages.⁷⁹ When faced with coverage disputes, courts must employ the principles of contract interpretation to determine whether there is coverage for the remedy granted in the underlying suit.

E. Interpretation of Insurance Contracts

Often, parties to an insurance policy dispute the meaning of its terms and conditions.⁸⁰ In order to resolve such disputes, the insurer or insured brings a declaratory judgment action seeking an interpretation of the policy or an interpretation of a word or phrase used in the policy.⁸¹ Although the courts often use the terms "construction" and "interpretation" interchangeably, the terms technically do not have the same meaning. While the "construction of an insurance policy is the process of determining the policy's legal effect[,] interpretation is the process of determining the meaning of the words used in the policy."⁸²

It is a well-settled rule that general principles of contract interpretation apply to insurance policies.⁸³ Therefore, like any

insured. *Id.*

79. See *supra* notes 60–67 and accompanying text (discussing how some courts hold that punitive damages are not covered by the general term "damages," while others hold that punitives are covered by the term "damages" and that it is not against public policy to provide coverage for punitives).

80. See JERRY & RICHMOND, *supra* note 18, at 125 (discussing kinds and causes of imprecision in contracts).

81. See 2 PLITT ET AL., *supra* note 19, § 21:1 (discussing how disputes between an insurer and its insured are resolved when the parties disagree about terms or conditions in the policy); *Meijer, Inc. v. Gen. Star Indem. Co.*, 826 F. Supp. 241, 243 (W.D. Mich. 1993) (providing that the insured brought a declaratory judgment action to determine whether coverage existed for punitive damages and attorney fees awarded in a tort suit against the insured).

82. *Thomas v. Progressive Cas. Ins. Co.*, 749 N.W.2d 678, 681 (Iowa 2008).

83. See, e.g., *SDR Capital Mgmt., Inc. v. Am. Int'l Specialty Lines Ins. Co.*, 320 F. Supp. 2d 1043, 1046 (S.D. Cal. 2004) ("Although insurance contracts have special features, they are still contracts subject to the ordinary rules of contract interpretation."); *Jimenez v. State Farm Lloyds*, 968 F. Supp. 330, 332 (W.D. Tex. 1997) ("In Texas, insurance contracts are interpreted by the same rules as are other contracts."); *Choharis v. State Farm Fire & Cas. Co.*, 961 A.2d 1080, 1087 (D.C. 2008) ("Disputes relating to the respective obligations of the parties to an insurance contract should generally be addressed within the principles of law relating to contracts, and bad faith conduct can be compensated within

other contract, an insurance policy is to be construed to give effect to the intentions of the parties at the time of contracting.⁸⁴ To ascertain the intent of the parties, courts must look to what the policy itself says.⁸⁵ When courts look to the policy at issue, they view the insurance contract “in [its] entirety and do not interpret phrases in isolation.”⁸⁶ When the terms of the insurance policy are clear and unambiguous, “the court may not resort to the rules of construction, and the terms are to be accorded their plain and ordinary meaning as an ordinary or reasonable person would understand them.”⁸⁷ Generally, courts will enforce “an insurance policy as written unless the policy language contains an ambiguity.”⁸⁸

An ambiguity in an insurance policy will be found only if “the policy is susceptible to more than one interpretation and reasonably intelligent persons would honestly differ as to its meaning.”⁸⁹ To determine whether an insurance policy contains

those principles.”); *Dairyland Ins. Co. v. Douthat*, 449 S.E.2d 799, 801 (Va. 1994) (“Initially, we observe that insurance policies are contracts whose terms are construed in accordance with the general principles applicable to all contracts.”).

84. See *Thomas*, 749 N.W.2d at 681 (stating that the “cardinal principle” in the construction of insurance policies “is that the intent of the parties must control”).

85. See *Boutilier v. Lincoln Benefit Life Ins. Co.*, 681 N.W.2d 746, 750 (Neb. 2004) (“[A] court shall seek to ascertain the intention of the parties from the plain meaning of the policy.”).

86. *Allstate Ins. Co. v. Bauer*, 977 P.2d 617, 620 (Wash. Ct. App. 1999).

87. *Boutilier*, 681 N.W.2d at 750; see also *Cincinnati Ins. Co. v. Milliken & Co.*, 857 F.2d 979, 981 (4th Cir. 1988) (“Absent ambiguity, in South Carolina the language of an insurance policy is given its plain, ordinary, and popular meaning.”); *City of Burlington v. Nat’l Union Fire Ins. Co.*, 655 A.2d 719, 721 (Vt. 1994) (providing that any “[d]isputed terms should be read according to their plain, ordinary, and popular meaning”).

88. *Cary v. United of Omaha Life Ins. Co.*, 108 P.3d 288, 290 (Colo. 2005); see also *Thomas v. Progressive Cas. Ins. Co.*, 749 N.W.2d 678, 681 (Iowa 2008) (“In the construction of insurance policies, the cardinal principle is that the intent of the parties must control; and except in cases of ambiguity this is determined by what the policy itself says.” (citation omitted)); *Boutilier*, 681 N.W.2d at 750 (“But a contract written in clear and unambiguous language is not subject to interpretation or construction and must be enforced according to its terms.” (citation omitted)); *Madison Constr. Co. v. Harleysville Mut. Ins. Co.*, 735 A.2d 100, 106 (Pa. 1999) (“Where, however, the language of the contract is clear and unambiguous, a court is required to give effect to that language.” (citations omitted)).

89. 2 PLITT ET AL., *supra* note 19, § 21:11.

an ambiguity, courts examine the policy as a whole, rather than clause by clause.⁹⁰ An insurance policy is not ambiguous simply because the parties disagree over the policy's interpretation.⁹¹ The fact that some people have difficulty understanding the language in an insurance policy does not render the policy ambiguous.⁹² When a court finds an ambiguity in an insurance policy, the policy is construed against the drafter of the document, the insurer, and in favor of the insured.⁹³ The rule of construction against the insurer comports with the general principle of contract law that "doubtful language is to be interpreted most strongly against the party who used it in drafting the contract."⁹⁴ Because courts will not employ the rule of construction against the insurer if there are no ambiguities in the policy,⁹⁵ insurers will argue that there is no ambiguity and that the court can interpret the disputed portion by the plain meaning of the words used in the policy at issue.⁹⁶

90. See *Cary*, 108 P.3d at 290 (discussing how to determine whether an insurance policy is ambiguous).

91. See *Union Ins. Co. v. Houtz*, 883 P.2d 1057, 1061 (Colo. 1994) ("A mere disagreement between the parties regarding the interpretation of the policy does not create an ambiguity.").

92. See *Nordi v. Keystone Health Plan W., Inc.*, 989 A.2d 376, 381 (Pa. Super. Ct. 2010) (comparing someone's lack of understanding of an insurance policy with the idea that a middle-aged judge finds "precise and unambiguous instructions for the latest computer software program . . . befuddling but a 15-year-old high school student finds [such instructions] simple and easy to follow").

93. See *Madison Constr. Co.*, 735 A.2d at 106 ("Where a provision of a policy is ambiguous, the policy provision is to be construed in favor of the insured and against the insurer."); *Alf v. State Farm Fire & Cas. Co.*, 850 P.2d 1272, 1274 (Utah 1993) ("If a policy is ambiguous, doubt is resolved against the insurer.").

94. 2 PLITT ET AL., *supra* note 19, § 22:22.

95. See *Alf*, 850 P.2d at 1274 ("[I]f a policy is not ambiguous, no presumption in favor of the insured arises and the policy language is construed according to its usual and ordinary meaning.").

96. See *Blackburn v. Nat'l Union Fire Ins. Co.*, 784 So. 2d 637, 641 (La. 2001) ("In analyzing a policy provision, the words, often being terms of art, must be given their technical meaning. When those technical words are unambiguous and the parties' intent is clear, the insurance contract will be enforced as written."); *Bergeron v. State Farm Fire & Cas. Co.*, 766 A.2d 256, 259 (N.H. 2000) (providing that a court will not "perform amazing feats of linguistic gymnastics to find a term ambiguous" and to construe it in favor of the insured).

In sum, the interpretation of an insurance policy involves a three-step analysis by the court:

(1) the intent of the parties must be inferred, if possible, solely from the written provisions of the contract; (2) if the court is faced with ambiguous policy language, ambiguity is resolved by interpreting the ambiguous provision in the sense in which the promisor (insurer) reasonably believed at the time of making it, that the promisee (insured) understood it; (3) if the ambiguity is not eliminated through an application of this rule, then ambiguous language is construed against the party who caused the uncertainty to exist [insurer]. It is not necessary, in the absence of evidence establishing mutual understanding of the parties, to proceed directly to the third prong of the interpretive framework and construe policy language against the insurer. An insurance policy must be construed according to its terms and the evident intent of the parties as expressed in the policy language.⁹⁷

Courts adopt different versions of the doctrine of reasonable expectations,⁹⁸ which is the second step in the analysis above. Some courts adopt a version of the doctrine that requires a finding of ambiguity before the doctrine can be invoked, while others view the doctrine as more than a rule of construction.⁹⁹ Those courts that err on the side of the second viewpoint adopt Professor (later Judge) Keeton's view that "the objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations."¹⁰⁰ A court's interpretation of an insurance contract in a coverage dispute is crucial because it will

97. 2 PLITT ET AL., *supra* note 19, § 21:4.

98. See JERRY & RICHMOND, *supra* note 18, at 145 (discussing different versions of the doctrine of reasonable expectations).

99. Compare *Liggatt v. Emp'rs Mut. Cas. Co.*, 46 P.3d 1120, 1127 (Kan. 2002) ("Unless there is a finding that an insurance policy is ambiguous, the reasonable expectations doctrine does *not* permit the court to reform the unambiguous meaning of the contract."), with *Collister v. Nationwide Life Ins. Co.*, 388 A.2d 1346, 1353 (Pa. 1978) (focusing on the reasonable expectation of the insured). The Pennsylvania Supreme Court's opinion represents the view that "[c]ourts should be concerned with assuring that the insurance purchasing public's reasonable expectations are fulfilled." *Id.*

100. Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions: Part One*, 83 HARV. L. REV. 961, 967 (1970).

determine whether the court will permit coverage for the remedy granted in the underlying suit.

F. Remedies in the Underlying Suit

In the underlying suit of an insurance coverage action, such as a suit for breach of fiduciary duty against a corporate director, the plaintiff may be awarded three possible civil remedies for which the insured-defendant seeks coverage from its insurer: compensatory damages, restitution, and punitive damages.¹⁰¹ A court will award compensatory damages “to put the plaintiff, so far as money can, where the plaintiff would have been without the defendant’s breach or invasion.”¹⁰² The plaintiff’s recovery of compensatory damages will be measured based on the plaintiff’s loss.¹⁰³ Restitution can be conceptualized as the midpoint, situated between compensatory damages on the one hand and punitive damages on the other, on a continuum of the three remedies.¹⁰⁴ A court will measure a plaintiff’s money restitution based on the defendant’s gain, not the plaintiff’s loss.¹⁰⁵ Punitive damages are granted to a plaintiff to punish a defendant for his

101. See Rendleman, *supra* note 8, at 975 (discussing a court’s choice of remedy on behalf of a successful claimant).

102. *Id.*; see *Jaffe v. Cranford Ins. Co.*, 214 Cal. Rptr. 567, 570 (Cal. Ct. App. 1985) (“‘Damages’ describes a payment made to compensate a party for injuries suffered.”).

103. See Rendleman, *supra* note 8, at 975 (discussing a court’s measurement of compensatory damages); *In re Consol. Objections to Tax Levies of Sch. Dist. No. 205*, 739 N.E.2d 508, 513 (Ill. 2000) (“Compensatory damages are damages sufficient in amount to indemnify the injured person for the loss suffered.” (citation omitted)).

104. See Rendleman, *supra* note 8, at 973–74 (“Restitution’s policy justifications often overlap with compensatory damages at one end of the continuum and with punitive damages at the other.”).

105. See *id.* at 975 (providing that a court will grant money restitution in order to prevent or reverse the defendant’s unjust enrichment); *Ellett Bros., Inc. v. U.S. Fid. & Guar. Co.*, 275 F.3d 384, 388 (4th Cir. 2001) (“Restitution and disgorgement require payment of the defendant’s ill-gotten gain, not compensation of the plaintiff’s loss.”); DAN B. DOBBS, *LAW OF REMEDIES: DAMAGES—EQUITY—RESTITUTION* 369 (2d ed. 1993) (providing that the goal of compensatory damages is to provide compensation for the plaintiff’s loss, while the goal of restitution is to force disgorgement of the defendant’s gain).

misconduct and to deter that defendant, as well as similarly situated potential defendants, from similar misconduct.¹⁰⁶

If there is unjust enrichment involved in a particular case, “[a] court will respond to a defendant’s unjust enrichment by granting the plaintiff restitution.”¹⁰⁷ “Disgorgement” can be conceptualized as a remedy that falls under the general label of “restitution,” as “[r]estitution measured by the defendant’s wrongful gain is frequently called disgorgement.”¹⁰⁸ “The object of the disgorgement remedy—to eliminate the possibility of profit from conscious wrongdoing—is one of the cornerstones of the law of restitution and unjust enrichment.”¹⁰⁹ Section 3 of the Third Restatement of Restitution and Unjust Enrichment marks this cornerstone and identifies the general principle “underlying the ‘disgorgement’ remedies in restitution,” whereby a defendant is stripped of any wrongful gain.¹¹⁰ Section 3 states: “A person is not permitted to profit by his own wrong.”¹¹¹

Unlike compensatory damages, “restitution and punitive damages rest on discrete noncompensatory policy bases.”¹¹² The purpose of both punitive damages and restitution is to deter a defendant’s profitable misconduct, but the policy bases for the two remedies are not identical.¹¹³ While a “court awards a plaintiff restitution to deter and to prevent or reverse the defendant’s unjust enrichment,” a “court imposes punitive damages on a defendant to punish it and to deter it and others from misconduct.”¹¹⁴ Because the policies underlying punitive damages and restitution “are unclear and may overlap,” it is possible “to argue that disgorgement has a punitive quality.”¹¹⁵

106. See Rendleman, *supra* note 8, at 976 (discussing the functional difference between compensatory damages, restitution, and punitive damages).

107. *Id.* at 975; see RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1 (2011) (“A person who is unjustly enriched at the expense of another is subject to liability in restitution.”).

108. RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 51 cmt. a (2011).

109. *Id.* § 51 cmt. e.

110. *Id.* § 3 cmt. a.

111. *Id.* § 3.

112. Rendleman, *supra* note 8, at 975.

113. See *id.* at 980 (comparing restitution with punitive damages).

114. *Id.*

115. *Id.*

However, “[d]isgorgement of wrongful gain is not a punitive remedy.”¹¹⁶ Various courts have held that a claim for unjust enrichment or disgorgement is not the same as punitive damages or a penalty.¹¹⁷

Because the disgorgement remedy deprives a wrongdoer of an unlawful gain, disgorgement does not impose a net loss on the wrongdoer.¹¹⁸ Therefore, it is possible for a court to conclude that the disgorgement of profits will not adequately deter the misconduct.¹¹⁹ If a court reaches this conclusion, it may decide to award the plaintiff punitive damages as well as restitution.¹²⁰ With the background on insurance law in mind, the question becomes whether insurance policies cover the remedies of restitution and disgorgement. Answering this question can be problematic for several reasons.

III. Controversies Surrounding Coverage for Restitution and Disgorgement

A. The Problem

Deciding whether there is insurance coverage for restitution and disgorgement is especially problematic for several reasons.

116. RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 51 cmt. k (2011).

117. See *In re Estate of Corriea*, 719 A.2d 1234, 1240 (D.C. 1998) (“INAPRO’s premise that punitive damages are legally ‘uninsurable’ under District law is one we need not evaluate, because we reject the equation of disgorgement and punitive damages. The remedy of disgorgement . . . is meant to provide just compensation for the wrong, not to impose a penalty.” (citation omitted)); *Perl v. St. Paul Fire & Marine Ins. Co.*, 345 N.W.2d 209, 214 (Minn. 1984) (holding “that damages measured by the forfeit of attorneys fees for breach of a fiduciary duty are not ‘exemplary or punitive damages,’ as that phrase is used in the policy, and, therefore, that the exclusion is not applicable”).

118. See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 51 cmt. k (2011) (providing that disgorgement is not a punitive remedy because the wrongdoer is “left in the position he would have occupied had there been no misconduct”).

119. See *id.* (highlighting the difference between restitution and punitive damages).

120. See *id.* (discussing a situation in which a court may award both restitution and punitive damages).

First, restitution is subject to misunderstanding by both lawyers and judges.¹²¹ One of the major sources of confusion surrounding restitution is that the meaning of the word restitution “change[s] between the vernacular language and the technical vocabulary of remedies.”¹²² In the ordinary sense of justice, the word restitution “may be used to describe any form of recovery or redress.”¹²³ For example, if a criminal is ordered to give restitution to his victim, that restitution will likely take the form of compensation.¹²⁴ Second, insurance companies do not provide a satisfactory definition of what constitutes “loss” to an insured. In D&O policies, “loss” is typically defined to include damages, judgments, and settlements.¹²⁵ But, insurance policies usually do not provide a definition of damages, judgments, or settlements,¹²⁶ which leads

121. See Rendleman, *supra* note 8, at 977 (“Restitution specialists frequently observe that restitution, which has fallen out of the law school curriculum, is subject to professional misunderstanding on every level.”); Andrew Kull, *Rationalizing Restitution*, 83 CALIF. L. REV. 1191, 1195 (1995) (“To put it bluntly, American lawyers today (judges and law professors included) do not know what restitution is. The subject is no longer taught in law schools, and the lawyer who lacks an introduction to its basic principles is unlikely to recognize them in practice.”); Douglas Laycock, *The Scope and Significance of Restitution*, 67 TEX. L. REV. 1277, 1277 (1989) (“Despite its importance, restitution is a relatively neglected and underdeveloped part of the law. In the mental map of most lawyers, restitution consists largely of blank spaces with undefined borders and only scattered patches of familiar ground.”); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1 cmt. c (2011) (“Employed to denote liability based on unjust enrichment, the word ‘restitution’ is a term of art that has frequently proved confusing.”).

122. Rendleman, *supra* note 8, at 977.

123. *Id.*

124. See *id.* (discussing the meaning of the word restitution in the criminal law context); George P. Roach, *How Restitution and Unjust Enrichment Can Improve Your Corporate Claim*, 26 REV. LITIG. 265, 274 (2007) (“Criminal restitution is a remedy based on compensating damages that seeks to restore the plaintiff or victim to her *ex ante* position by awarding damages.”); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1 cmt. e (2011) (“It is a natural use of the language to speak of requiring a criminal to ‘make restitution’; the problem is that the liability imposed in such cases is not based on unjust enrichment but on compensation for harm.”).

125. See, e.g., *Wedtech Corp. v. Fed. Ins. Co.*, 740 F. Supp. 214, 216 (S.D.N.Y. 1990) (quoting the insurance policy as providing that “the total amount which any Insured Person(s) become legally obligated to pay on account of all claims made against them for Wrongful Acts with respect to which coverage hereunder applies, including, but not limited to, damages, judgments, settlements, costs and Defense Costs”).

126. See Richard F. Hans, *On the Level 3: Reviewing the (Un)insurability of*

to issues in coverage litigation regarding what is covered under the policy. Because “damages” is a general term that encompasses “any form of money recovery[,] including recovery based on the defendant’s unjust enrichment, [or] restitution,”¹²⁷ insureds will often argue that restitution or disgorgement fall within damages and should be covered.¹²⁸ However, such a broad reading of the term fails to recognize the distinct meanings of compensatory damages, restitution, and punitive damages within the technical vocabulary of remedies.¹²⁹ Finally, insurance companies usually do not exclude coverage for restitution and disgorgement in the D&O policy exclusions, and if there is such an exclusion, the policy does not specifically define restitution and disgorgement.¹³⁰ If such remedies were explicitly excluded, then coverage disputes could be resolved more easily.

1. Interpreting the Controversy Between Insurer Versus Insured

When faced with coverage disputes, courts have to decide whether the insurer is required to pay the claim that the insured asserts is covered. As previously discussed, courts have to use the interpretive principles of contract law to decide whether there is

Restitutionary Payments, 42 TORT TRIAL & INS. PRAC. L.J. 165, 167 (2006) (discussing language used in insurance policies and which terms are defined and which terms are not defined).

127. Rendleman, *supra* note 8, at 977.

128. See McMinn, *supra* note 40, at 1005 (providing that insurers often argue that reference to payment “as damages” limits the policy’s application to amounts paid to compensate the claimant for covered injury and that amounts paid . . . as part of an equitable remedy (the return of ill-gotten gains) are not damages”).

129. See *supra* Part II.F (discussing the meanings of compensatory damages, restitution, and punitive damages and when each remedy may be awarded by a court).

130. See *William Beaumont Hosp. v. Fed. Ins. Co.*, No. 13-1468, 2014 WL 185388, at *2 (6th Cir. Jan. 16, 2014) (quoting the insurance policy as providing that “the term Loss . . . shall not include *disgorgement* by any Insured or any amount reimbursed by any Insured Person” (emphasis added)); *Am. Zurich Ins. Co. v. Doherty*, No 1:05CV866, 2006 WL 1391425, at *3 (E.D. Va. May 19, 2006) (quoting the insurance policy as providing that “damages” means “a monetary judgment or settlement and does not include fines or statutory penalties whether imposed by law or otherwise, nor the return or *restitution* of legal fees, costs and expenses arising therefrom” (emphasis added)).

coverage in the particular case at issue.¹³¹ Therefore, the court must first look to what the policy itself says,¹³² which includes looking at the definition of “loss” and any relevant policy exclusions.¹³³ If the policy at issue does not explicitly exclude restitution or disgorgement, then the court must decide whether restitution or disgorgement fall within the policy definition of “loss” or “damages,” whichever is the operative language in the policy.¹³⁴ This may prove difficult for two reasons. First, the definition of loss is ambiguous because it includes damages, judgments, and settlements but then fails to define those terms.¹³⁵ Second, application of the disgorgement remedy can be difficult when problems of attribution are involved because the court will have to decide what portion of the defendant’s assets is attributable to the underlying wrong.¹³⁶ Arguably, coverage should be granted for the amount the defendant paid to the plaintiff in the underlying litigation or in a settlement that is not attributable to the defendant’s ill-gotten gain.¹³⁷

131. See *supra* note 83 (providing that general principles of contract interpretation apply to insurance policies).

132. See *supra* notes 85–87 and accompanying text (providing that courts must first ascertain the intent of the parties by looking at the terms of the insurance policy).

133. See *Fid. Bank v. Chartis Specialty Ins. Co.*, No. 1:12-CV-4259-RWS, 2013 WL 4039414, at *1–2 (N.D. Ga. Aug. 7, 2013) (discussing the policy language, definitions contained in the policy, and relevant policy exclusions).

134. See *Hans*, *supra* note 126, at 167 (providing that courts must use the interpretive principles of contract law to decide whether “these terms, afforded their plain and ordinary meaning, include and thus provide coverage for disgorgement or other forms of restitutionary payments”).

135. See *infra* Part III.A.2 (discussing the issues surrounding the definition of “loss” in insurance policies).

136. See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 51 cmt. e (2011) (discussing the potential difficulties involved in the application of the disgorgement remedy). Application of the disgorgement remedy and calculation of profits “is simplest when the whole of the wrongdoer’s unjust enrichment is captured in the ownership, possession, or disposition of specific property.” *Id.*

137. See, e.g., *Ryerson Inc. v. Fed. Ins. Co.*, 676 F.3d 610, 613–14 (7th Cir. 2012) (“A judgment or settlement in a fraud case could involve a *combination* of restitution and damages, and then the insurance company would be liable for the damages portion in accordance with the allocation formula in the policy.” (citations omitted)).

2. The Definition of “Loss”

Because D&O policies provide coverage only for “loss” resulting from a covered claim based on a wrongful act, a policy’s definition of “loss” is critical to determining the scope of coverage.¹³⁸ One central issue is what constitutes loss for the purposes of indemnification and entity coverage.¹³⁹ Loss is a defined term in an insurance policy, and it is often defined in a restrictive manner.¹⁴⁰ The definition of loss generally includes damages, judgments, settlements, and the costs of defense.¹⁴¹ However, the words “damages,” “judgments,” and “settlements” are usually not defined in the policy.¹⁴² The failure to define these terms is especially problematic in the context of coverage for restitution and disgorgement because whether there is coverage will often turn on whether restitution and disgorgement fall within the policy definition of loss.¹⁴³ Therefore, the court’s interpretation of loss, and the terms used in the policy definition

138. See DAVISSON ET AL., *supra* note 30, at 63 (“For example, if punitive and exemplary damages are excluded from the definition of ‘loss,’ an insurer would not be obligated to reimburse a punitive damages award.”).

139. See *id.* at 35–36 (discussing several cases that address the issue of whether the coverage sought was a covered “loss” under the D&O policy).

140. See DAVISSON ET AL., *supra* note 30, at 70 (providing that loss may be defined to exclude “punitive damages, fines, penalties, sanctions, the multiplied portion of any multiplied damage award, and matters deemed uninsurable under applicable law”); *Genzyme Corp. v. Fed. Ins. Co.*, 622 F.3d 62, 67 (1st Cir. 2010) (quoting the insurance policy as providing that “loss does not include matters uninsurable under the law pursuant to which [the policy] is construed”).

141. See, e.g., *Level 3 Commc’ns, Inc. v. Fed. Ins. Co.*, No. 96C5346, 2000 WL 1053971, at *1 (N.D. Ill. June 31, 2000) (quoting the insurance policy as providing that “loss” is “the total amount which any insured person becomes legally obligated to pay . . . including but not limited to damages, judgments, settlements, costs and defense costs”); *Bd. of Educ. v. CNA Ins. Co.*, 839 F.2d 14, 16 (2d Cir. 1988) (quoting the insurance policy as providing that loss includes “judgments, settlements and costs, cost of investigation and defense of legal actions”).

142. See *Hans*, *supra* note 126, at 167 (providing terms that are typically not defined in the insurance policy).

143. See *Unified W. Grocers, Inc. v. Twin City Fire Ins. Co.*, 457 F.3d 1106, 1115 (9th Cir. 2006) (“The label of ‘restitution’ or ‘damages’ does not dictate whether a loss is insurable. The 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.” (citations omitted)).

of loss, is determinative in the context of coverage for restitution and disgorgement. To determine whether to permit coverage for restitution and disgorgement, courts engage one of two rationales.

B. Case Law Addressing the Insurability of Restitution and Disgorgement

Courts vary in the ways they interpret a policy's terms to determine whether an insurer has to cover restitutionary payments made by an insured. Some courts rely on the interpretive principles of contract law¹⁴⁴ to decide whether restitution and disgorgement are included in the term "loss" under the policy.¹⁴⁵ However, other courts rely on the public policy rationale to deny coverage for disgorgement and restitution.¹⁴⁶ Courts that employ the interpretive principle must ask whether the word "loss" and the terms included in the policy definition of loss, "afforded their plain and ordinary meaning, include and thus provide coverage for disgorgement or other forms of restitutionary payments."¹⁴⁷ *Level 3 Communications, Inc. v. Federal Insurance Co.*,¹⁴⁸ and the cases that have followed its rationale, state that restitution and disgorgement are not included within the meaning of "loss" or "damages" as those terms are defined in insurance policies.¹⁴⁹ While some courts rely

144. See *supra* note 83 (discussing the application of general principles of contract interpretation to insurance policies).

145. See, e.g., *Level 3 Commc'ns, Inc. v. Fed. Ins. Co.*, 272 F.3d 908, 910 (7th Cir. 2001) ("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.").

146. See, e.g., *Bank of the W. v. Super. Ct.*, 833 P.2d 545, 555 (Cal. 1992) ("When 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."). If an insured wrongdoer could obtain insurance coverage for restitutionary payments or disgorgement of ill-gotten gains, then the insured "would retain the proceeds of his illegal acts, merely shifting his loss to an insurer." *Id.*

147. Hans, *supra* note 126, at 167.

148. 272 F.3d 908 (7th Cir. 2001).

149. See *id.* at 911 ("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

on *Level 3* to hold that restitutionary payments or disgorgement of ill-gotten gains are not “losses,” other courts rely on public policy to conclude that restitution and disgorgement are uninsurable under the law that applies to the policy at issue.¹⁵⁰ Still other courts discuss or rely on both the interpretive principle and public policy.¹⁵¹

1. Pre-Level 3

Level 3 was not the first case to address the insurability of restitution nor was it the first case to articulate the interpretive principle—“that a ‘loss’ within the meaning of an insurance contract does not include the restoration of an ill-gotten gain.”¹⁵² Before *Level 3*, various courts held that restitutionary payments and disgorgement of ill-gotten gains are not covered under insurance policies. For example, in *Nortex Oil & Gas Corp. v. Harbor Insurance Co.*,¹⁵³ Nortex, the insured, sued Harbor, the

property’s return.”); *Town of Brookhaven v. CNA Ins. Cos.*, No. CV-86-3569, 1988 WL 23555, at *5 (E.D.N.Y. Feb. 24, 1988) (“The plain and ordinary meaning of loss, injury or damage cannot be ignored, and the town simply cannot lose that to which it was not legally entitled.” (citation omitted)).

150. See, e.g., *Unified W. Grocers, Inc. v. Twin City Fire Ins. Co.*, 457 F.3d 1106, 1115 (9th Cir. 2006) (“California case law precludes indemnification and reimbursement of claims that seek the restitution of an ill-gotten gain. This public policy exclusion for restitutionary relief applies in limited circumstances.” (citing *Bank of the W.*, 833 P.2d at 553)); *Exec. Risk Indem., Inc. v. Pac. Educ. Servs., Inc.*, 451 F. Supp. 2d 1147, 1162 (D. Haw. 2006) (“Because Hawaii courts seek to return illegally obtained property to victims, the Hawaii Supreme Court would likely rule that claims for the return of ill-gotten gains should not be insurable. Restitution is uninsurable under Hawaii law and therefore not covered by the Policy.”).

151. See, e.g., *Cent. Dauphin Sch. Dist. v. Am. Cas. Co.*, 426 A.2d 94, 97 (Pa. 1981) (“[T]his Commonwealth’s public policy does not permit a school district to make unlawful taxation just as revenue-productive as lawful taxation Hence there has been no ‘loss’ within the meaning of the insurance policy”). While the majority opinion in *Central Dauphin* focused more on public policy considerations to preclude coverage, the concurring opinion relied on the principles of contract interpretation to preclude coverage. *Id.* at 98 (Larsen, J., concurring). The concurring opinion emphasized that a refund of unlawfully collected taxes cannot constitute a loss because “the school district simply cannot lose that to which it was not legally entitled.” *Id.*

152. *Level 3*, 272 F.3d at 910.

153. 456 S.W.2d 489 (Tex. Civ. App. 1970).

insurer, seeking indemnification for property damage claims Nortex paid to Humble Oil & Refining Co. and Texaco, Inc. in the underlying suit against Nortex for trespass and conversion.¹⁵⁴ In the coverage suit, the court stated that the claims were not “for property damage within the meaning of the policy,” and employed the principles of contract interpretation to conclude that Nortex was not entitled to recover under the policy.¹⁵⁵

When Nortex settled the claims of Humble and Texaco it did not sustain a ‘loss’ within the meaning of the insurance contract; it was merely paying for oil it had removed and sold from the land of Humble and Texaco. An insured (under such a policy as we have here) does not sustain a covered loss by restoring to its rightful owners that which the insured, having no right thereto, has inadvertently acquired. (The insured’s innocence and good faith are immaterial.) The insurer did not contract to indemnify the insured for disgorging that to which it was not entitled in the first place, or for being deprived of profits to which it was not entitled.¹⁵⁶

Similarly, in *Town of Brookhaven v. CNA Insurance Cos.*,¹⁵⁷ the town sought coverage from its insurer, CNA, for payments made by the town as a result of three “tax distribution actions” filed by school districts against the town.¹⁵⁸ The U.S. District Court for the Eastern District of New York used the interpretive principle to deny coverage¹⁵⁹ and rejected CNA’s public policy argument.¹⁶⁰ The court reasoned that the payments to the school districts amount to “interest on the sums that the Town underpaid the School Districts collectively for the time such underpayment continued.”¹⁶¹ The court viewed the interest earned by the town on the unlawfully held funds as “the benefit enjoyed by the town by virtue of its improper withholding of

154. *See id.* at 490 (discussing the underlying suit against Nortex).

155. *Id.* at 493.

156. *Id.* at 493–94.

157. No. CV-86-3569, 1988 WL 23555 (E.D.N.Y. Feb. 24, 1988).

158. *See id.* at *1 (discussing the underlying “tax distribution actions” filed against the Town of Brookhaven).

159. *See id.* (“I find that the Town of Brookhaven will suffer no recoverable loss . . .”).

160. *See id.* at *6 (“Public Policy does not dictate a denial of recovery in the present case.”).

161. *Id.* at *3.

money which should have been earning interest on behalf of the districts.”¹⁶² Therefore, the town was never entitled to the use of those funds, and “disgorgement of them does not cause ‘injury or damage’ to the town within the meaning of the policy.”¹⁶³

A few years later, in *Bank of the West v. Superior Court*,¹⁶⁴ the insured argued that “the term ‘damages’ for insurance purposes includes virtually all forms of monetary relief.”¹⁶⁵ The California Supreme Court rejected the insured’s argument, stating that “[i]t is well established 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.”¹⁶⁶

Although courts had addressed the insurability of restitution or disgorgement previously, *Level 3* marked an important milestone because it “was the first [case] to articulate broadly those interpretive principles which bar coverage [for restitutionary payments].”¹⁶⁷ *Level 3* brought attention to the issues surrounding insurance coverage for restitution, and many courts and litigants began to cite, and continue to cite, its interpretive principle.¹⁶⁸

2. Level 3 and the Interpretive Principle

In *Level 3*, the insured, Level 3 Communications, Inc., made a claim under its D&O policy after settling a securities fraud suit brought against it by former shareholders of an acquired

162. *Id.*

163. *Id.*

164. 833 P.2d 545 (Cal. 1992).

165. *Id.* at 553.

166. *See id.* (citing multiple cases from various jurisdictions that support this proposition).

167. Hans, *supra* note 126, at 167.

168. *See, e.g.,* St. Paul Fire & Marine Ins. Co. v. Vill. of Franklin Park, 523 F.3d 754 (7th Cir. 2008) (discussing *Level 3*); Bank v. Chartis Specialty Ins. Co., No. 1:12-CV-4259-RWS, 2013 WL 4039414, at *3 (N.D. Ga. Aug. 7, 2013) (same); Exec. Risk Indem., Inc. v. Pac. Educ. Servs., Inc., 451 F. Supp. 2d 1147 (D. Haw. 2006) (same); J.P. Morgan Sec. Inc. v. Vigilant Ins. Co., 992 N.E.2d 1076 (N.Y. 2013) (same); Vigilant Ins. Co. v. Bear Stearns Cos. Inc., 814 N.Y.S.2d 566 (N.Y. Super. Ct. 2006) (same); Vigilant Ins. Co. v. Credit Suisse First Bos. Corp., 782 N.Y.S.2d 19 (N.Y. App. Div. 2004) (same).

corporation who claimed that Level 3 defrauded them.¹⁶⁹ The plaintiffs in the underlying securities fraud suit alleged that they sold shares in their corporation to Level 3 because of Level 3's fraudulent representations.¹⁷⁰ The plaintiffs sought to recover the monetary value of the shares.¹⁷¹ The securities fraud suit settled for \$11.8 million, and the district court concluded that the settlement was a loss within the meaning of the policy.¹⁷² Therefore, the district court held that Federal, the insurance company, was liable to its insured, Level 3.¹⁷³ Federal appealed to the Seventh Circuit Court of Appeals.

Although the definition of "loss" in the policy at issue included "settlements," Federal argued that the relief sought in the underlying suit was restitutionary in nature and was not covered by the policy.¹⁷⁴ In addition, Federal argued that "a D&O policy is designed to cover only losses that injure the insured, not ones that result from returning stolen property."¹⁷⁵ Stating that "the interpretive principle controls this case," the Seventh Circuit concluded that the relief the plaintiffs sought was "restitutionary in character."¹⁷⁶ The amount the plaintiffs obtained in the settlement of their claim was restitutionary in nature because "that amount was part of Level 3's gain from its officers' misbehavior," and thus was not covered under Level 3's D&O policy.¹⁷⁷

169. See *Level 3 Commc'ns, Inc. v. Fed. Ins. Co.*, 272 F.3d 908, 909–10 (7th Cir. 2001) (discussing the underlying securities fraud suit).

170. See *id.* at 910 ("In effect, Level 3 was accused of having obtained the plaintiffs' company by false pretenses . . .").

171. See *id.* ("[T]he plaintiffs' suit sought to rescind the transaction and recover their shares, or rather the monetary value of the shares because their company can no longer be reconstituted.").

172. See *id.* at 909 (discussing the district court's determinations on remand).

173. See *id.* (providing that Federal was liable to Level 3 for \$10 million due to the "insured versus insured" exclusion in the policy, which applied to one of the plaintiffs, Pompliano, who "had been a director of one of Level 3's subsidiaries, and as a result was covered by Federal's policy").

174. See *id.* 909–10 (providing that Federal argues it is as if Level 3 had stolen cash from the former shareholders and had been forced to return it and is "now asking the insurance company to pick up the tab").

175. *Id.* at 910.

176. *Id.*

177. *Id.* at 911. The shareholders sought to divest Level 3 "of the present

Even though the outcome in *Level 3* turned on the absence of compensation to the claimant in the underlying suit, the Seventh Circuit suggested that “loss or damages exist where the insured’s payment *is* intended to compensate the claimant for injury or harm rather than merely stripping the defendant of allegedly ill-gotten gain.”¹⁷⁸ In dicta, the Seventh Circuit suggested that the insurer would be required to provide coverage if the insured made a payment to the underlying claimant in the absence of any measurable benefit to the insured.¹⁷⁹ Other courts have also distinguished between returning ill-gotten gains and compensating the plaintiff and have held that restitution and disgorgement do not fall within the meaning of “loss” or “damages” as those terms are used in insurance policies.¹⁸⁰ The

value of the property obtained by fraud, minus the cost to the defendant of obtaining the property.” *Id.* at 910–11.

178. McMinn, *supra* note 40, at 1005 n.21.

179. See *Level 3 Commc’ns, Inc. v. Fed. Ins. Co.*, 272 F.3d 908, 911 (7th Cir. 2001) (providing situations in which there would be a covered loss). One example of a situation in which there would be a covered loss is if a corporate officer made a fraudulent statement “that inflated the price of the corporation’s stock without conferring any measurable benefit on the corporation.” *Id.*

180. See, e.g., *Ellett Bros. v. U.S. Fid. & Guar. Co.*, 275 F.3d 384, 388 (4th Cir. 2001) (“Restitution and disgorgement require payment of the defendant’s ill-gotten gain, not compensation of the plaintiff’s loss.”); *Jaffe v. Cranford Ins. Co.*, 214 Cal. Rptr. 567, 570 (Cal. Ct. App. 1985) (“The defendant is asked to return something he wrongfully received; he is not asked to compensate the plaintiff for injury suffered as a result of his conduct.”). The *Jaffe* court concluded that “payments of a restitutionary nature . . . are not ‘damages’ within the meaning of Jaffe’s policy.” *Id.* at 571. *But see* *AIU Ins. Co. v. Super. Ct.*, 799 P.2d 1253, 1274 (Cal. 1990) (“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.’”); *Bausch & Lomb Inc. v. Utica Mut. Ins. Co.*, 625 A.2d 1021, 1033 (Md. 1993) (“The ordinary person understands ‘damages’ as meaning money paid to make good an insured loss. In this context, environmental response costs fall within that definition.”). However, *AIU* and *Bausch & Lomb* can be distinguished because both cases involve coverage issues under comprehensive general liability (CGL) policies in the context of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA). Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. §§ 9601–9675 (2012). Within this context, “there is a split of authority over whether environmental cleanup costs [incurred pursuant to CERCLA] constitute ‘damages’ under an insurance policy.” *Helena Chem. Co. v. Allianz Underwriters Ins. Co.*, 594 S.E.2d 455, 459 (S.C. 2004). The South Carolina Supreme Court stated that “[t]he majority of state courts have held that there is coverage for these costs.” *Id.* (citations omitted).

view of those courts that distinguish between returning ill-gotten gains and compensating the plaintiff is in accordance with the Third Restatement of Restitution and Unjust Enrichment.¹⁸¹ Regardless of what label a court uses, it is important to distinguish between a remedy that requires a defendant to disgorge its ill-gotten gain in order to prevent unjust enrichment and a remedy that requires a defendant to compensate a plaintiff for harm or damage suffered. This distinction is critical in the context of coverage for restitution or disgorgement because a court's characterization of the remedy will often determine whether the disputed claim is covered or not covered by the insurance company.

3. *Post-Level 3 and Reactions to Level 3*

After *Level 3*, courts began to follow *Level 3*'s rationale to conclude that restitution or disgorgement of ill-gotten gains does not fall within the meaning of loss under D&O and liability insurance policies. In *Conseco, Inc. v. National Union Fire Insurance Co.*,¹⁸² the court stated, “[i]t is axiomatic that insurance cannot be used to pay an insured for amounts an insured wrongfully acquires and is forced to return, or to pay the corporate obligations of an insured.”¹⁸³ After this statement, the court cited *Level 3*, among others, and then concluded: “Indiana law is consistent with these cases. Insurance cannot be used to unjustly enrich insureds. Further, an insured is not allowed to

181. See *Jaffe v. Cranford Ins. Co.*, 214 Cal. Rptr. 567, 570–71 (Cal. Ct. App. 1985) (“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 W. v. Super. Ct.*, 833 P.2d 545, 556 (Cal. 1992) (“To 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.*’” (quoting *Jaffe*, 214 Cal. Rptr. at 570–71)); accord RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 51 cmt. a (2011) (“The principal focus of § 51 is on cases in which unjust enrichment is measured by the defendant’s profits, where the object of restitution is to strip the defendant of a wrongful gain.”).

182. No. 49D130202CP000348, 2002 WL 31961447 (Ind. Ct. App. Dec. 31, 2002).

183. *Id.* at *6.

profit from its wrongdoing through insurance.”¹⁸⁴ In *Vigilant Insurance Co. v. Credit Suisse First Boston Corp.*,¹⁸⁵ the New York appellate court relied on *Level 3* to uphold the lower court’s decision that the insured could not recover from its insurer the SEC settlement amount that represented the disgorgement of improperly acquired funds.¹⁸⁶ The court articulated *Level 3*’s interpretive principle: “The risk of being directed to return improperly acquired funds is not insurable. Restitution of ill-gotten funds does not constitute ‘damages’ or a ‘loss’ as those terms are used in insurance policies.”¹⁸⁷ The court also reasoned that restitution of ill-gotten funds fell within the exclusionary provision in the definition of loss, which provided that loss does not include “matters which are uninsurable under the law.”¹⁸⁸

Eleven years after *Level 3*, the Seventh Circuit Court of Appeals decided *Ryerson Inc. v. Federal Insurance Co.*¹⁸⁹ *Ryerson* articulated the same principles as *Level 3*, concluding that *Ryerson*’s disgorgement of the profits obtained by fraud “was not a ‘loss’ to *Ryerson* within the meaning of the insurance policy.”¹⁹⁰ The Seventh Circuit rightly distinguished between a claim for restitution and a claim for damages.¹⁹¹ Both the Seventh Circuit in *Ryerson* and the Ninth Circuit in *Unified Western Grocers, Inc.*

184. *Id.* at *6–7 (citations omitted).

185. 782 N.Y.S.2d 19 (N.Y. App. Div. 2004).

186. *See id.* at 20 (affirming the lower court’s holding).

187. *Id.* (citing *Level 3 Commc’ns, Inc. v. Fed. Ins. Co.*, 272 F.3d 908 (7th Cir. 2001)).

188. *See id.* (concluding that “restitution of ill-gotten funds is not insurable under the law”).

189. 676 F.3d 610 (7th Cir. 2012).

190. *Id.* at 613. The Seventh Circuit stated that “[y]ou can’t, at least for insurance purposes, sustain a ‘loss’ of something you don’t (or shouldn’t) have.” *Id.* (citations omitted).

191. *See id.* (“[A] claim for restitution is a claim that the defendant has something that belongs of right not to him but to the plaintiff.” (citing RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1 cmt. c (2011))). The Seventh Circuit distinguished damages from restitution stating, “[a] claim for ‘damages’ in the proper sense of the word is different.” *Id.* The court then provided an example to illustrate the difference between restitution and damages: “If a car driven negligently hits and injures a pedestrian, the pedestrian will sue the driver for the monetary equivalent of the harm done to him, not for the ‘profit’ that the accident generated for the driver. It generated no profit; it gave him nothing.” *Id.*

*v. Twin City Fire Insurance Co.*¹⁹² cited one of the core principles of *Level 3*: “[h]ow the claim or judgment order or settlement order is worded is irrelevant.”¹⁹³ This principle is critical for determining coverage when the insurance claim at issue could potentially be characterized as restitution or disgorgement. The courts deciding coverage disputes cannot simply rely upon the label that the lower court used or the characterization of a settlement by a regulatory agency, such as the SEC.¹⁹⁴ Courts must look at the nature of the asserted claim or payment.¹⁹⁵ For example, in *Vigilant Insurance Co. v. Bear Stearns Cos.*,¹⁹⁶ the New York appellate court examined the SEC settlement agreement’s description of the substance of the loss and concluded, “we find an issue of fact as to whether the portion of the settlement attributed to disgorgement actually represented ill-gotten gains or improperly acquired funds.”¹⁹⁷ While some courts use the interpretive principles of contract law to conclude that restitution and disgorgement do not constitute “loss,” others rely on public policy to conclude that restitution and disgorgement are uninsurable under the law.

192. 371 F. Supp. 2d 1234 (D. Haw. 2005).

193. *Level 3 Commc’ns, Inc. v. Fed. Ins. Co.*, 272 F.3d 908, 911 (7th Cir. 2001); *see also Ryerson Inc.*, 676 F.3d at 613 (“But the label isn’t important.” (citing *Level 3*, 272 F.3d at 910–11)); *Unified W. Grocers, Inc.*, 371 F. Supp. 2d at 1246 (“In fact, Judge Posner instructs that, regardless of how a claim is worded, if the relief sought is restitutionary in *character*, it is not insurable as a matter of law.” (referring to *Level 3*)).

194. *See Pan Pac. Retail Props., Inc. v. Gulf Ins. Co.*, 471 F.3d 961, 966 (9th Cir. 2006) (“In deciding whether a certain remedy is insurable, we must look beyond the labels of the asserted claims or remedies.” (citation omitted)); *Unified W. Grocers, Inc. v. Twin City Fire Ins. Co.*, 457 F.3d 1106, 1115 (9th Cir. 2006) (“The label of ‘restitution’ or ‘damages’ does not dictate whether a loss is insurable.” (citations omitted)).

195. *See Pan Pac. Retail Props., Inc.*, 471 F.3d at 966–67 (“An insurer is not required to provide coverage for claims seeking the return of something wrongfully received, but must still indemnify for claims that seek compensation for injury suffered as a result of the insured’s conduct.”).

196. 824 N.Y.S.2d 91 (N.Y. App. Div. 2006).

197. *Id.* at 94.

C. Public Policy

An alternative argument for an insurer who disputes the restitutionary nature of a claim is that the relevant state's public policy bars coverage.¹⁹⁸ Some courts find the public policy rationale more compelling and have held that restitutionary payments in the form of disgorgement are uninsurable because coverage for the return of ill-gotten gains would violate fundamental principles of public policy. *Bank of the West v. Superior Court* explicitly articulated the public policy rationale:

When 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.¹⁹⁹

One of the main principles underlying the public policy rationale is “moral hazard.”²⁰⁰ The moral hazard that would result if one could insure against disgorgement of ill-gotten gains was recognized in *Bank of the West*: allowing the insured wrongdoer to transfer the cost of disgorgement to the insurer “would eliminate the incentive for obeying the law.”²⁰¹ In *Unified Western Grocers, Inc. v. Twin City Fire Insurance Co.*, the U.S. District Court for the District of Hawaii stated that *Bank of the West* represents the “majority view” on the issue of whether restitution of an ill-gotten gain is uninsurable.²⁰²

198. See, e.g., *Vigilant Ins. Co. v. Bear Stearns Cos., Inc.*, No. 602160, 2006 WL 118368, at *5 (N.Y. Sup. Ct. Jan. 11, 2006) (“They contend that the disgorgement payment here is uninsurable as a matter of law based on public policy because, to allow Bear Stearns to recover its money through insurance, would enable it to retain money that it had improperly obtained and would eliminate its incentive to obey the law.”). Alternatively, the insureds argued “that the return of such ‘ill-gotten funds’ does not constitute damages within the meaning of the policies.” *Id.*

199. *Bank of the W. v. Super. Ct.*, 833 P.2d 545, 555 (Cal. 1992).

200. See *Zayed v. Arch Ins. Co.*, 932 F. Supp. 2d 956, 966 (D. Minn. 2013) (“[I]n distinguishing insurable claims from uninsurable claims, Minnesota courts have been concerned about moral hazard—that is, the risk that, if a particular type of wrongful conduct can be insured, people will engage in more of that type of wrongful conduct.”).

201. *Bank of the W.*, 833 P.2d at 555.

202. See *Unified W. Grocers, Inc. v. Twin City Fire Ins. Co.*, 371 F. Supp. 2d

Courts in which the issue of coverage for restitution is one of first impression may either adopt the public policy rationale or hold that the relevant state's public policy does not proscribe coverage for restitution. In *Executive Risk Indemnity, Inc. v. Pacific Educational Services, Inc.*,²⁰³ Hawaii law governed the construction of the insurance policy, but the court stated, "neither the Hawaii appellate courts nor the Hawaii legislature has expressly stated whether restitution is insurable."²⁰⁴ To resolve this issue, the court concluded, "[c]ase law from Hawaii and other jurisdictions indicates that the Hawaii Supreme Court would likely hold that restitution is uninsurable."²⁰⁵

However, in *Virginia Mason Medical Center v. Executive Risk Indemnity Inc.*,²⁰⁶ the U.S. District Court for the Western District of Washington refused to adopt the public policy rationale in determining "whether an insurer can provide coverage for the risk of being forced to [return] money that was wrongfully obtained."²⁰⁷ Recognizing that "[t]he Washington Supreme Court has distinctly acknowledged an absence of public policy in the construction of insurance contracts," the district court found that the coverage defined in the policy at issue was insurable under Washington law.²⁰⁸ The Washington Supreme Court previously indicated that "public policy must be clearly expressed in a state statute or judicial decision before it can override an insurance policy's explicit coverage."²⁰⁹ Additionally, the Washington

1234, 1243-44 (D. Haw. 2005) (citing multiple cases from various jurisdictions that reflect the "majority view").

203. 451 F. Supp. 2d 1147 (D. Haw. 2006).

204. *Id.* at 1157.

205. *Id.* The court reasoned that "[a] conclusion that restitution is insurable would contravene the express purpose of restitution recognized by Hawaii courts, which is to deter wrongdoers from benefitting or otherwise profiting from their improper actions." *Id.* at 1162.

206. No. C07-0636MJP, 2007 WL 3473683 (W.D. Wash. Nov. 14, 2007).

207. *Id.* at *4.

208. *See id.* ("Washington courts rarely invoke public policy to override express terms of an insurance policy.")

209. *Id.* (citing *Fluke Corp. v. Hartford Accident & Indem. Co.*, 34 P.3d 809 (Wash. 2001)). In *Fluke*, the Washington Supreme Court stated, "[i]n sum, Hartford can identify no public policy clearly expressed in Washington statutes or case law that would justify overriding the policy's explicit coverage for malicious prosecution." *Fluke Corp. v. Hartford Accident & Indem. Co.*, 34 P.3d 809, 813 (Wash. 2001).

Supreme Court had stated, “[t]he paramount public policy . . . is the commitment to upholding the plain language of contracts.”²¹⁰ Because the insurer, Executive Risk, failed to provide any Washington statutes or case law expressing public policy against coverage for damages resulting from alleged wrongful acts, the court found that the coverage defined in the policy was insurable under Washington law.²¹¹ As *Pacific Educational Services* and *Virginia Mason Medical Center* make clear, whether the public policy rationale will apply in a given case depends on how the particular jurisdiction conceptualizes public policy in the insurance context. In several recent cases, the ability of insurance companies to rely on the public policy defense to coverage has been weakened.

D. Recent Problematic Cases

Two 2013 cases, *J.P. Morgan Securities Inc. v. Vigilant Insurance Co.* and *Cohen v. Lovitt & Touche, Inc.*,²¹² have made this area of the law regarding insurance coverage for restitution and disgorgement even more unsettled than it had been in the last few decades. *J.P. Morgan Securities* highlights the uncertainty surrounding the meaning of disgorgement and how it should be measured.²¹³ *Cohen* highlights how the public policy rationale can be subject to harsh criticism and provides a persuasive analysis for rejecting this rationale.²¹⁴ Arguably, both cases narrow the ability of insurers to rely on the public policy rationale to deny coverage for claims or payments labeled as

210. *Fluke*, 34 P.3d at 814.

211. *See Va. Mason Med. Ctr.*, 2007 WL 3473683, at *4 (providing why the settlement at issue was insurable under Washington law).

212. 308 P.3d 1196 (Ariz. Ct. App. 2013).

213. *See J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 992 N.E.2d 1076, 1080 (N.Y. 2013) (“Bear Stearns alleges that much of the payment, although labeled disgorgement by the SEC, did not actually represent the disgorgement of its own profits. It submits that the rule precluding coverage for disgorgement should apply only where the insured requests coverage for the disgorgement of its own illicit gains.”).

214. *See infra* notes 261–262 and accompanying text (providing that Arizona’s “exacting” public policy analysis could not be harmonized with the “categorical preclusion” of coverage for restitutionary losses).

restitution or disgorgement.²¹⁵ These decisions represent a potential victory for insureds if other courts follow suit in limiting the ability of insurance companies to rely on the public policy rationale.²¹⁶ A third case from 2013, *Fidelity Bank v. Chartis Specialty Insurance Co.*,²¹⁷ demonstrates the uncertainty surrounding insurance coverage for restitution or disgorgement in jurisdictions that have not yet addressed the issue.²¹⁸ Finally, a 2014 case, *William Beaumont Hospital v. Federal Insurance Co.*,²¹⁹ demonstrates how amorphous the term “disgorgement” can be.²²⁰ Although the context in each of the above cases is different, each case highlights the need for a clear definition and understanding of restitution and disgorgement, especially in the

215. See Brian S. Scarbrough & Jan A. Larson, *New York Court of Appeals Sharply Limits Ability of Insurers to Escape Coverage for “Disgorgement” or Restitution*, LEXOLOGY (June 19, 2013), <http://www.lexology.com/library> (“[*J.P. Morgan Securities Inc. v. Vigilant Insurance Co.*] serves as an important victory to policyholders by narrowing the ability of insurers to rely on such public policy rationales, particularly in the context of SEC settlements.”); *J.P. Morgan Sec. Inc.*, 992 N.E.2d at 1083 (comparing the cases the insurers rely on with the present action and stating that “in contrast, Bear Stearns alleges that it is not pursuing recoupment for the turnover of its own improperly acquired profits and, therefore, it would not be unjustly enriched by securing indemnity”); *Cohen*, 308 P.3d at 1200 (“Therefore, before concluding that an insurance policy that would have covered the Wood settlement payments would be unenforceable as a matter of law, we must consider whether the public policy against insuring restitutionary payments would outweigh the interest in enforcing such a contract.”).

216. See John N. Ellison, *New York’s Highest Court ‘Disgorges’ Insurance Companies of Overused Non-Policy Based Defense*, LEXOLOGY (June 20, 2013), <http://www.lexology.com/library> (“[A]s of today, policyholders . . . in New York, or those having claims made against them based on activities occurring in New York, have a far better chance of obtaining coverage based on what the policy covers, instead of facing an [insurer’s] efforts to avoid coverage based on a ‘public policy’ argument.”).

217. No. 1:12-CV-4259-RWS, 2013 WL 4039414 (N.D. Ga. Aug. 7, 2013).

218. See *id.* at *3–4 (discussing the “rule” from *Bank of the West* and *Level 3* but subsequently stating that “this Court hesitates to purport to announce a ‘new’ Georgia rule”).

219. No. 13-1468, 2014 WL 185388 (6th Cir. Jan. 16, 2014).

220. See *id.* at *3 (“Federal’s principal argument is that the nurses’ claims arose from Beaumont’s gaining of profit, remuneration, or advantage to which it was not entitled and the settlement was a disgorgement of that advantage.”). In response to the insurer’s argument, the insured based its counterargument upon a verbal distinction between the words “retained” and “acquired.” *Id.* at *4. The insured contends that “money unlawfully *retained* is not the same in its legal character as money wrongfully *acquired*.” *Id.*

context of insurance coverage. How a court conceptualizes restitution and disgorgement will often determine whether a claim or payment is covered.

1. *J.P Morgan Securities Inc. v. Vigilant Insurance Co.*

J.P. Morgan Securities examined whether coverage is prohibited “where, as Bear Stearns claims, the disgorgement payment was (at least in part) linked to gains that went to others.”²²¹ In 2003, the SEC undertook an investigation of Bear Stearns & Co., Inc., a broker-dealer, and Bear Stearns Securities Corp., a clearing firm (the Bear Stearns companies are now J.P. Morgan Securities, Inc.), for allegedly facilitating late trading and deceptive market timing on behalf of its hedge fund customers.²²² The SEC notified Bear Stearns of its intent to charge Bear Stearns with violations of federal securities laws.²²³ Bear Stearns disputed the proposed charges claiming,

as a clearing broker that processed transactions initiated by others, it did not knowingly violate any law; its management did not facilitate the late trading or market timing, and it did not share in the profits or benefits from the late trading, from which it received only \$16.9 million in commissions.²²⁴

Bear Stearns made a settlement offer, which the SEC accepted.²²⁵ “Without admitting or denying the findings, Bear Stearns agreed to pay \$160 million as ‘disgorgement’ and \$90 million as a civil penalty.”²²⁶ Bear Stearns then sought indemnification from its primary carrier, Vigilant Insurance Co., and six excess carriers.²²⁷

221. *J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 992 N.E.2d 1076, 1083 (N.Y. 2013).

222. *See id.* at 1078 (discussing the underlying SEC investigation of Bear Stearns).

223. *See id.* (providing the course of events during the SEC’s investigation).

224. *Id.*

225. *See id.* (providing the terms of the settlement between Bear Stearns and the SEC).

226. *Id.* “The agreed-upon \$250 million payment was deposited in a fund to compensate any mutual fund investors who had been harmed by Bear Stearns’ conduct.” *Id.*

227. *See id.* at 1079 (“It requested indemnity for three claims: the \$160 million SEC disgorgement payment . . . ; \$40 million in defense costs; and the

The insurers denied coverage for all three claims, and Bear Stearns commenced a breach of contract and declaratory judgment action.²²⁸ Bear Stearns argued “that its claims all fell within the definition of Loss and alleged that a substantial portion of the SEC disgorgement payment (\$140 million) represented illicit profits obtained by its hedge fund customers rather than gains enjoyed by Bear Stearns itself.”²²⁹ The insurers argued “that Bear Stearns could not be indemnified for any portion of the SEC disgorgement payment as a matter of public policy.”²³⁰ The trial court denied the insurers motions to dismiss, but the Appellate Division reversed, dismissed the complaint, and held “that, as a matter of public policy, Bear Stearns could not seek recoupment of the \$160 million disgorgement payment.”²³¹

In June 2013, the New York Court of Appeals reversed the order of the Appellate Division.²³² The court rejected the insurers’ public policy argument that “Bear Stearns should not be entitled to seek indemnity for the \$160 million disgorgement payment because Bear Stearns enabled its customers to make millions through its trading tactics.”²³³ The court explicitly stated the rationales that support denial of coverage for disgorgement:

Although we have not considered the issue, other courts have held that the risk of being ordered to return ill-gotten gains—disgorgement—is not insurable. Some courts reached this conclusion because, as a matter of contract interpretive principles, the return of improperly acquired funds does not constitute a “loss” or “damages” within the meaning of insurance policies [citing *Level 3 Commc’ns, Inc. v. Fed. Ins. Co.*, 272 F.3d 908, 910 (7th Cir. 2001)]. Others have emphasized that public policy prohibits an insured from receiving indemnification for the disgorgement of its own illicit

\$14 million private settlement.”).

228. *See id.* at 1080 (discussing the events that led to the coverage dispute).

229. *Id.*

230. *Id.*

231. *See id.* (providing the procedural history of the coverage suit).

232. *See id.* at 1083 (“[A]lthough we certainly do not condone the late trading and market timing activities described in the SEC order, the Insurers have not met their heavy burden of establishing, as a matter of law . . . , that Bear Stearns is barred from pursuing insurance coverage under its policies.”).

233. *Id.* at 1080.

gains [citing *Bank of the W. v. Super. Ct.*, 833 P.2d 545, 555 (Cal. 1992)].²³⁴

Although it discussed these established principles, the court ultimately recognized Bear Stearns's claim "that much of the payment, although labeled disgorgement by the SEC, did not actually represent the disgorgement of its own profits."²³⁵ Because the findings in the SEC order did not "conclusively link the disgorgement payment to improperly acquired funds in the hands of the insured," the court found that the insurers were not entitled to dismissal of Bear Stearns' claims related to the SEC disgorgement payment.²³⁶ The insurers also relied on a policy exclusion that essentially denied coverage for claims that constitute disgorgement.²³⁷ However, the court found that this exclusion did not defeat coverage because the SEC order did not conclusively refute Bear Stearns' contention that its misconduct profited others and not itself.²³⁸

J.P. Morgan Securities highlights the ambiguities surrounding the concept of disgorgement. It also demonstrates how the application of the disgorgement remedy can be difficult, especially when the insured claims, as Bear Stearns did, that only a portion of the disgorgement payment represents the insured's ill-gotten profits.²³⁹ While the purpose of disgorgement—"to eliminate the possibility of profit from conscious wrongdoing"—"is easily stated and readily understandable," the application of the remedy can be difficult.²⁴⁰

234. *Id.* at 1082.

235. *Id.*

236. *Id.* at 1083. The court stated that at the summary judgment stage of litigation, "the documentary evidence does not decisively repudiate Bear Stearns' allegation that the SEC disgorgement payment amount was calculated in large measure on the profits of others." *Id.*

237. *See id.* (quoting the insurance policy as denying coverage for claims "arising out of [Bear Stearns] gaining in fact any personal profit or advantage to which [Bear Stearns] was not legally entitled, including but not limited to any actual or alleged commingling of funds or accounts").

238. *See id.* (providing that the two policy exclusions, relied upon by the insurers, do not defeat coverage).

239. *See id.* at 1080 (providing that Bear Stearns "contends that it was not unjustly enriched by at least \$140 million of the disgorgement payment because that portion was attributable to the profits of its customers").

240. RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 51 cmt. e (2011).

For example, in situations such as the one in *J.P. Morgan Securities*, “the application of the disgorgement remedy turns on problems of *attribution*, as the court attempts to decide what portion of the defendant’s assets or income is properly attributable to the underlying wrong to the claimant.”²⁴¹ The Third Restatement of Restitution and Unjust Enrichment provides that “the problem of attribution may involve questions that facts cannot answer,” such as “[w]hat proportion of the defendant’s overall profits to treat as the product of the underlying wrong.”²⁴² As *J.P. Morgan Securities* demonstrates, if the insured can claim that only a portion of the disgorgement payment represents its ill-gotten profits, then it is not likely that the insurer will win on its motion to dismiss the insured’s claims.

2. Cohen v. Lovitt & Touche, Inc.

In the underlying suit leading up to the coverage dispute in *Cohen*, Canyon Ranch employees filed a class action lawsuit against Canyon Ranch alleging that the company had violated the Massachusetts Tip Act, which requires “that all moneys collected as a ‘service’ charge be paid directly to the company’s employees.”²⁴³ The lawsuit was settled for approximately \$16 million.²⁴⁴ The directors and officers, Cohen and Zuckerman, personally paid the settlement costs because the company was insolvent.²⁴⁵ Cohen and Zuckerman sought indemnification under their D&O policies, but the insurance companies denied coverage, “claiming the policies excluded coverage, or alternatively, that coverage for the cost of the Wood settlement was uninsurable as a matter of law.”²⁴⁶ Cohen and Zuckerman then filed suit against the insurance companies.²⁴⁷ The trial court granted summary

241. *Id.*

242. *Id.*

243. Cohen v. Lovitt & Touche, Inc., 308 P.3d 1196, 1198 (Ariz. Ct. App. 2013).

244. *See id.* (discussing the underlying settlement).

245. *See id.* (discussing the events leading up to the coverage dispute).

246. *Id.*

247. *See id.* (providing that Cohen and Zuckerman alleged breach of contract and breach of the implied covenant of good faith and fair dealing).

judgment in favor of the insurers and found “that the payment to the Wood plaintiffs was restitutionary and that such payments were uninsurable as a matter of public policy.”²⁴⁸

The sole issue on appeal was “whether restitutionary payments are potentially insurable under Arizona law or whether, as the trial court found, any agreement to insure such payments would be unenforceable because such payments are not ‘losses,’ or are uninsurable as a matter of law.”²⁴⁹ This presented an issue of first impression in Arizona.²⁵⁰ The appellate court began its analysis by stating that the Arizona Supreme Court has emphasized the freedom of parties to contract²⁵¹ and “warned that courts must therefore be hesitant to declare contractual provisions invalid on public policy grounds.”²⁵² The trial court, rather than applying the *Ocotillo* test²⁵³ to determine whether restitutionary payments are insurable, followed the reasoning of extrajurisdictional case law, such as *Level 3* and *Bank of the West*.²⁵⁴ The appellate court provided a critical analysis of the interpretive principle rationale and the public policy rationale.²⁵⁵ First, the court addressed the *Level 3* rationale that “restitutionary payments are not strictly losses,” but it stated that this rationale “does not resolve whether such coverage

248. *Id.*

249. *Id.*

250. *See id.* (“No Arizona case has squarely addressed whether losses incurred from unforeseen restitutionary payments are insurable.”).

251. *See id.* at 1198–99 (“Our law generally presumes . . . that private parties are best able to determine if particular contractual terms serve their interests.” (citation omitted)).

252. *Id.* at 1198 (citation omitted). In *1800 Ocotillo, L.L.C. v. WLB Group, Inc.*, the Arizona Supreme Court set forth the following test for determining when public policy should outweigh the contractual terms agreed upon by the parties: “Absent legislation specifying that a contractual term is unenforceable, courts should rely on public policy to displace the private ordering of relationships only when the term is contrary to an otherwise identifiable public policy that clearly outweighs any interests in the term’s enforcement.” 196 P.3d 222, 224 (Ariz. 2008).

253. *Supra* note 252.

254. *See Cohen v. Lovitt & Touche, Inc.*, 308 P.3d 1196, 1199 (Ariz. Ct. App. 2013) (providing that the trial court followed the reasoning of the courts that have addressed whether restitutionary payments may be insurable).

255. *See id.* (“These cases all conclude that restitutionary payments may not be covered by insurance policies for two reasons.”).

should be available as a matter of public policy.”²⁵⁶ The possibility still exists that the parties could agree that the insurer would indemnify the insured for payments that are restitutionary in nature.²⁵⁷ Second, the court stated that the rule from *Bank of the West*²⁵⁸ “is categorical and would render losses from restitutionary payments uninsurable, regardless of the specific language of the agreement or the specific circumstances of the claim.”²⁵⁹

The court was concerned that *Level 3's* approach “forecloses consideration of variation in contractual language,” which might mitigate or even eliminate public policy concerns because *Level 3* and its progeny focus solely on the nature of the claim rather than the conduct of the insured.²⁶⁰ Because Arizona’s approach mandates “an exacting analysis of the impact of public policy on the enforceability of specific contractual agreements,” the court could not adopt the “categorical preclusion” of coverage for restitutionary losses.²⁶¹ The court considered a hypothetical insurance contract that covered restitutionary payments and concluded that the interest in enforcing such a contract

256. *Id.*

257. *See id.* (“Hypothetically, parties could negotiate other insurance policy language to expressly insure business hardships arising from an unexpected duty to make a restitutionary payment.”).

258. *See Bank of the W. v. Super. Ct.*, 833 P.2d 545, 553 (Cal. 1992) (“It is well established that one may not insure against the risk of being ordered to return money or property that has been wrongfully acquired.”).

259. *Cohen*, 308 P.3d at 1199.

260. *See id.* at 1200 (analyzing *Level 3* and declining to adopt its rationale); *Level 3 Commc’ns, Inc. v. Fed. Ins. Co.*, 272 F.3d 908, 911 (7th Cir. 2001) (“How the claim or judgment order or settlement is worded is irrelevant.”); *CNL Hotels & Resorts, Inc. v. Hous. Cas. Co.*, 505 F. Supp. 2d 1317, 1324 (M.D. Fla. 2007) (“[T]he important factor in determining ‘loss’ is the restitutionary character of the payment at issue, not the malfeasance (or lack thereof) on the part of the entity making it.”); *Conseco, Inc. v. Nat’l Union Fire Ins. Co.*, No. 49D130202CP000348, 2002 WL 31961447, at *11 (Ind. Ct. App. Dec. 31, 2002) (“[A]n insured has no greater right to something wrongfully acquired by mistake or accident than it does to something acquired by fraud—the critical factor is that the money or property does not belong to the insured, and it has to be returned.”); *Nortex Oil & Gas Corp. v. Harbor Ins. Co.*, 456 S.W.2d 489, 494 (Tex. Civ. App. 1970) (“The insured’s innocence and good faith are immaterial.”).

261. *Cohen v. Lovitt & Touche, Inc.*, 308 P.3d 1196, 1200 (Ariz. Ct. App. 2013).

outweighs the public policy against insuring restitutionary payments:

Thus, while potential policy language could substantially mitigate any public policy concern arising from coverage of restitutionary losses, the public has a countervailing interest in the enforcement of insurance policies protecting well-intentioned directors and officers from the type of unforeseen losses occurring here. Prohibiting such agreements altogether would discourage persons from acting as officers or directors of companies expanding to other states.²⁶²

There are two factors that seem to be critical to the court's decision. First, the policy forbidding coverage for restitutionary payments has never been expressed in any Arizona legislation or judicial decisions.²⁶³ Second, "parties to an insurance contract are fully capable of drafting language that prohibits coverage when an insured has intentionally or recklessly acquired property in a wrongful fashion."²⁶⁴ Although the court concluded that Arizona public policy does not prohibit coverage for restitutionary payments, it did not decide whether the policies at issue covered the losses claimed by Cohen and Zuckerman and remanded the case to the trial court.²⁶⁵ The Cohen court declined to follow *Level 3* and instead recognized a strong public policy in favor of enforcing contracts.²⁶⁶ The court was concerned with the intent of the insured, and it seemed that the court would favor coverage in situations when well-intentioned insureds suffer unforeseen losses that might be restitutionary in nature.²⁶⁷

262. *Id.*

263. *See id.* ("The policy forbidding insurance coverage for restitutionary payments in Arizona is not strong.").

264. *Id.*

265. *See id.* (concluding that "the trial court erred when it determined as a matter of law that Arizona law prohibits insurance coverage for restitutionary payments" and remanding "for further proceedings consistent with this opinion").

266. *See supra* note 251 (providing that the Arizona Supreme Court has emphasized the freedom of parties to contract for terms that best serve their interests).

267. *See Cohen v. Lovitt & Touche, Inc.*, 308 P.3d 1196, 1200 (Ariz. Ct. App. 2013) ("Thus, while potential policy language could substantially mitigate any public policy concern arising from coverage of restitutionary losses, the public has a countervailing interest in the enforcement of insurance policies protecting well-intentioned directors and officers from the type of unforeseen losses

3. Fidelity Bank v. Chartis Specialty Insurance Co.

In *Fidelity Bank v. Chartis Specialty Insurance Co.*, Fidelity Bank purchased a “Management and Professional Liability for Financial Institutions policy” from Chartis Specialty Insurance Company.²⁶⁸ Fidelity Bank’s customers sued the Bank in a class action lawsuit alleging, “the fee that Plaintiff charged its customers for overdrafts amounted to a usurious interest charge in violation of Georgia law.”²⁶⁹ The Bank settled the underlying class action suit and brought suit against its insurer, Chartis, claiming that Chartis “has a duty to indemnify Plaintiff for the sums that it lost as a result of the suit.”²⁷⁰ Chartis argued that it was not obligated to indemnify the Bank for several reasons. The two relevant arguments were that “the amounts that Fidelity paid to settle the Underlying Action are uninsurable as a matter of law because they amount to restitution,” and that “the Policy excludes claims arising out of disputes over fees.”²⁷¹

The U.S. District Court for the Northern District of Georgia found the insurer’s arguments “compelling.”²⁷² The court reasoned that the damages claimed by the underlying plaintiffs did not amount to money that the Bank lost because the Bank was using “funds from its customers’ accounts in a manner that was not legally authorized.”²⁷³ Therefore, the Bank was required to return its customers’ funds, which the court characterized as “restitution for amounts Plaintiff collected pursuant to illegal practices.”²⁷⁴ Although the court could not locate Georgia case law that addressed the issue of insurance coverage for restitution, it used the same line of reasoning as *Bank of the West*.²⁷⁵ However,

occurring here.”).

268. See *Fid. Bank v. Chartis Specialty Ins. Co.*, No. 1:12-CV-4259-RWS, 2013 WL 4039414, at *1 (N.D. Ga. Aug. 7, 2013) (discussing the factual background of the case).

269. *Id.*

270. *Id.*

271. *Id.* at *3.

272. *Id.*

273. *Id.*

274. *Id.*

275. See *id.* (providing that if the court found coverage, “it would amount to a ruling that Plaintiff is free to collect fees and make profits from its customers through illegal conduct, and the insurer is on the hook when the customers sue

the court declined to adopt this rationale stating, “this Court hesitates to purport to announce a ‘new’ Georgia rule.”²⁷⁶ The court avoided expressing its position on insurance coverage for restitution and disgorgement because it was able to conclude that there was no coverage based upon a policy exclusion.²⁷⁷ The fact that the court brings up this “rule” from courts in several states but then declines to either adopt or reject it demonstrates the uncertainty and inconsistency among courts when addressing the issue of insurance coverage for restitutionary payments, especially when the issue is one of first impression.

4. William Beaumont Hospital v. Federal Insurance Co.

In the underlying suit in *William Beaumont Hospital v. Federal Insurance Co.*, two nurses instituted a class action against eight Detroit-area hospital systems, including William Beaumont Hospital,²⁷⁸ alleging that the hospitals had violated the Sherman Anti-Trust Act.²⁷⁹ The class action plaintiffs “sought to recover for the compensation properly earned by [registered nurses] employed at Detroit-area hospitals but unlawfully retained by such hospitals.”²⁸⁰ William Beaumont Hospital sued its insurer, Federal, seeking a declaration that Federal was obligated to indemnify the hospital.²⁸¹ Federal argued that “the settlement constituted disgorgement and was not considered a Loss under the Policy and thus was uninsurable.”²⁸²

The policy limited the definition of loss, which explicitly carved out “disgorgement.”²⁸³ Federal argued that the nurses’

while Plaintiff keeps the ill-gotten gains”).

276. *Id.* at *4.

277. *See id.* (finding that Exclusion (h) “speaks to exactly this type of claim” because it “excludes from indemnification (but not defense) disputes involving fees and commissions”).

278. *See William Beaumont Hosp. v. Fed. Ins. Co.*, No. 13-1468, 2014 WL 185388, at *2 (6th Cir. Jan. 16, 2014) (discussing the facts of the underlying suit brought against William Beaumont Hospital and seven other hospitals).

279. Sherman Anti-Trust Act, 15 U.S.C. § 1 (2012).

280. *William Beaumont Hosp.*, 2014 WL 185388, at *2.

281. *See id.* (discussing the coverage dispute).

282. *Id.*

283. *See William Beaumont Hosp. v. Fed. Ins. Co.*, No. 11-15528, 2013 WL

claims fell within this policy exclusion because “the advantage gained was nursing services at below-market compensation and that settlement is clearly disgorgement of the value of that advantage.”²⁸⁴ The Sixth Circuit rejected Federal’s argument stating, “[t]his is a classic compensatory damages calculation—it attempts to put the nurses in the position they would have been if not for the violation.”²⁸⁵ The court provided a definition of the word “disgorge” from the dictionary: “disgorge means to give up illicit or ill-gotten *gains*.”²⁸⁶ After defining each word used in the definition of “disgorge,” the court reasoned that “Beaumont *retained* the due, but unpaid, wages unlawfully,” but Beaumont “never gained possession of (or obtained or acquired) the nurses’ wages illicitly, unlawfully, or unjustly.”²⁸⁷ According to the court, because the hospital never *gained* possession of the nurses’ wages illicitly, but merely *retained* them illicitly, the money paid in settlement was not “disgorgement.”²⁸⁸ This analysis is unresponsive to the insurer’s disgorgement argument because it simply made a verbal distinction between the words “retain” and “obtain.”²⁸⁹ *William Beaumont* demonstrates how amorphous the term “disgorgement” can be, especially in the hands of skilled lawyers who are able to make arguments that exploit the ambiguities surrounding the meaning of the term.

992552, at *5 (E.D. Mich. Mar. 13, 2013) (quoting the insurance policy as providing that “any Claim based upon, arising from or in consequence of profit, remuneration or advantage to which an Insured was not legally entitled, the term Loss . . . shall not include *disgorgement* by any Insured” (emphasis added)).

284. *William Beaumont Hosp. v. Fed. Ins. Co.*, No. 13-1468, 2014 WL 185388, at *3 (6th Cir. Jan. 16, 2014).

285. *Id.* at *5.

286. *Id.* at *4 (citation omitted).

287. *Id.* at *5.

288. *See id.* (“The hospital could not have taken money from the nurses because it was never in their hands in the first place.”).

289. *See id.* (“[W]e find the hospital never gained possession of (or obtained or acquired) the nurses’ wages illicitly, unlawfully, or unjustly. Rather, according to the nurses’ complaint, Beaumont *retained* the due, but unpaid, wages unlawfully. This is not mere semantics. Retaining or withholding differs from obtaining or acquiring.”).

5. *Where Does This Leave Us?*

The former chairman of the SEC, William Donaldson, “described the issues relating to the insurability of disgorgement as ‘complicated’ and said it is up to the courts to determine as a matter of state law whether they are insurable.”²⁹⁰ It is clear that the courts have struggled, and continue to struggle, with these issues. Sometimes the difficulty in determining coverage for amounts labeled as disgorgement “lies in the distinction between ‘disgorgements’ that actually represent compensatory damages and payments that truly are the return of ill-gotten gains.”²⁹¹ “In determining whether a ‘disgorgement’ will be insurable, one must look beyond the label placed on the payment to the substance and facts forming its basis.”²⁹² In sum, courts must look at the nature of the claim or payment to see if it constitutes restitution or disgorgement.²⁹³ However, this task has proven difficult because specific, universal definitions of these terms do not exist to serve as guideposts for courts.²⁹⁴ This is where the Third Restatement of Restitution and Unjust Enrichment comes in.

IV. *What Do We Do About It?*

Utilizing the definitions in the Third Restatement of Restitution and Unjust Enrichment will aid in the development of specific, clear definitions of the terms “restitution” and “disgorgement.”²⁹⁵ Having clear definitions of these terms in the

290. See RICHARD A. ROSEN, SETTLEMENT AGREEMENTS IN COMMERCIAL DISPUTES: NEGOTIATING, DRAFTING AND ENFORCEMENT § 34.15 (2013) (citing William H. Donaldson, Chairman, SEC, Testimony Concerning Global Research Analyst Settlement before the Senate Committee on Banking, Housing and Urban Affairs (May 7, 2003)).

291. *Id.*

292. *Id.*

293. See *supra* note 260 (discussing cases that focus on the nature of the claim).

294. See Kull, *supra* note 121, at 1194–95 (“[I]n the area of liability for unjust enrichment . . . this threshold task of definition was not pursued to a conclusion The result has been a persistent uncertainty about this part of the law that continues to hamper analysis and even comprehension.”).

295. See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1 (2011) (“A person who is unjustly enriched at the expense of another is subject

insurance context will help reduce and, in some cases, avoid litigation. Currently, the precedent for the courts regarding whether restitutionary payments are insurable is unclear.²⁹⁶ Because courts vary in their approaches to this issue,²⁹⁷ courts that have not yet addressed this issue do not have a clear rule to follow. Although some courts adopt the rule from *Level 3*²⁹⁸ or the public policy approach from *Bank of the West*,²⁹⁹ other courts decline to adopt either and devise their own approach for addressing this issue.³⁰⁰

Because the approaches among the courts vary and are rarely consistent with one another, litigants cannot readily predict the likely result of their case. Therefore, litigants may be unsure whether they should expend large amounts of money challenging the insurance company's denial of coverage for payments that may or may not be restitutionary in nature. More broadly, it is important for insureds to understand what their insurance policies cover. Having clear definitions of restitution and disgorgement will help insureds predict, with some degree of certainty, whether a certain payment or claim will be covered and will help them avoid potentially devastating economic consequences.³⁰¹

to liability in restitution.”); *id.* § 51(4) (“The object of restitution in such cases is to eliminate profit from wrongdoing while avoiding, so far as possible, the imposition of a penalty. Restitution remedies that pursue this object are often called disgorgement or accounting.” (internal quotation marks omitted)).

296. See *supra* notes 148–151 and accompanying text (providing two rationales that courts have used to reach the conclusion that restitutionary payments or disgorgement of ill-gotten gains are uninsurable).

297. See *supra* notes 144–146 and accompanying text (discussing the different ways that courts interpret a policy's terms to determine whether an insurer has to cover restitutionary payments made by an insured); *supra* Part III.D (discussing recent cases that take various approaches in determining whether restitution and disgorgement are insurable).

298. See *supra* Part III.B.3 (discussing cases that have followed *Level 3*'s rationale to deny coverage for restitution or disgorgement).

299. See *supra* Part III.C (discussing cases that have followed the public policy rationale to deny coverage for payments or claims that are restitutionary in nature).

300. See *supra* Part III.D.2 (providing a discussion of *Cohen v. Lovitt & Touche, Inc.*, in which the Arizona Court of Appeals declined to follow *Level 3* or *Bank of the West* and concluded that Arizona public policy does not prohibit coverage for restitutionary payments).

301. See Eric W. Collins, Note, *Level 3 v. Federal Insurance: Do You Know*

A blanket rule prohibiting coverage for restitution and disgorgement is inappropriate because facts and circumstances of cases vary, and insurers and insureds are free to contract for coverage of restitutionary payments.³⁰² Therefore, the application of the rule prohibiting coverage for restitution and disgorgement should be determined on a case-by-case basis. This approach is consistent with the fact that insurance law disputes are typically resolved on a case-by-case basis.³⁰³ The following suggested solutions are intended to provide clarity and guidance in determining whether restitution and disgorgement should be insurable.

A. Suggested Solutions

1. *The Third Restatement of Restitution and Unjust Enrichment*

First, courts should employ the principles of contract interpretation in light of the Third Restatement of Restitution and Unjust Enrichment. The Third Restatement clarifies the meanings of “restitution” and “disgorgement.”³⁰⁴ Because the

What Is In Your Directors and Officers Liability Insurance Policy?, 73 UMKC L. REV. 199, 212 (2004) (“Allowing insurance companies to avoid their coverage responsibility as they see fit opens the door to potentially devastating economic consequences. After companies have paid the steep cost of insurance premiums, they do not receive the benefit that the payment of those premiums was ‘guaranteed’ to provide.”).

302. See *supra* note 257 (providing an example of a situation in which an insurer might agree to indemnify the insured for payments that are restitutionary in nature).

303. See James M. Fischer, *The Doctrine of Reasonable Expectations Is Indispensable, If We Only Knew What For?*, 5 CONN. INS. L.J. 151, 176 (1998) (“[A]ny approach we may develop, which attempts to balance the interests of the policyholder and the carrier will introduce uncertainty into insurance law due to the prevalence of case-by-case determination to resolve ambiguity and achieve expectations, which are largely individualistic and context specific.”); John K. DiMugno, *The Shifting Tides of Insurance Policy Interpretation: Does McKinnon v. Truck Insurance Exchange Change How Courts Will Interpret Insurance Policies?*, 15 CAL. INS. L. & REG. REP. 215, 215 n.2 (2003) (“Drafting policy elaborate provisions to address [the vast] circumstances would be extremely difficult; so, rather than attempt to deal with these matters, the insurance industry has simply punted, opting to deal with these matters on a case by case basis.”).

304. See *supra* note 295 (providing the meanings of restitution and

Third Restatement provides clear definitions, courts can easily apply its principles on a case-by-case basis. Given the uncertainty surrounding the terminology of restitution, the courts, and even lawyers, could benefit themselves and litigants by utilizing and adopting the definitions and principles from the Third Restatement of Restitution and Unjust Enrichment § 1 and § 51.³⁰⁵ These sections, along with the comments following each section, not only provide clear definitions of these terms but also provide a clear picture as to where restitution fits within the realm of damages and where restitution and disgorgement fall on the spectrum of remedies.³⁰⁶ Having a clear definition and understanding of these terms is critical for coverage disputes in which courts have to determine whether there is coverage for claims or payments that were labeled as restitution or disgorgement in the underlying suit or settlement.³⁰⁷ Although labeled as such, the claim or payment may not actually be restitutionary in nature.³⁰⁸ Therefore, courts must have a sound understanding of the meanings of these terms before deciding whether there is coverage or not. Using the principles of contract interpretation in conjunction with the Third Restatement will allow courts to effectively decide coverage disputes on a case-by-case basis instead of relying upon the nebulous public policy rationale to deny coverage for restitutionary payments.

disgorgement under §§ 1 and 51 of the Third Restatement of Restitution and Unjust Enrichment).

305. See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1 (2011) (restitution and unjust enrichment); *id.* § 51 (enrichment by misconduct, disgorgement, and accounting).

306. See *supra* notes 108–111 and accompanying text (illustrating the meaning of “disgorgement” and providing that disgorgement can be conceptualized as falling under the label of “restitution”); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1 cmt. a (2011) (“Liability in restitution derives from the receipt of a benefit whose retention without payment would result in the unjust enrichment of the defendant at the expense of the claimant.”); *id.* § 51 cmt. k (providing that “[d]isgorgement of wrongful gain is not a punitive remedy”).

307. See *J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 992 N.E.2d 1076, 1082–83 (N.Y. 2013) (analyzing the nature of the payment at issue despite the fact that the payment was labeled “disgorgement” by the SEC).

308. See *id.* at 1082 (concluding that the insurers are not entitled to dismissal of the insured’s coverage claim because the insured argued that “much of the payment . . . did not actually represent the disgorgement of its own profits” even though it was labeled “disgorgement” by the SEC).

2. Abandoning the Public Policy Rationale

Second, the public policy rationale should be abandoned or, at least, should be subject to a more exacting analysis when used by insurance companies to disclaim coverage for restitutionary payments. Both the Arizona Court of Appeals in *Cohen* and the Sixth Circuit Court of Appeals in *William Beaumont Hospital* disgorge the insurers of this overused defense that is not based on exclusions in an insurance policy. In *Cohen*, the Arizona Court of Appeals found that the public policy rationale—that “one may not insure against the risk of being ordered to return money or property that has been wrongfully acquired”³⁰⁹—is “categorical” and “forecloses consideration of variation in contractual language which could substantially mitigate or even eliminate any public policy concerns.”³¹⁰ The court concluded that Arizona’s approach to public policy, which mandates “an exacting analysis of the impact of public policy on the enforceability of specific contractual agreements,” could not be harmonized with “the categorical preclusion of insurance for restitutionary losses.”³¹¹ The Arizona Court of Appeals did not accept the “categorical rule” from *Bank of the West* but engaged in a thoughtful public policy analysis to determine whether Arizona law prohibited insurance coverage for restitutionary payments.³¹²

Similarly, in *William Beaumont Hospital*, the Sixth Circuit did not accept the insurer’s argument that coverage is contrary to Michigan’s public policy because “no one should benefit from his own wrongdoing.”³¹³ The Sixth Circuit recognized that under the Michigan cases, “the doctrine that an insured may not profit from its own wrongdoing relates to intentional tortious or criminal

309. *Bank of the W. v. Super. Ct.*, 833 P.2d 545, 553 (Cal. 1992).

310. *Cohen v. Lovitt & Touche, Inc.*, 308 P.3d 1196, 1200 (Ariz. Ct. App. 2013).

311. *Id.*

312. *See id.* (providing that Arizona’s approach required the court “to (1) presume that private parties are best able to determine if particular contractual terms serve their interests and, (2) in light of that presumption, weigh the particular beneficial features of a proposed agreement against any public policy concerns raised by it” (citation omitted)).

313. *William Beaumont Hosp. v. Fed. Ins. Co.*, No. 13-1468, 2014 WL 185388, at *6 (6th Cir. Jan. 16, 2014).

acts.”³¹⁴ Because the insurer did not identify “any cases in the Sixth Circuit holding that disgorgement is not insurable,” the court found that the insurer’s public policy claim failed.³¹⁵ Public policy belongs in the hands of legislators, not courts.³¹⁶ Therefore, a third potential solution is a legislative approach to the issue of whether restitution and disgorgement are insurable.

3. A Legislative Approach

Just as some state legislatures have passed laws addressing the insurability of punitive damages³¹⁷ and willful acts,³¹⁸ state legislatures could propose legislation addressing the insurability of restitution and disgorgement. The legislation should clearly define the terms “restitution” and “disgorgement” and should be precise about what is insurable and what is not insurable.³¹⁹ However, without legislation, the courts must decide whether restitutionary payments and the disgorgement of ill-gotten gains are insurable. Courts have struggled with this issue because the terms restitution and disgorgement are subject to

314. *Id.*

315. *Id.* at *7–8.

316. See *Halpin v. Am. Family Mut. Ins. Co.*, 823 S.W.2d 479, 483 (Mo. 1992) (“When the contract language is clear, . . . exceptions based on public policy must usually find support in necessary implication from statutory provisions.” (citation omitted)); *Eichelman v. Nationwide Ins. Co.*, 711 A.2d 1006, 1008 (Pa. 1998) (“In the absence of a plain indication of that policy through long governmental practice or statutory enactments, or of violations of obvious ethical or moral standards, the Court should not assume to declare contracts . . . contrary to public policy. The courts must be content to await legislative action.” (citation omitted)); *Cary v. Allstate Ins. Co.*, 922 P.2d 1335, 1338 (Wash. 1996) (“Public policy is generally determined by the Legislature and established through statutory provisions.”).

317. See *supra* notes 71–76 and accompanying text (discussing legislation passed in Virginia, Kansas, and South Carolina regarding the insurability of punitive damages).

318. See *Downey Venture v. LMI Ins. Co.*, 78 Cal. Rptr. 2d 142, 154 (Cal. Ct. App. 1998) (“Section 533 [of the California Insurance Code] precludes insurance coverage for a ‘wilful act.’ The purpose of such a prohibition is obviously to discourage wilful torts. . . . It is an implied exclusionary clause which, by statute, must be read into all insurance policies.” (citations omitted)).

319. See, e.g., *supra* notes 72–74 and accompanying text (discussing statutes that explicitly provide what is insurable and what is uninsurable as a matter of law).

misunderstanding.³²⁰ Utilizing the Third Restatement of Restitution and Unjust Enrichment and adopting its definitions could prove to be a successful first step toward resolving the issues surrounding insurance coverage for restitutionary payments.³²¹

4. Insurance Policy Exclusions for Restitution and Disgorgement

Fourth, insurance companies could include explicit provisions in liability policies that address coverage or non-coverage for restitutionary payments or disgorgement of ill-gotten gains. Typically, insurers rely on the limitation provided in the definition of loss—that loss does not include matters uninsurable under applicable law³²²—to argue that the state’s public policy prohibits coverage for restitutionary payments or disgorgement of ill-gotten gains.³²³ Instead of relying on this general language, insurance companies could either define loss to exclude restitution and disgorgement, or they could provide explicit exclusions in the exclusions section of the policy.³²⁴ However, if insurers do provide such exclusions, the policy should also provide definitions of restitution and disgorgement in order to provide clarity and hopefully limit litigation.³²⁵

320. See Rendleman, *supra* note 8, at 977 (“Professional misunderstanding of restitution exacerbates the difficulties of developing boundaries.”).

321. See *supra* note 295 and accompanying text (stating the meanings of restitution and disgorgement as provided by §§ 1 and 51 of the Third Restatement of Restitution and Unjust Enrichment).

322. See *Genzyme Corp. v. Fed. Ins. Co.*, 657 F. Supp. 2d 282, 286 (D. Mass. 2009) (quoting the insurance policy as providing that the term “loss” does not include “matters uninsurable under the law pursuant to which [the insurance policy] is construed”).

323. See *id.* at 288 (“Second, [the insurance company] contends that even if the Settlement Payment might fall within the commonly understood meaning of the word ‘loss,’ the Payment is uninsurable under Massachusetts law for reasons of public policy.”).

324. See *supra* note 130 (discussing insurance policy provisions that have limited the definition of “loss” as to exclude restitution or disgorgement).

325. See *supra* notes 125–126 and accompanying text (providing that the failure to define “damages,” “judgments,” and “settlements,” each of which is included in the definition of loss, has led to issues in coverage litigation regarding what is covered under the insurance policy).

William Beaumont Hospital demonstrates why insurers need to provide clear definitions of restitution and disgorgement if they are excluded from coverage and why such exclusions may not prove to be helpful.³²⁶ The insurance policy explicitly carved out “disgorgement” from the definition of “loss.”³²⁷ This policy provision did not prohibit coverage because the court found that the claims were for compensatory damages.³²⁸ The court rejected the insurer’s argument that the settlement did not constitute a loss stating that “Federal’s arguments, which use the terms restitution and disgorgement interchangeably, even though the Policy speaks only in terms of disgorgement, are unpersuasive.”³²⁹ The court also emphasized that “Federal used the term restitution elsewhere in the Policy, so it should be aware of the difference between the two terms.”³³⁰ If insurance companies want to explicitly exclude coverage for restitutionary payments or disgorgement, then insurers must expressly define these terms in the policy, especially if the policy language contains both terms.

The policy exclusion in *J.P. Morgan Securities* did not prove to be effective, at least at the summary judgment phase of litigation.³³¹ The exclusion essentially denied coverage for claims that constitute disgorgement.³³² However, this exclusion did not defeat coverage because Bear Stearns argued that “its misconduct profited others, not itself.”³³³ The policy exclusion in *Cohen* was very similar to the policy exclusion in *J.P. Morgan Securities*.³³⁴

326. See *supra* notes 283–289 and accompanying text (discussing the definition of loss, which excluded disgorgement, and providing why the Sixth Circuit rejected the insurer’s argument that relied on this exclusionary clause).

327. See *supra* note 283 (providing the policy definition of loss, which excluded “disgorgement”).

328. See *William Beaumont Hosp. v. Fed. Ins. Co.*, No. 13-1468, 2014 WL 185388, at *5 (6th Cir. Jan. 16, 2014) (“[T]he calculation of the settlement itself indicates that the nurses were seeking purely compensatory damages.”).

329. *Id.* at *4.

330. *Id.*

331. See *supra* notes 237–238 and accompanying text (discussing the policy exclusion in *J.P. Morgan Securities* and why the exclusion did not defeat coverage).

332. See *supra* note 237 (stating the policy exclusion that the insurance company relied upon to deny coverage).

333. *J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 992 N.E.2d 1076, 1083 (N.Y. 2013).

334. See *Cohen v. Greenwich Ins. Co.*, No. C20092552, 2011 WL 8780709, at

Despite the existence of this exclusion, the Arizona Court of Appeals did not address whether this exclusion prohibited coverage because it concluded “the trial court erred when it determined as a matter of law that Arizona law prohibits insurance coverage for restitutionary payments” and remanded the case for further proceedings.³³⁵

As *J.P. Morgan Securities* and *Cohen* demonstrate, it is possible that such exclusions will not effectively bar coverage for restitution and disgorgement.³³⁶ These exclusions could also prove to be problematic if restitution and disgorgement are defined too broadly or too narrowly.³³⁷ However, there is much to be said about a carefully drafted policy. If insurers are precise when drafting these exclusions and provide specific definitions of restitution and disgorgement, then it would be easier for courts to resolve these disputes.³³⁸ Policyholders that are sophisticated businesspersons or entities will also benefit from specific exclusions because such exclusions will put insureds on notice that their coverage is limited.³³⁹ However, policy exclusions for

*3 (Ariz. Super. Ct. Dec. 1, 2011) (quoting the insurance policy as excluding coverage for “profit or remuneration gained by any Insured to which such insured is not legally entitled”).

335. *Cohen v. Lovitt & Touche, Inc.*, 308 P.3d 1196, 1200 (Ariz. Ct. App. 2013).

336. *See J.P. Morgan Sec. Inc.*, 992 N.E.2d at 1083 (“[T]he Insurers have not met their heavy burden of establishing, as a matter of law . . . , that Bear Stearns is barred from pursuing insurance coverage under its policies.”); *Cohen*, 308 P.3d at 1200 (concluding that the trial court erred and remanding to the trial court for further proceedings).

337. DiMugno, *supra* note 303, at 215 (“While the industry is constantly trying to strike a balance between specificity and generality, the pragmatic business need for a policy that will sell to a vast array of insureds has necessarily resulted in comprehensive policy language, which . . . results in uncertainty about the policy’s applicability to specific coverage situations.”).

338. *See, e.g.*, *Fid. Bank v. Chartis Specialty Ins. Co.*, No. 1:12-CV-4259-RWS, 2013 WL 4039414, at *4 (N.D. Ga. Aug 7, 2013) (“[I]t is clear that Exclusion (h) speaks to exactly this type of claim. . . . Exclusion (h) excludes from indemnification (but not defense) disputes involving fees and commissions or, in other words, amounts that Plaintiff was accused of wrongfully or excessively charging its customers.”).

339. *See Collins*, *supra* note 301, at 212 (providing that explicit policy exclusions put insureds on notice so that “they no longer have to wait until they have contacted their insurer for reimbursement to discover their policy’s shortcomings”).

restitution and disgorgement certainly are not the final answer to the problem.

V. Conclusion

The uncertainty surrounding coverage for restitutionary payments, especially disgorgement, has implications for insureds as well as insurers. Insureds pay high premiums for insurance coverage, but their claims for indemnification have a good chance of getting denied if they are labeled disgorgement or restitution. However, as recent decisions have indicated, courts are placing the public policy rationale under greater scrutiny and might even be moving away from accepting this rationale as a blanket bar against coverage for restitutionary payments. Both *J.P. Morgan Securities* and *Cohen* serve as a victory for insureds by narrowing the insurer's ability to rely on the public policy rationale and by reducing the ability of insurers to deny coverage merely because a claim or payment is labeled disgorgement or restitution.

However, it is important to remember that the object of disgorgement is "to strip the defendant of a wrongful gain."³⁴⁰ If an insured can pass off liability for disgorgement to its insurer, then the problem of moral hazard arises. The insured will believe that it can profit from its own wrongdoing by retaining its ill-gotten profits because the insurer will provide coverage for the insured's disgorgement. This is not a just result and has serious implications for insurers. To prevent insureds from profiting from their own ill-gotten gains, courts must have a strong understanding of the meaning of disgorgement so that coverage can be denied for claims that seek to disgorge the insured's ill-gotten profits. The Third Restatement of Restitution and Unjust Enrichment will help courts and lawyers gain a sound understanding of restitution and disgorgement not only through its definitions but also through the comments, which provide further explanation of these two remedies and the potential issues relating to their application.

340. RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 51 cmt. a (2011).