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Insurance Law Update

Sixth Circuit Limits Insurer's Disgorgement Exclusion and Public Policy Defense, Preserving Coverage for Loss Arising From Alleged Wrongful Retention of Funds

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PRACTICAL POLICYHOLDER ADVICE

When facing a denial of coverage based on the alleged uninsurability of ill-gotten gains, policyholders should keep in mind that not all jurisdictions have adopted a public policy barring insurance coverage for disgorgement and courts may distinguish between coverage for loss based on profits allegedly wrongfully retained as compared to wrongfully acquired. Policyholders should be sensitive to how the policy defines "loss," as carve outs for disgorgement may not exclude coverage for loss based on alleged wrongful retention. In addition, policyholders should be cautious when structuring an underlying settlement because courts may consider how the settlement is calculated in determining whether the policy language or public policy excludes coverage.

The Sixth Circuit recently held that Michigan public policy and an Executive Protection Policy's definition of "Loss," including its carve-out for disgorgement of unlawful profits, do not preclude insurance coverage for a class action settlement consisting of wages that were allegedly wrongfully retained in violation of the Sherman Act, 15 U.S.C. § 1. *William Beaumont Hosp. v. Federal Ins. Co.*, __ F. App'x __, 2014 WL 185388, at *5-7 (6th Cir. Jan. 16, 2014) (No. 13-1468). The Sixth Circuit joins a number of other jurisdictions that have distinguished the Seventh Circuit's often cited decision in *Level 3 Communications, Inc. v. Federal Insurance Co.*, 272 F.3d 908 (7th Cir. 2001), in which the court held that "loss" in a directors' and officers' liability insurance policy does not include the restoration of an ill-gotten gain. *Id.* at 910.

In *Beaumont*, plaintiff William Beaumont Hospital ("Beaumont") sought a declaratory judgment that defendant Federal Insurance Company ("Federal") had to provide indemnification coverage for a multimillion dollar settlement with a class of registered nurses. The nurses had sued the policyholder and seven other Detroit-area hospital systems for wages and treble damages. The nurses alleged that the defendants had unlawfully agreed to share compensation information in a manner that harmed competition and depressed the nurses' wages.

Federal counterclaimed, arguing that Beaumont's settlement with the nurses constituted disgorgement and, therefore, coverage was precluded by the policy's definition of "Loss" and Michigan public policy. The policy defined "Loss" to exclude "disgorgement by any Insured or any amount reimbursed by any Insured Person," but solely with respect to claims based on "profit, remuneration or advantage to which an Insured was not legally entitled." *Beaumont*, 2014 WL 185388 at *2. Federal contended that the settlement was a disgorgement of the advantage that Beaumont gained by providing nursing services at below-market compensation. *Id.* at *3. In the alternative, Federal argued that Michigan public policy barred coverage because "no one should benefit from his own wrongdoing" and coverage would "transfer the cost of returning money wrongfully withheld to the insurer." *Id.* at *6.

The court rejected both of Federal's arguments, affirming declaratory judgment on the pleadings that Federal was obligated to indemnify Beaumont. *Beaumont,* 2014 WL 185388 at *1. The court held that the carve-out for "disgorgement" did not preclude coverage for the settlement because the nurses alleged that the policyholder wrongfully retained, rather than acquired, the unpaid wages. *Id.* at *4-5. Relying on dictionary definitions, the court defined "disgorgement" as the act of giving up something wrongfully obtained or acquired. *Id.* at *4. The court held that "[r]etaining or withholding differs from obtaining or acquiring," distinguishing *Level 3* and its progeny as involving wrongful acquisitions. *Id.* at *5.

The court further held that the calculation of the underlying settlement indicated that the nurses sought "purely compensatory damages" and not disgorgement. *Beaumont,* 2014 WL 185388 at *5. The court considered that the nurses' damages expert computed injury to the class using "a classic compensatory damages calculation," as the difference between class members' actual earnings and the earnings the hospital would have paid but for the alleged anti-competitive misconduct. *Id.* The court also considered that the settlement was calculated based on a percent of the total wages paid to the nurses during the class period – a formula that bore no relationship to Beaumont's profits. *Id.*

As to Federal's public policy argument, the court noted that Federal had not identified any cases in the Sixth Circuit holding that disgorgement is uninsurable as a matter of public policy. *Beaumont*, 2014 WL 185388 at *7. The court limited the doctrine that an insured may not profit from its own wrongdoing to cases involving intentional tortious or criminal acts. *Id.* at *6. The court distinguished *Level 3* as not involving Michigan's public policy and on the grounds that it related to something unlawfully obtained rather than withheld. Id. at *7.

Beaumont reinforces that not all jurisdictions adopt the analysis and result in *Level 3* or maintain a public policy against insurance coverage for disgorgement. When facing a denial of coverage based on *Level 3* or public policy, policyholders should determine whether courts applying the law of the applicable state have identified a clear public policy rendering the particular type of loss uninsurable.

Policyholders should also be sensitive to how the policy defines "loss," particularly whether the definition excludes coverage for disgorgement, restitution, increases in consideration or other types of alleged wrongful gains. *Beaumont* indicates that, even if the policy excludes coverage for disgorgement, policyholders may be entitled to coverage if the loss arises from alleged wrongful profits that were *retained* and not *acquired.*

When settling underlying litigation, policyholders should keep in mind that, as in *Beaumont*, courts may consider the method used to calculate the underlying settlement when determining whether the policy language or public policy excludes coverage, although some courts have held that characterizations in a settlement agreement are not determinative. Based on *Beaumont*, where the policy defines "loss" to exclude "disgorgement," courts may be more likely to find coverage if the settlement is not calculated based on the policyholder's profit.

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