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Ensuring Insurability of Management Liability Claims

By Geoffrey B. Fehling and Jae Lynn Huckaba*

In this article, the authors explain that banks and other financial sector entities seeking coverage under directors and officers (D&O) and errors and omissions (E&O) liability policies will do well to ensure that courts are properly enforcing the burden for insurers to prevail on defenses based on policy exclusions, including limiting coverage for allegedly uninsurable loss.

The financial service industry is understandably apprehensive of fraudulent investing, whether it be fraud perpetrated on the institution by a customer or service provider or misconduct by an institution's employees, directors, or officers. A recent decision from a federal district court in Ohio, *The Huntington National Bank v. AIG Specialty Insurance Company*,[1] highlights the real risk of financial institutions falling victim to fraud but also questioning whether the insurance policies they purchase to mitigate those risks will protect them as intended.

Banks and other financial lenders are exposed to a heightened risk of liability. In light of the risks, institutions purchase different kinds of insurance policies to protect themselves in a variety of situations, including from allegations of fraud. Those companies commonly purchase directors and officers (D&O) and similar management liability policies to protect the entity and its directors, officers, and other insureds against losses from claims for wrongful acts. D&O policies provide coverage for the "Loss," subject to certain carve outs, including for any amounts deemed "uninsurable" as a matter of public policy. The justification for this carve out is that allowing compensation for these losses defeats any deterrence of the wrongdoing that led to the loss, and thus, insuring the loss violates public policy. The line between "insurable" and "uninsurable" losses, however, is not always clear from the policy language or governing law. As a result, courts are often tasked with assessing "insurability" of certain losses based on the circumstances of a particular claim.

The difficulty interpreting and enforcing uninsurable loss language to bar coverage is twofold.

First, states do not often have clearly-articulated public policy addressing insurability of a particular kind of loss. Where there is no clear pronouncement

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[1] The Huntington National Bank v. AIG Specialty Insurance Company, No. 2:2020cv00256 (S.D. Ohio Dec. 16, 2022), appeal filed, No. 23-3039 (6th Cir. 2023).

on the insurability of a loss, an insurer should not be permitted to rely on a vague "uninsurability" defense to coverage.

Second, the placement of the relevant uninsurable loss language in the policy, usually as a carve out to the definition of loss, can present an important threshold question in assessing coverage because the classification of "uninsurable" loss provisions within the policy determines which party bears the burden of proof.

Insurers often argue that proving insurability is a condition to coverage on which the policyholder bears the burden of proof. Policyholders, for their part, counter by showing that the effect of a policy provision – like an "uninsurable" loss carve out limiting coverage – and not its location or label in the policy is what should control. Despite black-letter insurance law showing that the insurer, not the policyholder, carries the burden of proof in those instances, coverage disputes on insurability abound.

THE INSURER BEARS THE BURDEN TO ESTABLISH LOSS IS UNINSURABLE AS A MATTER OF PUBLIC POLICY IN THE RELEVANT JURISDICTION

Luckily for policyholders, numerous courts have provided clear guidance on how to evaluate insurability defense, particularly with respect to the high burden insurers face when attempting to limit or deny coverage based on alleged uninsurability. Despite common insurer refrains to the contrary, many courts have held that an insurer bears the burden with respect to policy provisions that exclude or limit coverage, even if those provisions are not labeled "exclusions" like those styled as carve outs to the definition of loss.[2]

In *Astellas US Holding*, for example, Astellas sought coverage under its D&O policy for a $50 million settlement payment to the Department of Justice to resolve a civil investigation regarding the company's potential violations of the Anti-Kickback Statute and the False Claims Act (FCA).[3] The U.S. Justice

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[2] See, e.g., Borough of Moosic v. Darwin Nat'l Assur. Co., 556 F. App'x 92, 97 (3d Cir. 2014) (stating that an insurer bears the burden of proving that a particular policy provision applies where the provision "acts to limit coverage under the policy," even where the provision is not labeled as an "Exclusion"); RLI Ins. Co., Inc. v. Carr, No. 8:14-CV-2246 (M.D. Fla. Jan. 22, 2016) (noting that the insurer "bears the burden to prove the applicability" of a related-claim provision in the "CONDITIONS" section of the policy); Astellas US Holding, Inc. v. Starr Indem. & Liab. Co., 566 F. Supp. 3d 879, 886–87 (N.D. Ill. 2021) (finding "uninsurable under applicable law" carve out to definition of loss "is an exclusion notwithstanding the fact that it is located in the section defining 'Loss' rather than in the 'Exclusions' section"), appeal filed, No. 21-3075 (7th Cir.).

[3] Astellas, 566 F. Supp. 3d at 886–87.

Department (DOJ) accused Astellas of committing federal health care offenses by donating money to patient assistance charities that provided co-payment assistance to Medicare beneficiaries.[4] Astellas and the DOJ subsequently entered into a settlement agreement, which characterized the $50 million settlement payment as "restitution to the United States."[5]

The insurer relied on this portion of the agreement, contending that, given the restitutionary nature of the payment, the settlement fell within the "uninsurable under applicable law" exception to the policy's definition of loss.[6] The insurer characterized the provision as a condition to coverage and argued that Astellas "cannot meet its burden of proof" to show that the settlement was covered.[7] Astellas, in contrast, characterized the uninsurable loss carve out as an exclusion and asserted that it was the insurer that could not meet its burden under Illinois law to prove that the settlement payment "clearly and unequivocally" constituted uninsurable disgorgement.[8]

The court agreed with the policyholder. It stated that the uninsurable loss provision was the equivalent of an exclusion because, regardless of its location in the policy, the provision was an attempt to "avoid policy coverage."[9] As such, the insurer and not the policyholder bore the burden of establishing that the settlement payment was uninsurable.[10]

The court also rejected the insurer's argument that coverage for the settlement is contrary to public policy, first questioning whether it is clear that there is "a body of Illinois law prohibiting coverage for any kind of damages arising out of fraudulent conduct." The court then took the insurer to task for not citing *any* cases standing for the proposition that it is against Illinois public policy to insure the payment of damages to a third party resulting from an insured's fraudulent conduct. In fact, the court agreed with the pharmaceutical company that Illinois courts have held that "there is in fact no general Illinois public policy prohibiting insurance for damages caused by the insured's intentional acts, unless the insured wrongdoing is the one to recover the

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[4] Id. at 893.

[5] Id. at 897.

[6] Id. at 896.

[7] Id.

[8] Id.

[9] Id. at 897 (citing Rutgens Distribs., Inc. v. U.S. Fid. & Guar. Co., 94 Ill. App. 3d 753, 758– 59 (Ill. App. 1981)).

[10] Id. at 897.

proceeds." Because the insurer had not cited Illinois public policy prohibiting covering claims involving allegations of fraud, in the absence of such a policy, the court declined to "invent one."[11]

Similarly, a former employee and the US government filed a *qui tam* complaint against a company alleging violations of the FCA.[12] Specifically, the complaint alleged that the company violated the FCA by "knowingly mischarging the Government by billing labor to a cost-based contract when the labor was actually performed to meet requirements on other fixed-price contracts, and obtaining contracts through improper influence."[13] The employee also sued the company for employment retaliation, and the US intervened in the alleged FCA violations and the company's recruitment of another employee.[14] Shortly after, the employee and the company settled the retaliation claim, and the company's insurer reimbursed the company for the full amount of the settlement.[15] The company also settled with the DOJ on the recruitment issue and paid a penalty.[16] The company did not seek reimbursement from its insurer for the DOJ settlement or penalty.[17]

Eventually, the company and the DOJ settled the remainder of the claims, including the violations of the FCA, counts for civil penalties, breach of contract, unjust enrichment, mistake, and breach of fiduciary duty.[18] The insurer paid almost all of the company's defense expenses, as well as the various employment settlements, but it denied coverage for the FCA settlement on insurability grounds.[19] The policy defined "Loss" to include "settlements," but the definition excluded "matters which are uninsurable."[20] The insurer argued that the settlement was for "matters which are uninsurable" because it constituted "either fines, penalties and multiplied damages or overpayment of money paid to [the company]."[21] The insurer characterized the settlement as

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[11] Id. at 909.

[12] Gallup, Inc. v. Greenwich Ins. Co., No. N14C-02-136FWW (Del. Super. Ct. Feb. 25, 2015).

[13] Id.

[14] Id.

[15] Id.

[16] Id.

[17] Id.

[18] Id.

[19] Id.

[20] Id.

[21] Id.

restitution and argued that restitution is not "Loss" because restitution is uninsurable as a matter of public policy.[22] The company countered that the settlement was clearly "Loss" because the policy explicitly defined "Loss" to include "settlements."

The court began with the premise that the insurer has the burden "to prove the applicability of any exclusion in coverage."[23] It concluded that the insurer's attempt to characterize the settlement as "offensive to public policy" was "unpersuasive" when reading the policy as a whole because the policy's ill-gotten gains exclusion showed that the insurer contemplated coverage for restitution.[24] The court held that the insurer, relying solely on the allegations set forth in the underlying complaint to establish that the settlement was for restitution, failed to meet its burden that the exclusion barred coverage.[25]

In another coverage dispute, a worldwide manufacturer purchased D&O insurance to protect itself from lawsuits arising from mergers and acquisitions.[26] Thereafter, when the company was acquired, several shareholders filed suit.[27] The manufacturer resolved the suits for $30 million.[28] One of the manufacturer's insurers claimed that its policy expressly excluded coverage for claims arising from the acquisition.[29] Specifically, the policy's definition of "loss" excluded any "amount representing, or substantially equivalent to, an increase in consideration paid . . . in connection with any purchase of securities or assets of a Corporation."[30] The policy defined "Corporation" as "the Named Corporation and any Subsidiary thereof," and because the manufacturer was the named Corporation, the insurer argued that the purchase of the manufacturer's assets was excluded under the definition of "Loss."[31] The manufacturer countered that the use of the word "a" before "Corporation" in the loss

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[22] Id.

[23] Id.

[24] Id.; see also U.S. Bank Nat'l Ass'n, et al. v. Indian Harbor Ins. Co., No. 12-cv-3175 (D. Minn. July 3, 2014) ("Because the parties expressly excluded any restitution resulting from a final adjudication through the Ill-Gotten Gains Provision, they must have intended to include any restitution not resulting from a final adjudication (say, a settlement) within the definition of 'Loss.'").

[25] Gallup, Inc.

[26] Gardner Denver, Inc. v. Arch Ins. Co., No. CV16-0159 (E.D. Pa. Dec. 16, 2016).

[27] Id.

[28] Id.

[29] Id.

[30] Id.

[31] Id.

provision made the language ambiguous and that a reasonable person could construe the phrase as meaning a corporation other than the manufacturer.[32]

The court agreed with the policyholder's interpretation that the provision limiting coverage should be treated as an exclusion. It held that the language in the "Loss" definition amounted to a bump-up exclusion and found that the manufacturer had shown a reasonable expectation for coverage.[33] In other words, the insurer did not meet its burden of proving that the exclusion applied to exclude coverage.

HUNTINGTON NATIONAL BANK

In light of the foregoing precedent, the *Huntington* court had ample guidance for analyzing the insurer's insurability defense. Indeed, the court seemed to be setting the stage for a similar conclusion, until it flipped the script and placed the burden on the policyholder to prove the uninsurable loss exclusion did not preclude coverage.

By way of background, in September of 2002, Huntington National Bank agreed to provide banking services to a computer-services business.[34] Unbeknownst to Huntington, Brian Watson – the chairman and chief executive of the business – was a convicted fraudster.[35] And, Huntington was his next victim. The purported computer-services business sought out financing companies for assistance in obtaining computer equipment.[36] As part of its scheme, the business set up a system in which the financing companies would pay the requested funds directly to the business's vendor.[37] Initially, Huntington loaned the business $9 million, "comprised of a revolving line of credit, a term note, and letters of credit."[38] Over the next two years, the loan increased to $16 million[39] but the business did not actually purchase computer equipment, and the purported vendor was a paper company, acting through the business's executives.[40]

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[32] Id.

[33] Id.

[34] Huntington Nat'l Bank.

[35] Id.

[36] Id.

[37] Id.

[38] Id.

[39] Id.

[40] Id.

Eventually, the bank became suspicious, and its regional head of security investigated Watson and the computer-services business.[41] The head of security, however, did not share Watson's history of fraud or any other information with the Huntington employees managing the business's account.[42] In 2004, to Huntington's relief, the computer-services business paid off its debt to the bank.[43]

The bank's relief, however, was short-lived. After the FBI raided the computer-services business's offices in late 2004, both the business and the vendor were bankrupt.[44] The trustee appointed to represent the companies in bankruptcy proceedings "felt an injustice occurred," believing "Huntington put its desire to be repaid ahead of its concerns that Watson was committing a Ponzi scheme and, by doing so, perpetuated the Ponzi scheme to its benefit and other lenders' detriment."[45] The trustee filed proceedings against Huntington on behalf of the computer-services business and its vendor, alleging fraudulent transfers and seeking recovery of the transfers from the bank.[46] Despite Huntington's contention that the transfers were not recoverable because the bank accepted them in good faith, the bankruptcy court found that the bank could only establish good faith for transfers before April 30, 2004.[47]

The U.S. Court of Appeals for the Sixth Circuit affirmed the bankruptcy court's finding that Huntington did not act in good faith when it accepted transfers after April 30, 2004.[48] The Sixth Circuit, however, determined that the bankruptcy court erred in considering all transfers regardless of whether the transfers were actually paid to Huntington.[49] Only the transfers actually paid to Huntington were recoverable.[50] Therefore, on remand, the bankruptcy court had to recalculate the recoverable transfers.[51] Before the bankruptcy court

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41 Id.

42 Id.

43 Id.

44 Id.

45 Id.

46 Id.

47 Id.

48 Id.

49 Id.

50 Id.

51 See id.

adopted a new report and recommendation, the parties reached a settlement for $32 million.[52]

Prior to the settlement, back when the trustee initiated proceedings against the bank, Huntington sent a copy of the complaint to its insurer and requested a coverage analysis.[53] The insurer issued Huntington an errors and omissions (E&O) policy, which covered Huntington's "Losses" arising from "alleged Wrongful Acts of any Insured in the rendering or failure to render Professional Services."[54] Like many other E&O and D&O policies, the policy's definition of "Loss" had several carve outs, including one for "matters that may be deemed uninsurable under the law pursuant to which this policy shall be construed."[55] Huntington's insurer denied coverage based on this uninsurable loss carve out.[56] Huntington initiated a coverage action, alleging breach of contract and bad faith.[57] In response, the insurer continued to assert that the settlement payment was an uninsurable loss under the policy.[58]

The U.S. District Court for the Southern District of Ohio first answered the threshold question for determining the insurability of a loss: which party has the burden of proof. It found the insurer's argument that the uninsurable loss exclusion was a condition of coverage was meritless, stating that "the location of exclusionary language does not change the fact that it is an exclusion . . . even if the exclusion is within the coverage section of the contract or within the definition of 'loss.'"[59] The court emphasized the well-established insurance principles that an insurer, as the drafter of the policy, is responsible for drafting exclusions "such that only one meaning can reasonably be attributed to it" and that "this framework would be defeated could insurers switch the burden by masquerading exclusions as conditions for coverage."[60] The next question, then, should have been whether the insurer had met this high burden.

But the court took a different route, engaging in its own analysis of whether the Huntington settlement was insurable. Next, the court posited that Huntington "offer[ed] no persuasive authority to support" that its disgorge-

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[52] Id.

[53] Id.

[54] Id.

[55] Id.

[56] Id.

[57] Id.

[58] Id.

[59] Id. (citing, among other cases, Astellas, 566 F. Supp. 3d at 897).

[60] Huntington Nat'l Bank.

ment payments are insurable under Ohio law, effectively shifting the burden of proof to Huntington, the policyholder, to negate the uninsurable loss exclusion by proving a negative – that is, the absence of public policy prohibiting coverage for the settlement.[61] The court's analysis also ignored the commonly understood insurance principle that a loss is deemed insurable where there is no clear pronouncement to the contrary.[62] The court acknowledged that Huntington cited a Delaware case for the proposition that losses are uninsurable as a matter of public policy only where the legislature so provides, but stated that Ohio did not have an analogous rule.[63] The court, therefore, upheld the insurer's denial of coverage and entered final judgment in the insurer's favor.[64] The decision is a recent example of how courts can err when ruling on the applicability of the uninsurable loss exclusion to preclude coverage.

COMBATTING INSURABILITY DEFENSES

So what are policyholders to do when faced with insurance coverage disputes based on alleged uninsurability, whether based on a definition, condition, exclusion, or other policy provision?

First, understand at the time of purchase what the policy actually says and, if needed, negotiate modified language to strengthen coverage and limit the breadth of exclusions, including those found in the definition of "Loss." Policies are not one-size-fits-all, and uninsurable loss provisions vary widely between insurers and policies.

For instance, do carve outs addressing insurability of losses as a matter of public policy specify how that state law issue is analyzed (such as by the law of the state most favorable to the insured)? Does the policy cover punitive, exemplary, and multiplied damages and, if so, in what circumstances? How does the policy treat "restitution" and "disgorgement"? Are there appropriate exceptions to uninsurable loss provisions, like those for violations of Sections 11, 12, and 15 of the Securities Act of 1933? The time to answer these and similar questions and make any improvements to broaden coverage and limit exclusions is at the time of policy placement or renewal.

Second, when dealing with an uninsurable loss defense, carefully analyze the grounds supporting the insurer's position. As noted above, generic or conclu-

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[61] Id.

[62] See id. ("[W]hile no Ohio court has addressed whether disgorgement is insurable, the Court finds that Ohio courts are unlikely to permit insurance coverage for wrongfully obtained money.").

[63] Id.

[64] Id.

sory allegations that a particular claim or loss is "uninsurable," without more, should not suffice. Rather, assess whether the law in the relevant jurisdiction (as determined by the policy and applicable choice-of-law rules) has actually articulated a public policy against the kind of loss at issue. And query whether common law decisions by courts, especially trial or intermediate appellate courts, are sufficient or whether the insurer's cited "public policy" is predicated on pronouncements by an actual policy maker, i.e., governmental officials or agencies. As the case law above makes clear, leveraging the burden of proof is critical and can negate uninsurability defenses if the insurer cannot point to controlling public policy.

And finally, like all matters of insurance policy interpretation, uninsurable loss defenses are matters of state law. As a result, consider whether insurance policies have choice-of-law, choice-of-venue, dispute resolution, or similar provisions that could impact what law applies to a particular dispute.

Implementing these practices can help mitigate the risk of uncovered losses and maximize the availability of coverage should a claim arise.

CONCLUSION

Huntington has already appealed the district court's decision to the Sixth Circuit, where it may raise many of the same issues discussed above. The court of appeals has the opportunity to correct the district court's error and place the burden where it belongs. Banks and other companies in the financial sector that may face similar exposures under D&O or E&O policies will do well to watch whether the federal appellate court reverses the trial court's errors and correctly enforces the right burden for insurers to prevail on defenses based on policy exclusions.