

Officer's Repayment of Undeserved Severance Payments Is Not Covered Loss and Triggers Profit Exclusion

July 2008

The United States District Court for the Southern District of Texas, applying Texas law, has granted an insurer's motion for summary judgment, holding that amounts an officer owes as repayment for severance payments to which the officer was not entitled do not constitute a "loss" under the policy and that such severance payments were excluded from coverage as a "profit or advantage" to which the officer was "not legally entitled." *Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. U.S. Bank, Nat'l Assoc., et al.*, 2008 WL 2405975 (S.D. Tex. Jun. 11, 2008).

The insurer issued an Executive and Organization Liability Policy to a company that subsequently filed for bankruptcy. Under the Reorganization Plan, the company's existing CEO was given a three-year employment agreement to serve as the post-petition CEO. The employment agreement provided, in part, that the CEO could only be terminated for cause during the first two years of the agreement and that if he were terminated for reasons other than cause, he would be entitled to \$3 million in severance payments.

Less than two years into the agreement, the CEO and the company's board of directors agreed that he would resign but that the resignation would be treated as a termination without cause, thus entitling him to the \$3 million severance payment. Although the company was insolvent and unable to conduct normal business operations during this time, it did make payments to the CEO. Upon filing for bankruptcy a second time, the company's liquidating trustee brought suit against the former CEO to recover the severance payments, claiming that the payments were avoidable preferences under federal law and fraudulent transfers under both federal and Texas law. The CEO then made a claim under the policy for coverage for the suit, and the insurer advanced defense costs under a reservation of rights.

Subsequently, the bankruptcy court held in favor of the trustee and found that the CEO had resigned from the company and was not entitled to any severance payments under the employment agreement. The insurer subsequently filed a declaratory judgment action against the CEO and the trustee, seeking a declaration that the judgment against the CEO for repayment of the severance was not "loss" as defined in the policy and that the claim was excluded under the policy's "profit or advantage" exclusion.

The policy defined a covered "loss" as "damages, settlements, judgments (including pre/post judgment interest on a covered judgment), Defense Costs and Crisis Loss; however, "Loss" (other than Defense Costs) shall not include: . . . (6) matters which may be deemed uninsurable under the law pursuant to which this policy shall be construed." The policy also provided that

The Insurer shall not be liable to make any payment for Loss in connection with any Claim made against an Insured: (a) arising out of, based upon or attributable to the gaining in fact of any profit or advantage to which the Insured was not legally entitled.

In holding that the severance repayments were not a covered "loss," the district court stated that "the law does not permit recovery of matters 'uninsurable under the law.'" *Relying on Nortex Oil & Gas Corp. v. Harbor Insurance Co.*, 456 S.W.2d 489, 493 (Tex. App. 1970), the court stated that a policyholder "does not sustain a covered loss by restoring to its rightful owners that which the insured, having no right thereto, has inadvertently acquired." The court also relied on *Level 3 Communications, Inc. v. Federal Insurance Co.*, 727 F.3d 908 (7th Cir. 2001), in stating that "a 'loss' within the meaning of an insurance contract does not include the restoration of an ill-gotten gain." As the bankruptcy court previously had found that the CEO had resigned and not been terminated, he was not entitled to the severance payments he had received. Accordingly, the district court concluded that "the payments Stanley owe[d] because of the Bankruptcy Court's judgment against him do not qualify as a 'Loss' under the Policy."

The court also held that coverage was barred based on the "profit or advantage" exclusion. The court determined that the CEO had "received a 'profit or advantage' by diverting Trans Texas corporate assets to his own use." In denying the liquidating trustee's argument that the judgment against the CEO was covered because the severance payments were covered "remuneration," the court noted that the "terms 'remuneration' and 'profit or advantage' are not mutually exclusive" and that "overlapping terms do not bar the applicability of" the exclusion. The court also stressed that the exclusion applied because the bankruptcy court's ruling focused on the "fact that [the CEO] actually resigned, and therefore was never entitled to the severance payments." The court rejected the trustee's contention that the profit or advantage must have been obtained by fraud or otherwise illegal means. The court stated that the exclusion "does not require a finding of fraud or other illegal conduct" but just a "finding that [the CEO] was not 'legally entitled' to the payments," as was found by the bankruptcy court.