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NEWSLETTER

Eleventh Circuit Affirms that Payment Made to Settle Section 11 Liability Does Not Constitute "Loss"

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In March 2007, the United States District Court for the Middle District of Florida held that amounts paid into a settlement fund in connection with a shareholder class action lawsuit alleging violations of § 11 of the Securities Act of 1933 do not constitute a covered "Loss" under a D&O policy. The decision was rendered under New York law, though the court suggested that Florida law would support the same result. Now, in *CNL Hotels & Resorts, Inc. v. Twin City Fire Insurance Company*, 2008 WL 3823898 (11th Cir., Aug. 18, 2008), the Eleventh Circuit has affirmed that decision.

A number of insurers issued primary and excess D&O policies to CNL Hotels & Resorts, Inc. (CNL). The primary policy defined "Loss" as sums that insureds "are legally liable to pay solely as a result of any Claim insured by this Policy, including Claims Expenses, compensatory damages, settlement amounts and legal fees and costs awarded pursuant to judgments, but excluding fines, penalties, taxes, any amount allocated to uncovered loss pursuant to § VII of this Policy, or matters uninsurable pursuant to any applicable law."

The coverage litigation arose after the company paid $35 million to settle a shareholder class action suit and sought to recover the settlement amount from its D&O insurers. Relying on *Vigilant Insurance Co. v. Bear Stearns Companies, Inc.*, 814 N.Y.S.2d 566 (table), 2006 WL 118368 (N.Y. Sup. Ct. Jan. 11, 2006), and *Level 3 Communications, Inc. v. Federal Insurance Co.*, 272 F.3d 908 (7th Cir. 2001), the district court concluded that "a 'loss' within the meaning of an insurance policy does not include the restoration of an ill-gotten gain."

The Eleventh Circuit considered two questions on appeal. First, the court considered whether the $35 million settlement payment constituted a covered "Loss" under the D&O policy. CNL argued that the payment was a covered "Loss" for three reasons: 1. without a finding of fraud, it was impossible to conclude that the money involved was "wrongly acquired"; 2. Section 11 of the Securities Act of 1933 does not provide for restitutionary damages; and 3. the settlement agreement between the plaintiffs and CNL explicitly stated that the payment was not "restitution" or disgorgement.

The court rejected all three of CNL's arguments. As the court explained, "[t]he return of money received

through a violation of law, even if the actions of the recipient were innocent, constitutes a restitutionary payment, not a 'loss.' It is immaterial whether CNL committed fraud." The court further held that, at least when the loss to the plaintiff is equal to the gain of the defendant, "§ 11 does not preclude restitutionary relief." Finally, the court explained that because "[t]he agreement between CNL and the Purchaser Class is not binding on any third party or this Court" and "[t]he policy, not the settlement agreement, governs our resolution of this appeal," the fact that the settlement agreement provided that the payment was not restitutionary was of no import.

Second, the court considered whether the $5.5 million in legal fees paid to the counsel for the plaintiff class constituted "loss" under the D&O policy. The policy contained an endorsement (Endorsement 17) that specifically exempted from the definition of "loss" payment to plaintiffs' counsel in a lawsuit over the price paid for corporate ownership. Despite Endorsement 17, CNL argued the payment to plaintiffs' counsel was a covered loss because the settlement agreement between CNL and its primary insurer expressly allocated $5.5 million of the settlement payment for this purpose. CNL also argued that, even if the payment is not "loss" under Endorsement 17, the endorsement is void because the insurers did not comply with Florida insurance law, which requires insurance forms to be filed with and approved by the Office of Insurance Regulation before use.

The court rejected CNL's first argument because, as with the question of whether the payment was restitutionary in nature, the characterization of a payment in an agreement between two parties was held to be not binding on third parties or the court. Accordingly, "[w]hether the payment to the counsel for the Proxy Class is a covered "loss" under the . . . policy depends on the language of the policy, not the settlement agreement." The court, however, remanded the case to the district court to resolve factual questions regarding whether Endorsement 17 had been properly filed with the Office of Insurance Regulation and to determine whether it is void.