

Suit to Recover Value of Shares Allegedly Acquired by Defendant Through Misrepresentations Does Not Give Rise to a “Loss” under D&O Policy

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The United States Court of Appeals for the Seventh Circuit has held that the settlement of a suit in which plaintiffs alleged that the defendant procured their stock at an unduly low price due to misrepresentations does not give rise to a "loss" under a directors' and officers' liability policy. *Level 3 Communications, Inc. v. Federal Ins. Co.*, No. 01-1806, 2001 WL 1486188 (7th Cir. Nov. 26, 2001).

The coverage dispute arose out of a shareholders' suit claiming that the defendants had acquired their shares of stock at an unduly low price because of misrepresentations that directly affected the value of the shares they were selling. The selling shareholders sought the difference between the value of the shares at the time of trial and the price for which the shares were sold. The parties in the underlying litigation settled for \$11.8 million.

The insurer denied coverage for the settlement on a variety of grounds (see *Level 3 Communications, Inc. v. Federal Ins. Co.*, 168 F.3d 956 (7th Cir. 1999)). It argued, inter alia, that the settlement did not give rise to a covered loss under the D&O policy because it amounted to the restoration of an ill-gotten gain. The insured took issue with this position, noting that the policy broadly defined "loss" as "the total amount which any Insured Person becomes legally obligated to pay... including, but not limited to... settlements."

The Seventh Circuit sided with the insurer. The court found that the plaintiffs in the underlying suit were seeking only "to deprive the defendant of the net benefit of the unlawful act, the value of the unlawfully obtained stock minus the cost to the defendant of obtaining the stock." Judge Posner, writing for the court, accepted the general proposition that the restoration of an ill-gotten gain does not give rise to a "loss" within the meaning of an insurance policy and concluded broadly that the way in which the claim, judgment or settlement order was worded was irrelevant to whether the payment gave rise to a loss: "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 property's return." The court also rejected the argument that such a claim is covered if it is settled before a judgment. It noted that the settlement amount

was far more than a nuisance value payment and opined that, under Level 3's analysis, it improperly would be allowed to "retain the profit it had made from a fraud." Thus, under the court's analysis, the central focus is whether the payment by the insured resolves a claim for damages or restitutionary relief for a transaction in which the insured allegedly benefited improperly.

The court noted that there may be circumstances in which the policy applies to settlements for suits alleging fraud in the procurement of corporate stock. The court cited an officer's misrepresentation that inflates the value of the corporation's stock without conferring a benefit on the corporation. It also mentioned an officer receiving property under false pretenses for the benefit of the corporation without the corporation's knowledge. Under these circumstances, the court suggested that the legal fees spent defending such a suit would be a loss not offset by any benefit to the corporation-as opposed to the value of the stolen property itself.