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NEWSLETTER

Insureds' $20 Million Settlement Payment to FTC Redress Fund Held Uninsurable Restitution

April 2011

The Commonwealth Court of Pennsylvania, which is overseeing the liquidation of the insurer in the coverage dispute, entered an order approving the insurer's denial of coverage under an excess policy for a $20 million settlement that two individual insureds paid into a Federal Trade Commission (FTC) redress fund. *Pratter v. Reliance Ins. Co.,* No. 269 M.D. 1001 (Pa. Cmw. Ct. Mar. 25, 2011). The court adopted the recommendation of the referee appointed to hear the coverage dispute, who applied California law and concluded that the insurer was entitled to summary judgment following briefing and oral argument. Wiley Rein represented the insurer before the referee.

The insureds, the founder and CEO of the insured mortgage lender and his wife, also a former officer and director of the company, sought coverage for $20 million they personally paid to settle numerous lawsuits filed against them concerning the company's lending practices. The $20 million payment was part of a global settlement of actions filed by the FTC, the American Association of Retired Persons, six states' attorneys general and various private individuals that named as defendants the insureds, the company and others. These actions alleged that the lender and the insureds engaged in fraudulent and predatory lending practices, in violation of state and federal laws, and charged borrowers unconscionable fees and interest.

The referee first concluded that the insureds had not incurred any covered or insurable "Loss" because their $20 million payment constituted uninsurable restitution under applicable California law. The referee noted that, pursuant to the underlying settlement, the insureds' payment was transferred to an FTC-administered redress fund from which class members were to receive refunds in the amount of the loan origination fees paid to the lender. A ccordingly, the referee concluded that the fees were amounts to which the lender was not entitled in the first instance and were uninsurable restitution.

The referee also concluded that a prior litigation exclusion in the excess policy independently barred coverage. The exclusion barred coverage for Loss in connection with claims against the directors and officers arising from or based on substantially the same matters as alleged in litigation against the company prior to or pending as of July 29, 1997. The referee noted that the lawsuits for which the insureds sought coverage and two other lawsuits filed against the company in 1996 included common allegations that the lender and other

defendants used deceptive sales practices to misrepresent and conceal unconscionable fees and the principal amount of loans. In addition, the referee found common allegations that the defendants induced vulnerable individuals, and particularly elderly homeowners, to borrow without regard to their ability to repay in order to charge unconscionable fees and appropriate the equity in the borrowers' homes.

However, the referee declined to find as a matter of law that coverage was barred based on two additional independent grounds–a warranty statement and a fraud exclusion. The CEO had warranted as of the inception date of the policy that, to the best of his knowledge, none of the directors or officer had knowledge of any facts or circumstances that might give rise to a claim under the proposed excess policy. The warranty also provided that, if such knowledge of any such fact or circumstance exists, any claim arising therefrom would be excluded from coverage under the excess policy. The referee noted that, although circumstantial evidence indicated that the CEO had knowledge of unlawful lending practices prior to the time he signed the warranty statement, neither party had introduced direct evidence with respect to whether the warranty statement was breached.

The referee also declined to grant summary judgment to the insurer based on the fraud exclusion, which barred coverage for claims brought about or contributed to in fact by any dishonest or fraudulent act or omission by the directors or officers, as established by a judgment or other final adjudication. The insurer argued that such a final adjudication occurred in related litigation that continued against entities that provided the lender with financing in connection with its mortgage lending activities. The jury in that litigation found that the financing entities had aided and abetted the settled defendants' fraud. The referee reasoned that it would be unfair to apply these findings of fraud to the insureds because they were not a party to the litigation when the findings were made.