

No Duty To Defend or Reimburse Claim Expenses Arising from an SEC Action

January 2012

The United States District Court for the Northern District of Illinois has held that an insurer has no duty to defend or reimburse claim expenses for an action brought by the Securities Exchange Commission (SEC) because the relief sought fell outside the policy's definition of "damages." *Con'l Cas. Co. v. Duckson*, 2011 WL 5554035 (N.D. Ill. Nov. 15, 2011). In addition, the court determined that civil penalties and disgorgement of ill-gotten gains were outside the policy's scope of coverage even if the SEC could potentially use such funds to reimburse injured parties.

The SEC sued the policyholder law firm, alleging that the firm, "acting as outside counsel, made materially false and/or misleading statements . . . orally and in writing . . . in the preparation of two private placement memoranda." The firm held a professional liability policy that provided that the insurer would pay all sums that the policyholder "shall become legally obligated to pay as damages and claim expenses because of a claim that is first made against the Insured and reported . . . during the policy period by reason of an act or omission in the performance of legal services." The policy excluded from the definition of damages:

Costs and expenses paid or incurred or charged by any Insured, no matter whether claimed as restitution of specific funds, forfeiture . . . or otherwise, and injuries that are a consequence of any of the foregoing;

. . .

B. Civil or criminal fines, sanctions, penalties or forfeitures,

whether pursuant to law, statute, regulation or court rule . . . and

injuries that are a consequence of any of the foregoing;

. . . [and]

E. Injunctive or declaratory relief

The insurer brought a declaratory judgment action seeking to establish that it had no duty to defend or indemnify in connection with the SEC suit. The policyholder counterclaimed for a declaration that it was entitled to coverage. "In order to avoid the clear language of the Policy," the policyholder argued that civil

penalties and disgorgement are potentially covered damages "because of the potential use of the funds . . . to compensate victims."

In rejecting the insured's position, the court categorized the relief sought by the SEC as "(1) a declaratory judgment; (2) injunctive relief; (3) disgorgement of ill-gotten gains; (4) civil penalties; and (5) officer-director bars." The court then stated that "Illinois courts have held that the disgorgement or restitution of ill-gotten gains is not covered by insurance where such relief is restitutionary in nature," citing *Level 3 Communications v. Federal Insurance Co.*, 272 F.3d 908, 910 (7th Cir. 2001). The court determined that "none of the relief sought by the SEC constitutes 'damages' under the Policy and therefore, the duty to defend is not triggered." Accordingly, the court held that the insurers "do not have a duty to defend [the policyholder] in the SEC action because the relief sought by the SEC falls outside the scope of coverage damages."

The court next considered the policyholder's argument that the insurer must pay "claim expenses" even if there were no duty to defend. The policyholder argued that the policy created "at least three entirely independent obligations"—the duty to defend, the duty to pay damages and the duty to pay "claim expenses." The court rejected this argument, characterizing it as "urging a deconstruction of the Policy" in contravention of Illinois rules of interpretation requiring that a policy be considered "as a whole, taking into account the type of insurance purchases, the risks undertaken and purchased, the subject matter that is insured, and the purposes of the entire contract." Applying this standard, the court predicted that the "Illinois Supreme Court would read the 'coverage' and 'defense' paragraphs in conjunction." The court also stated that, to hold that insurers could have a "duty to cover all costs of defense regardless of whether they have any potential liability in the underlying suit would be unreasonable and would render the limitations on the duty to defend essentially meaningless." Accordingly, the court held that "there are not separate obligations for defense and payment of 'claim expenses' under the Policy."