wiley

NEWSLETTER

Payment for Settlement of Restitution Claim Is Not an Insurable "Loss"

May 2012

The United States Court of Appeals for the Seventh Circuit has held that an insured's payment to resolve allegations that the insured fraudulently induced the purchase of its subsidiary at an artificially inflated price did not constitute an insurable "loss" under Illinois law. *Ryerson Inc. v. Fed. Ins. Co.*, 2012 WL 126282 (7th Cir. Apr. 12, 2012).

The case arose out of the insured's sale of a group of subsidiaries for $29 million. After the transaction was completed, the buyer discovered that the insured had failed to disclose that one of the subsidiaries was on the verge of losing its largest customer. The buyer brought suit against the insured, alleging fraudulent concealment and that the insured had caused it to pay more for the subsidiary's stock than the subsidiary actually was worth. The buyer sought rescission of the sale and restitution of the purchase price. The insured ultimately settled the suit by making a payment of $8.5 million, which the parties described as a "post-closing price adjustment." The insured turned to its directors and officers liability insurer for reimbursement, which the insurer refused to provide on the grounds that the claim by the buyer did not present a covered risk. The district court agreed, granting summary judgment for the insurer in a decision discussed in the November 2010 issue of *Executive Summary* here.

The Seventh Circuit affirmed, finding that the settlement payment represented the return of part or all of the amount that the insured had obtained by inducing the buyer to overpay for the subsidiary. According to the court, to allow the insured to obtain reimbursement for this amount would permit the insured to "have gotten away with fraud." The court held that "there is no insurable interest in the proceeds of a fraud" and noted that "no state would enforce . . . an insurance policy" that included the disgorgement of such proceeds within its definition of "loss." More broadly, the court recognized that a claim for restitution, whether based on fraud or an innocent mistake, "is a claim that the defendant has something that belongs of right not to him but to the plaintiff." Citing its prior decision in *Level 3 Communications, Inc. v. Federal Insurance Co.*, 272 F.3d 908 (7th Cir. 2001), the court concluded that having to surrender or return that "something" is not a "loss [to the insured] within the meaning of the insurance policy."

The court rejected the insured's reliance on the fact that the buyer styled its claim as one for "damages" as opposed to "restitution," finding that it is not the "label" but rather the nature of the remedy that is determinative. The court did recognize, however, that "[a] judgment or settlement in a fraud case could

involve a *combination* of restitution and damages [such that] the insurance company would be liable for the damages portion in accordance with the allocation formula in the policy." In this regard, the court noted that the buyer, along with the inflated purchase price, sought to recover "transaction costs," reimbursement for which "would not be restitution because [the insured] gained nothing from the money that [the buyer] paid its lawyers and accountants to handle the acquisition." Nonetheless, the court held that because the insured admittedly "made no effort to allocate its loss between the loss of ill-gotten gains and other costs," any claim to recover those costs under the policy was "forfeited."

The court also rejected the insured's contention that the "mend the hold" doctrine precluded the insurer's "no loss" argument here because the insurer had not raised it as a ground for denying coverage when the insured first requested coverage. According to the court, the doctrine does not forbid an insurer in a breach of contract case from adding a defense to coverage after being sued. The court reasoned that requiring the insurer to commit to a defense or defenses before being sued would be "unreasonable to the point of absurdity."