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Northrop Ruling Highlights Insurability Of Settlements

By **Cary Lerman and Laura Lin** (September 28, 2020, 6:14 PM EDT)

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In its recent decision in Axis Reinsurance Co. v. Northrop Grumman Corp., the U.S. Court of Appeals for the Ninth Circuit ruled in Northrop's favor and called into question whether and when settlement-based disgorgement payments, not excluded by the terms of a policy, may be excluded from insurance coverage based on public policy.[1]

In its opinion, the Ninth Circuit joined a wave of recent decisions undercutting insurance carriers' stock position that losses arising from disgorgement claims are uninsurable per se.

Insurance carriers have long argued that disgorgement or restitutionary payments — or settlements purportedly reflecting some portion of disgorgement payments — are uninsurable as a matter of public policy.

A cornerstone of this argument rests on the California Supreme Court's 1992 decision in Bank of the West v. Superior Court.[2] That case concluded that insurable damages do not include the costs of disgorgement under California's Unfair Competition Law.

The California Supreme Court supported its holding on public policy grounds, reasoning:

> When the law requires a wrongdoer to disgorge money or property acquired through a violation of the law, to permit the wrongdoer to transfer the cost of disgorgement to an insurer would eliminate the incentive for obeying the law.

The Bank of the West dispute involved a settlement, but the court's discussion of public policy was couched in terms of a party being ordered to disgorge.

Contrary to coverage arguments often made by carriers, multiple courts around the country have refused to extend this public policy prohibition articulated in Bank of the West to settlements. Settlements, these decisions reason, do not reflect disgorgement payments and coverage therefore does not offend public policy.

The Ninth Circuit's recent Northrop Grumman decision cited with approval the reasoning in U.S. Bank National Association v. Indian Harbor Insurance Co. In that case, the U.S. District Court for the District of Minnesota held:

When an underlying action alleging ill-gotten gains and seeking disgorgement of those gains settles before trial, there is no final adjudication in that action determining that the gains were ill-gotten and ordering the return of those gains.[3]

In 2018, the Delaware Supreme Court likewise rejected an argument advanced by multiple insurance carriers that settlement payments reflected disgorgement in certain class action suits. That case, In re: TIAA-CREF Insurance Appeals, held that the settlements could not be characterized as disgorgement payments because the insured defended itself against the claims and "[n]o finding that the [disputed payments] were ill-gotten gain was made in any forum."[4]

As a result, the Delaware Supreme Court observed that a settlement payment did not implicate any public policy against enforcing insurance agreements in cases of disgorgement.[5]

Cases out of Texas and Washington have also agreed with this stance. As Texas' 14th Court of Appeals explained in Burks v. XL Specialty Insurance Co., "there is necessarily a fact issue" when it comes to determining what a settlement of a disputed allegation represents.[6]

The U.S. District Court for the Western District of Washington went further in Virginia Mason Medical Center v. Executive Risk Indemnity Inc., holding that a settlement payment is incapable of being characterized as disgorgement because "a settlement is a negotiated bargain between two parties who have foregone the right to a finding of culpability."[7] The Washington court rejected the premise of Bank of the West's policy arguments, concluding that "vague public policy arguments should not limit the express language in a policy."

The Ninth Circuit's recent Northrop Grumman decision echoes these earlier rulings in limiting public policy arguments with respect to settlement payments allegedly representing disgorgement. The Ninth Circuit reasoned that any public policy rationale limiting the insurability of disgorgement payments applies only in the case of a judgment or order requiring disgorgement — not mere allegations seeking disgorgement or a settlement thereof.

The Northrop Grumman decision explains that the public policy rationale for prohibiting coverage for disgorgement "may not be applicable where, as [in the Northrop Grumman case], there was no final adjudication of Northrop's alleged ERISA violations, Northrop made no admissions of guilt, and the [government] asserted multiple theories of recovery besides disgorgement."

The distinction in this context between a judgment and a settlement is significant. In the case of a judgment requiring disgorgement, a court has determined that the defendant obtained ill-gotten gains that should be disgorged. But in the case of a settlement, all that may be known is that a plaintiff claims the defendant acquired gains he should not have had.

It is not an established fact the defendant actually received these gains, nor that any such gains, if acquired, were ill-gotten. The Northrop Grumman decision reflects the view that insurers should not be able to rely on a public policy rationale to justify such an expansive denial of coverage, absent a judgment.

Consistent with the Ninth Circuit's articulation, many market policies prohibit coverage for disgorgement

only upon entry of "a final non-appealable adjudication adverse to the Insureds."

Insurance carriers argue at times, however, that such a final adjudication is effectively a foregone conclusion due to the nature of the allegations or evidence. But the Ninth Circuit's decision underscores that insurance contract language excluding disgorgement payments from coverage only upon "a final non-appealable adjudication adverse to the Insureds" implies that coverage is provided for settlements occurring without a final adjudication.

Insurers may find it increasingly wise to price the risk of disgorgement settlements into their underwriting, to the extent they do not already. Insurers, who do intend to exclude settlement of disgorgement claims, should address this issue directly by expressly excluding coverage for settlements of allegations that an insured received ill-gotten gains, recognizing that doing so may place them at a competitive disadvantage if competitors continue to provide such coverage.

Absent express contractual exclusions for settlements of disgorgement claims, insurers, who are subject to an implied covenant of good faith and fair dealing, as well as insurance department regulations, to accept a reasonable settlement,[8] may act at their peril if they refuse to consent to a settlement of disgorgement allegations. Doing so may be construed as forcing their insureds to trial in the expectation that a noninsurable judgment will result.

The recent decisions suggest that insurers will not be able to rely on broad public policy judicial rules as a basis to deny coverage for settlement of disgorgement claims. The decision in Northrop Grumman joins the increasing wave of court decisions rejecting efforts to avoid coverage for settlements absent clear policy language excluding coverage in the event of disgorgement allegations.

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[1] The case is Axis Reinsurance Co. v. Northrop Grumman Corp., case number 19-55135, in the U.S. Court of Appeals for the Ninth Circuit.

[2] Bank of the West v. Superior Court (1992) 2 Cal.4th 1254.

[3] U.S. Bank Nat'l Ass'n v. Indian Harbor Ins. Co., 68 F.Supp.3d 1044, 1049 (D. Minn. 2014).

[4] In re: TIAA-CREF, 192 A.3d 553 (Del. 2018).

[5] Id.

[6] Burks v. XL Specialty Ins. Co., 534 S.W.3d 458, 468 (Tex. App. 2015).

[7] Va. Mason Med. Ctr. v. Exec. Risk Indem. Inc., 2007 WL 3473683, at *4 (W.D. Wash. Nov. 14, 2007).

[8] PPG Industries, Inc. v. Transamerica Ins. Co. (1999) 20 Cal.4th 310, 312