The Dishonesty, Personal Profit, and Money Laundering Exclusions in D&O and E&O Insurance

By Alan Rutkin

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TIP
When considering whether exclusions apply, first note the policy's evidentiary requirements. Does the policy require a final "adjudication," or must the circumstances simply exist "in fact"?

Since the beginning of the recent financial crisis, significant losses by a wide range of individuals and businesses have led to lawsuits against a host of companies—and against many corporate directors, executives, and employees. In many instances, these lawsuits have led to extensive motion practice and pretrial discovery, with full-blown litigation frequently following or on the horizon.

Where individuals are defendants in these lawsuits, court actions very well may implicate both directors' and officers' (D&O) insurance policies and errors and omissions (E&O) insurance policies. Moreover, where defendants seek to rely on these insurance policies to provide a defense on their behalf or indemnity for any damages they may be required to pay, these actions raise many insurance coverage issues.

This article focuses on three exclusions that both insurance carriers and insureds must analyze in these circumstances: the "dishonesty" exclusion, the "personal profit" exclusion, and the "money laundering" exclusion.

The Dishonesty Exclusion
Dishonesty exclusions bar coverage for "any claim for damages arising out of the dishonest, criminal, malicious or deliberately fraudulent act, error or omission of the insured." The critical question concerning this exclusion is often evidentiary, namely, what is required to support a dishonesty finding?

Some dishonesty exclusions are written to require a "judgment or final adjudication" establishing wrongful conduct. This provision raises difficult issues. Must the policyholder lose the underlying action before the insurer can win on the exclusion? If the dishonesty is clear but the underlying case is settled, is the insurer precluded from raising this exclusion? And at what point is a case fully adjudicated?

The majority of courts have held that an insurer is required to pay the policyholder's legal fees as they are incurred, subject to the right of reimbursement, until the criminal proceeding ends and a final adjudication has been made.[1]

It would seem only to make sense that where the policyholder settles the underlying fraud action before trial—and hence before the policyholder's dishonesty has been determined—the insurer should be permitted to subsequently litigate the issue so as to apply the exclusion. However, some courts have found the dishonesty exclusion inapplicable when the policyholder settles without any adjudication or admission of wrongdoing.[2] Similarly, at least one court has found the exclusion to be inapplicable when a jury verdict has not clearly indicated that it was based on dishonesty.[3] This seems to be an unfairly harsh result, especially because the insurer is not a party to the underlying litigation and cannot influence the outcome. An insurer may simply never have the opportunity to litigate the policyholder's dishonesty, even where there may be sufficient factual evidence to support such a finding had the matter proceeded to trial. Courts have supported this interpretation on the basis that it is not unfair to afford the parties to the underlying litigation some control over the insurer's liability—to the extent that the parties can affect the jury charge and evidence received—because "contracts routinely have conditions of performance contingent on the behavior or conduct of only one of the contracting parties or of strangers to the contract."[4] Courts also note that insurers have the ability to redraft the exclusion.[5]

A guilty plea would appear to be sufficient to invoke the dishonesty exclusion. In *First National Bank Holding Co. v. Fidelity & Deposit Co. of Md.*,[6] the court held that an officer's guilty plea to bank fraud constituted a final adjudication.[7] In a strained effort to find coverage for the policyholder, the court in *Great American Insurance Co. v. Gross*,[8] however, held that the entry of guilty pleas was not enough to bar entitlement to policy benefits under a fraud exclusion containing the "final adjudication or judgment" language.[9] Although the policyholders pled guilty to insurance fraud, the court reasoned that it had not yet been determined whether the fraudulent conduct admitted by the policyholders in their criminal cases contributed to or brought about the underlying claims in the civil litigation.[10]

In a recent case, a court held that the final adjudication requirement does not require the policyholder to exhaust all appeals from his conviction.[11] Another court found that the final adjudication requirement was satisfied by an arbitration decision.[12]

Does the dishonesty exclusion apply when a participant in a fraudulent scheme decides to flee rather than fight, or otherwise does not answer the complaint timely? It appears so. A default judgment has been found to constitute final adjudication for purposes of enforcing a dishonesty exclusion.[13] Counts of tortious interference with contract and unlawful conspiracy to defraud have been found

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to fall within the terms of the exclusion.[14]

Rather than requiring adjudication, other exclusions bar coverage for conduct that is fraudulent "in fact," and this language may lower the evidentiary requirement. The "in fact" language is often used in personal profit exclusions. In *National Union Fire Insurance Co. v. Continental Illinois Corp.*,[15] the court contrasted the different evidentiary standards the insurer used in its dishonesty and personal profit exclusions:

> Unlike their dishonesty exclusion, the Policies' personal profit exclusion contains no requirement of an adverse final adjudication before the exclusion comes into play. That means the settlement of underlying claims has no effect on the personal profit exclusion.[16]

The court suggested that the insurer obviously knew how to draft policy language that excluded coverage based on the existence of an underlying fact, rather than based on that fact having been adjudicated in another suit.[17] Many insurers now use the "in fact," rather than "final adjudication," language in their dishonesty exclusions.

Ultimately, the dishonesty exclusion comes down to three key elements: (1) the claim involved dishonesty, (2) a judgment was entered on that claim, and (3) proof of intent was material to that cause of action.[18]

The Personal Profit Exclusion

The language of the personal profit exclusion varies, although a commonly used provision excludes losses "arising out of the gaining in fact of any personal profit or advantage to which the Insured is not legally entitled . . . ."[19]

The rationale behind the exclusion makes perfect sense. Put most simply, you cannot claim an insurable loss for the cost of returning something that was not rightfully yours. The personal profit exclusion is "a safeguard to prevent . . . [insureds] from receiving a windfall for wrongfully obtaining money to which they were not legally entitled."[20] As one court has put it, "[a]n 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."[21]

The personal profit exclusion often involves consideration of one or more of the following three issues: (1) did the disputed sums involve profits that the policyholder was "not legally entitled" to receive; (2) what evidence is required to establish "not entitled"; and (3) if the evidence does establish a wrongful profit, was that profit actually received by someone whose receipt supports applying the exclusion.

When does a profit rise—or sink—to the level of being subject to the exclusion? At least one court held that illegality must actually be alleged in the underlying case; the case cannot be interpreted to involve something not explicitly alleged.[22] The court found that "[c]laims are simply not 'based upon or attributable to' certain conduct unless they *allege* such conduct."[23] Of course, if there is no evidence that the policyholder received something to which it was not legally entitled, the exclusion does not apply.[24]

A federal appellate court held that the personal profit exclusion did not apply to circumstances where the corporate officer received a benefit that was claimed to be "wasteful" but not "illegal."[25]

Criminal conduct likely provides the clearest example supporting the personal profit exclusion. In 2006 the District of Kansas in *Ary v. Cincinnati Insurance Co.*[26] applied the exclusion where the policyholder had been convicted in a criminal trial.[27] A criminal conviction, however, is not a requirement. Courts have applied the personal profit exclusion under less compelling circumstances. For example, *Bogatin v. Federal Insurance Co*.[28] found that the personal profit exclusion applied to a class action. Unlike *Ary*, where the court had a ruling of a prior conviction, the *Bogatin* court applied the exclusion based upon allegations alone. In *Greenwich Insurance Co. v. Media Breakaway, LLC*,[29] the court applied the personal profit exclusion based upon findings in an arbitration.

In *FDIC v. Gray*,[30] the court took a broad view as to the acts subject to this exclusion: "The 'personal profits' exclusion is not limited to claims based upon or attributable to a director's or officer's gaining of a personal monetary *profit*. On its face the exclusion also applies to claims 'based upon or attributable to' a director's or officer's gaining any advantage to which he was not legally entitled."[31]

The most creative effort to circumvent this exclusion may be found in *Nicholls v. Zurich American Insurance Group.*[32] In that case the policyholders argued that the profits received had been approved by other policyholders. The policyholder argued that these sham approvals sanctioned the receipts, and receipts by others caused the profits not to be personal. The court rejected the policyholder's argument based upon the "well-worn adage that 'two wrongs do not make a right.' "[33]

This issue is, ultimately, a highly factually intensive question. That leads to the question, what evidence is required to establish that the policyholder was not entitled to the profit? The issue is the same discussed with dishonesty exclusions. Most policies apply to a profit gained in fact. Some policies require an adjudication that the policyholder was not entitled to the profit.

No adjudication is necessary with the "in fact" language.[34] Yet some policyholder-friendly courts have held that for something to be in fact true, there must be an adjudication. These courts have interpreted the "in fact" language as requiring adjudication.[35] The better view is that in fact provisions should not be rewritten and narrowed into provisions requiring adjudication; instead, the "in fact" language should be given its plain meaning.[36] Also, as noted by one court that rejected a policyholder's effort to equate "in fact" with "adjudicated," requiring adjudication of the underlying action before applying the personal profit exclusion might effectively limit the personal profit exclusion to applications after the insurer was forced to provide a defense. This would eviscerate the exclusion.[37]

Questions often arise concerning the person who received the profit. Does receipt by that person establish the requirements of the exclusion? Policyholders argue that the exclusion is inapplicable because the wrongdoing should be attributed to someone else.

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Consequently, the policy language and facts must be examined carefully to ensure that the personal profit was received by the appropriate actor. For example, if the personal profit exclusion is directed to the insured, and the policy defines "insured" as an "officer or director," the personal profit must be received by an officer or director.[38] Similarly, a court refused to apply the exclusion where the insurer could not show who actually received the profit.[39]

The most favorable circumstance for carriers involves provisions that bar coverage when "an insured"—as opposed to "the insured"—receives a profit. Here "coverage is excluded for all Insureds, not merely the Insured who profited."[40] Another court, however, reached the opposite result based upon a severability clause that stated, "[t]he Wrongful Act of a Director or Officer shall not be imputed to any other Director or Officer for the purpose of determining the applicability of the foregoing exclusions . . . ."[41] The rationale of these decisions is "to render the personal profit exclusion truly personal as to each officer."[42]

The approach to this issue—who must do it—can be pivotal to the claim.

The Money Laundering Exclusion

A federal district court has ruled that a money laundering exclusion in a D&O policy relieved insurers of any obligation to pay defense costs in a case involving the alleged Ponzi scheme perpetrated by R. Allen Stanford and his Stanford Financial Group.[43]

The court found that the officers, who were certified public accountants, reverse engineered their financial reports based upon the returns that were promised, as opposed to the returns that had been actually achieved. Their bookkeeping included increasing the value of a real estate investment by a factor of 50 only three months after the property was acquired. The court then applied the money laundering exclusion. The policy set its own definition of money laundering that included not only statutory money laundering but a variety of acts concerning "criminal property," defined as "property which constitutes a benefit obtained from . . . or in connection with criminal conduct . . . [which a director or officer] knows or suspects or *reasonably should have known or suspected that it constitutes*" such property.[44] The court took careful note of the italicized policy language, declaring that if the policyholders should have known of the criminal property, coverage was barred. With this standard, the court was able to reach its findings by a simple conclusion that the policyholders' denial of knowledge was "unpersuasive" and "strain[ed] credulity." The court said that it did not need to find that the policyholders actually knew of the criminal property.

It also should be noted that the court enforced this exclusion as written. If the transactions related to criminal property and the policyholders should have known so, coverage was barred. The court's analysis was an intensely factual consideration of whether the policyholders were tied to the alleged fraud, ruling that the officers had the required tie to the alleged fraud.

This exclusion and the court's findings should be distinguished from the exclusions that typically require determinations in fact or judicial determinations. In this instance, the court saw no such hurdle, given that the money laundering exclusion contained neither requirement.

Conclusion

By all measures, the financial meltdown has been a major business issue that has turned into a significant insurance concern. In instances where individuals have been named as defendants, both D&O and E&O insurance policies have been implicated, and they will likely continue to be. In particular, the focus will continue to be on the three particular exclusions discussed above. As suggested here, the legal issues raised by those exclusions are complex, and the analysis must consider everything from the evidence required to support a dishonesty finding and the applicability of the personal profit exclusion to the specific requirements of the money laundering exclusion.

Accordingly, whether individual defendants in actions arising from the financial crisis will be entitled to a defense or indemnity under these insurance policies will require careful examination of the facts, the specific language in the policies involved, established case law, and the rulings emerging from the courts in recent years.

Endnotes

1. *See, e.g., In re* Enron Corp. Secs., Derivative & ERISA Litig., 391 F. Supp. 2d 541, 573–74 (S.D. Tex. 2005) (surveying cases). Cases rejecting contemporaneous payment include *Kenai Corp. v. National Union Fire Insurance Co.*, 136 B.R. 59, 63 (S.D.N.Y. 1992), and *Zaborac v. American Casualty Co. of Reading*, 663 F. Supp. 330, 333 (C.D. Ill. 1987).

2. *See, e.g.,* Atl. Permanent Fed. Sav. & Loan v. Am. Cas. Co., 839 F.2d 212, 217 (4th Cir. 1988), *cert. denied,* 486 U.S. 1056 (1988); Nat'l Union Fire Ins. Co. of Pittsburgh v. Cont'l Ill. Corp., 666 F. Supp. 1180, 1198 (N.D. Ill. 1987); PepsiCo, Inc. v. Cont'l Cas. Co., 640 F. Supp. 656, 660 (S.D.N.Y. 1986).

3. *See In re* Donald Sheldon & Co., 186 B.R. 364, 370 (S.D.N.Y. 1995).

4. *Id*.

5. *Id*.

6. 885 F. Supp. 1533 (N.D. Fla. 1995).

7. *Id*. at 1537; *see also* Cont'l Cas. Co. v. Kriz, 3:09CV00835, 2011 U.S. Dist. LEXIS 33555 (D. Conn. Mar. 29, 2011) (dishonesty exclusion applied based upon guilty plea).

8. No. 3:05CV159, 2005 U.S. Dist. LEXIS 8003 (E.D. Va. May 3, 2005).

9. *Id*. at *17.

10. *Id*. at *18–19.

11. Unencumbered Assets v. Great Am. Ins. Co., 2:04CV908, 2011 U.S. Dist. LEXIS 106153 (S.D. Ohio Sept. 16, 2011).

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12. Greenwich Ins. Co. v. Media Breakaway, LLC, 08CV937, 2009 U.S. Dist. LEXIS 63454 (C.D. Cal. July 22, 2009), *aff'd*, 417 Fed. App'x 642 (9th Cir. 2011).

13. *See, e.g.,* Rice v. Liberty Surplus Ins. Corp., 113 Fed. App'x 116 (6th Cir. 2004).

14. *Id*. at 123.

15. 666 F. Supp. 1180 (N.D. Ill. 1987).

16. *Id*. at 1199.

17. *Id*.

18. *See, e.g.,* Int'l Surplus Lines Ins. Co. v. Univ. of Wyo. Research Corp., 850 F. Supp. 1509, 1525 (D. Wyo. 1994), *aff'd*, 52 F.3d 901 (10th Cir. 1995); Serio v. Nat'l Union Fire Ins., 795 N.Y.S.2d 529 (N.Y. App. Div. 2005), *appeal denied*, 6 N.Y.3d 703 (2006).

19. A clear and simple example: The personal profit exclusion was applied to circumstances where the policyholder earned money from fraudulent transactions. Carter v. Westport Ins. Co., B-09-99, 2010 U.S. Dist. LEXIS 40247 (S.D. Tex. Apr. 23, 2010).

20. Fed. Ins. Co. v. Cont'l Cas. Co., 2:05CV305, 2006 U.S. Dist. LEXIS 85323, at *74 (W.D. Pa. Nov. 22, 2006).

21. Level 3 Communs., Inc. v. Fed. Ins. Co., 272 F.3d 908, 910–11 (7th Cir. 2001).

22. Nat'l Union Fire Ins. Co. v. Cont'l Ill. Corp., 666 F. Supp. 1180, 1199 (N.D. Ill. 1987).

23. *Id*.

24. Bank of Am. v. SR Int'l Bus. Ins. Co., 2007 N.C.B.C. 36, 53 (N.C. Super. Ct. 2007).

25. Int'l Ins. Co. v. Johns, 874 F.2d 1447, 1457 (11th Cir. 1989).

26. No. 05CV1201, 2006 U.S. Dist. LEXIS 31119 (D. Kan. May 17, 2006).

27. *Id*. at *30.

28. No. 99CV4441, 2000 U.S. Dist. LEXIS 8632 (E.D. Pa. June 21, 2000).

29. No. 08CV937, 2009 U.S. Dist. LEXIS 63454 (C.D. Cal. July 22, 2009).

30. No. 88CV839, 1991 U.S. Dist. LEXIS 21851 (W.D. Okla. Jan. 8, 1991).

31. *Id*. at *23 (noting that claims against bank director for breach of fiduciary and contractual duties in permitting or in failing to correct his self-dealing without approval, and in violation of statute, are claims potentially based on or attributable to director gaining an unlawful advantage).

32. 244 F. Supp. 2d 1144 (D. Colo. 2003).

33. *Id*. at 1160 (citation omitted).

34. Harristown Dev. Corp. v. Int'l Ins. Co., 87CV1380, 1988 U.S. Dist. LEXIS 12791, at *19 n.1 (M.D. Pa. Nov. 15, 1988).

35. PMI Mortg. Ins. Co. v. Am. Int'l Specialty Lines Ins. Co., C 02-1774, 2006 U.S. Dist. LEXIS 24853 (N.D. Cal. Mar. 29, 2006) (mere allegations are not adequate); *see also* Fed. Ins. Co. v. Cintas Corp, 1:04CV00697, 2006 U.S. Dist. LEXIS 33369 (S.D. Ohio, May 25, 2006) (mere allegations of a personal profit are not enough to apply exclusion; court noted that "there has been no finding yet that Cintas obtained a personal benefit to which it was not entitled").

36. Westport Ins. Corp v. Hanft & Knight, 523 F. Supp. 2d 444, 454 (M.D. Pa. 2007) (finding that no final adjudication was needed where undisputed allegations of underlying complaint demonstrated that policyholder gained a personal profit to which he was not legally entitled). *Compare* Fed. Ins. Co. v. Kozlowski, 792 N.Y.S.2d 397, 401 (N.Y. App. Div. 2005) (since duty to defend is broader than duty to indemnify, and allegations do not "solely and entirely fall within the personal profit exclusion," carrier must pay all defense costs as incurred, subject to recoupment when liabilities are determined).

37. Brown & LaCounte v. Westport Ins. Corp., 307 F.3d 660, 663 (7th Cir. 2002).

38. Rector, Wardens and Vestryman of St. Peter's Church v. Am. Nat'l Fire Ins. Co., 00CV2806, 2002 U.S. Dist. LEXIS 625, at *21 (E.D. Pa. Jan. 14, 2002), *aff'd*, 97 Fed. App'x 374 (3d Cir. 2004).

39. Westport Ins. Corp. v. Black, Davis & Shue, 513 F. Supp. 2d 157, 168 (M.D. Pa. 2007).

40. TIG Specialty Ins. Co. v. Pinkmonkey.com Inc., 375 F.3d 365, 371 (5th Cir. 2004).

41. Pereira v. Nat'l Union Fire Ins. Co., 04CV1134, 2006 U.S. Dist. LEXIS 49263, at *22 (S.D.N.Y. July 12, 2006); *see also Kozlowski*, 792 N.Y.S.2d at 399.

42. *Pereira*, 2006 U.S. Dist. LEXIS 49263, at *22.

43. Pendergest-Holt v. Certain Underwriters at Lloyd's of London, 751 F. Supp. 2d 876 (S.D. Tex. 2010).

44. Italics added.

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