

# Fraud Litigation, Fraud Exclusions

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February 9, 2001

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## More Fraud and Dishonesty Allegations

Shareholder litigation accounts for 47% of all directors' and officers' liability cases filed against executives of for-profit organizations, 16% against executives of privately held companies, and 1% against executives of not for profit companies in the United States.<sup>2</sup> Most shareholder lawsuits are securities actions. The average shareholder claim cost \$8.67 million to resolve in 1999, up from \$7.16 million in 1998.<sup>3</sup> These numbers make clear that shareholder securities lawsuits represent some of the most significant claims brought against directors and officers today.

The Private Securities Litigation Reform Act ('Reform Act') was promulgated in 1995 in an effort to encourage meritorious and discourage frivolous securities actions, accomplished in part by elevating the pleading requirements.<sup>4</sup> Since passage of the Reform Act, courts have been trying to assess what level of detail must be pled to establish fraud claims under the new Act. Most notably, the 9<sup>th</sup> Circuit, which includes California, has swung from applying one of the more lenient standards for proof of fraud to now applying one of the most stringent standards, requiring proof of deliberately reckless or conscious misconduct.<sup>5</sup>

The heightened pleading requirements under the Reform Act have resulted in an increase in the specificity of dishonesty and fraud allegations lodged against directors and officers in already expensive securities cases. More complaints contain more detailed allegations of insider trading in an effort to meet the need to prove that the individuals were deliberate or conscious in their acts of wrongdoing, in an effort to maximize their own share values. This increase in detailed allegations of fraud and dishonesty raises grave coverage issues under directors' and officer's liability policies ('D&O Policies'), as these policies contain a dishonesty and fraud exclusion. This article analyzes the scope and impact of the exclusion.

## D&O Policies Exclude Dishonesty and Fraud

Most D&O policies exclude claims based upon the fraud or dishonesty of directors and officers.<sup>6</sup> Courts have recognized the exclusion.<sup>7</sup> Most policies provide that the exclusion applies only if the executive's company does not indemnify the executive, although some apply the exclusion regardless of indemnification.

The fraud and dishonesty exclusion poses a very real issue for insured executives today, because the increasing number of dishonesty and fraud allegations create an increasing number of cases in which insurers may deny or attempt to deny coverage based on the

exclusion. Hence the issues become, what does a fraud and dishonesty exclusion provide, and just how broad is it?

Not all fraud and dishonesty exclusions are created equal. There are two major types: those that require a final adjudication of fraud or dishonesty, and those that do not.

- *'Final adjudication' exclusion:* The final adjudication version of the fraud and dishonesty exclusion provides that no coverage applies if there is a final adjudication of active and deliberate dishonesty which was material to the cause of action.<sup>8</sup> Two features of the final adjudication exclusion inure to the benefit of the insureds. First, courts have held that this means that the exclusion cannot be used to deny coverage unless and until there is a final adjudication.<sup>9</sup> There must be an actual adjudication that the executives engaged in dishonesty for the exclusion to apply. Thus, if an action is settled, the dishonesty exclusion does not apply because the settlement precludes the possibility of adjudication on the issue of dishonesty.<sup>10</sup> However, if and when an adjudication of dishonesty is rendered, coverage no longer applies and the insureds must reimburse the insurer retroactively for all defense costs incurred up to that point in time.<sup>11</sup> Second, if the case is settled, the insurer is not allowed to re-litigate the underlying case in an attempt to create final adjudication of dishonesty under the guise of a coverage case.<sup>12</sup>
- *'In fact' exclusion:* The second type of fraud and dishonesty exclusion is the 'in fact' version, which provides that no coverage applies if the fraud or dishonesty of the insured executives is established in fact. Two features of this version of the exclusion inure to the benefit of the insurers. First, it is argued that the exclusion does not require a final adjudication to apply. Second, courts have permitted insurers to re-litigate the underlying action to attempt to garner a final adjudication specifying dishonesty.<sup>13</sup>

### **What are Fraud and Dishonesty?**

Fraud and dishonesty are generally not defined in policies containing the exclusion.<sup>14</sup> However, the courts have provided guidance. One court held that dishonesty means a willful and intentional intent to deceive.<sup>15</sup> Thus, a merely negligent act, lacking in intent, would not trigger the exclusion. Another court has noted that the term dishonesty applies to civil as well as criminal proceedings, since dishonesty means a disposition to defraud, deceive or betray, all of which include non-criminal acts.<sup>16</sup> Another court has held that breaches of fiduciary duty invoke the dishonesty exclusion, that the term dishonesty is a broader concept than mere fraud, and as such it covers acts, which fall short of fraud.<sup>17</sup> Thus, fraud is a subset of dishonesty, and if dishonesty is excluded, fraud is excluded.

### **What is Final Adjudication?**

If a fraud and dishonesty exclusion applies only upon a final adjudication, the issue becomes when is adjudication final? Is a default judgment final? Is a trial verdict final? What is the impact of an appeal, and is it covered when it follows an adjudication at the trial level of fraud or dishonesty? These questions are critical, as the answers determine the critical point at which an insured director or officer loses coverage for a claim.

Courts have held that a default judgment is a final judgment within the meaning of the exclusion.<sup>18</sup> Final adjudication has also been held to consist of a trial.<sup>19</sup> The more interesting question is whether the insurer has to continue to provide coverage through the appellate courts; can it abandon its insureds with the first verdict of dishonesty? One court has noted that “a default judgment is in fact a *final* judgment for purposes of appealability...”. Describing an initial trial court judgment as ‘final’, regardless of an appeal, suggests that the exclusion applies regardless of an appeal.<sup>20</sup>

### **Specific Finding of Dishonesty Required**

A mere allegation of fraud or dishonesty amidst other allegations, coupled with a subsequent general verdict against the defendant executive, will not work to vitiate coverage. Courts have held that the final judgment itself must show that the executive was in fact dishonest and must show that the dishonesty was necessary to establish the case.<sup>21</sup>

For example, in one case various allegations were made, some that involved dishonesty, some that did not. In the end, the jury found that executives were liable but did not specify the exact basis for the finding against them. Because the general verdict did not identify whether it was attributable to the dishonesty allegations or the other allegations, there was no way to tell if the finding was based upon dishonesty or not. The insurer tried to deny coverage based on a final adjudication dishonesty exclusion. The court found that since the jury could have found liability without finding dishonesty, then the exclusion did not apply. The court held that a general verdict establishes dishonesty only if a finding of dishonesty was necessary to the judgment.<sup>22</sup>

The pleadings are not necessarily determinative, however. One court held that even if dishonesty is never specifically alleged in a complaint, the issue becomes whether the facts adduced at trial support a finding that acts of active and deliberate dishonesty transpired. If so, coverage will not apply.<sup>23</sup>

### **Conclusion**

More cases are pleading more dishonest and fraudulent acts of directors and officers to satisfy the more rigorous pleading requirements of the Reform Act. Unfortunately, these fraud allegations draw the insured directors and officers into a confrontation with his or her D&O policy which contains some version of a fraud and dishonesty exclusion. Therefore, it is incumbent upon producers and risk managers alike to become aware of the type and parameters of the exclusion in the D&O policy, as it may be critical to a director or officer in the event of a claim.

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<sup>2</sup> Tillinghast-Towers Perrin 1999 Directors’ and Officers’ Liability Survey.

<sup>3</sup> Tillinghast, supra note 2.

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- <sup>4</sup> Private Securities Litigation Reform Act of 1995, 15 U.S.C. 78u-4 et seq. (West Supp. 1999); Jay A. Dubow and Laura E. Krabill, Wolf, Block, Schorr & Solis-Cohen LLP., Federal Courts Deeply Divided Over Securities Fraud Intent Standard, Legal Backgrounder, January 21, 2000, Vol. 15, No. 7; Ryan G. Miest, Note, Would the Real Scientist Please Stand Up: The Effect of the Private Securities Litigation Reform Act of 1995 on Pleading Securities Fraud, 82 Minn. L. Rev. 1103 (1998).
- <sup>5</sup> Janas v. McCracken (In re Silicon Graphics Inc. Sec. Litig.), 183 F.3d 970 (9th Cir. 1999); The Business Law Subcommittee on the Annual Review of the Federal Regulation of Securities Committee, Brian F. McDonough, Chair, Annual Review of Federal Securities Regulation: Significant 1999 Case Law Developments, The Business Lawyer, February, 2000, 55 Bus. Law. 917.
- <sup>6</sup> See, e.g., Chubb Policy Form (14-02-0943[Ed. 1/92] at Section 6(b); St. Paul Companies Policy Form FP095 Ed. 1/97 at Section IV. C. 1.
- <sup>7</sup> Finci v. American Casualty Company of Reading, Pa., et. al., 593 A.2d 1069, 1086 (Md. App. 1991).
- <sup>8</sup> CNA Select Solutions Policy, Directors, Officers & Entity Securities Liability Coverage Part (G-129161-A (11/98)) at Section III, Exclusions, paragraph 2, clause b; CNA Combined Solutions Policy, Directors, Officers & Entity Securities Liability Coverage Part (G-132818-A (11/98)) at Section III, Exclusions, paragraph 2, clause b; CNA E-Pack Policy, Directors & Officers Liability Coverage Part (G-129170-A (06/00)) at Section IV, Exclusions, paragraph 2, clause b.
- <sup>9</sup> Federal Ins. Co. v. Hawaiian Elec. Indus., Inc., No. 94-00125HG (D.Haw. Dec. 15, 1995).
- <sup>10</sup> National Union Fire Insurance v. Seafirst Corp., 662 F.Supp. 36 (W.D. Wash. 1986); Harristown Development Corp. v. International Ins. Co., 1988 U.S. Dist. LEXIS 12791 (M.D. Pa. 1988).
- <sup>11</sup> Little v. MGIC Indemnity Corp., 649 F.Supp. 1460 (W.D. Pa. 1986); PepsiCo, Inc. v. Continental Casualty Co., 640 F.Supp. 656, 659-660 (S.D.N.Y. 1986).
- <sup>12</sup> PepsiCo, *supra* note 10 at 660; Seafirst, *supra* note 9.
- <sup>13</sup> American Casualty Co. v. United Southern Bank, 950 F.2d 250 (5<sup>th</sup> Cir. 1992).
- <sup>14</sup> See, policies cited at footnote 6.
- <sup>15</sup> Eglin National Bank v. Home Indemnity Company, 583 F.2d 1281, 1287 (1978).
- <sup>16</sup> International Surplus Lines Ins. Co. v. Univ. of Wyoming Research Corp., 850 F.Supp. 1509, 1523 (D. Wyo. 1994).
- <sup>17</sup> Leucadia v. Reliance Insurance Co., 864 F.2d 964 (2<sup>nd</sup> Cir. 1988), cert. denied, 109 S.Ct. 3160 (1989).
- <sup>18</sup> International Surplus Lines, *supra* note 15 at 1523.
- <sup>19</sup> Eglin, *supra* note 14 at 1288.
- <sup>20</sup> International Surplus Lines, *supra* note 15 at 1524.
- <sup>21</sup> Federal Ins. Co. v. Sheldon, (In re Donald Sheldon & Co.), 186 B.R. 364, 370 (S.D.N.Y. 1995).
- <sup>22</sup> Sheldon, *supra* note 20.
- <sup>23</sup> Country Manors Asso. Inc. v. Master Antenna Systems, 534 So.2d 1187 (Fla. Dist. Ct. App. 1988).