

Personal Profit or Advantage and Dishonesty Exclusions Do Not Apply

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In an unpublished opinion, *In re Donald Sheldon & Co.*, No. 98-5040, 1999 U.S.App. LEXIS 13954 (2d Cir. June 22, 1999), the Second Circuit summarily affirmed the district court's conclusion that the "Personal Profit or Advantage" and "Dishonesty Adjudication" exclusions in a directors and officers liability policy do not apply to a claim against two former officers of the now insolvent Donald Sheldon & Company ("DSCO").

In an action by DSCO's bankruptcy trustee against two former directors, a jury determined that the directors were liable to the trustee for approximately \$16 million. The trustee's claim alleged that the directors approved a transaction that caused the company to default on loans and therefore surrender its collateral, which consisted of securities held in an account by the lender. Those same securities had been sold, but not yet delivered, to investors, to whom DSCO was liable for the loss of the securities. This action pushed DSCO into liquidation. The trustee brought claims alleging that the directors knew or should have known that their actions would lead to the default and knew or should have known that the company had been illegally hypothecating investors' securities. The trustee also alleged that the transaction violated the duty of loyalty, as the directors had a personal financial interest in the transaction.

In a subsequent proceeding concerning the availability of coverage for the award under DSCO's D&O policy, the district court ruled that the policy's "Personal Profit or Advantage" and "Dishonesty Adjudication" exclusions did not apply to the trustee's claim against the directors. The "Personal Profit of Advantage" exclusion provided that the insurer (Federal Insurance Company) would not be responsible for any "Loss" from any claim against an Insured Person "based upon or attributable to such Insured Person having gained any personal profit or advantage to which he was not legally entitled regardless of whether or not (1) a judgment or other final adjudication established that such Insured Person in fact gained such personal profit or advantage to which he was not entitled, or (2) the Insured Person has entered into a settlement agreement to repay such unentitled personal profit or advantage to the Insured Organization." *In re Donald Sheldon & Co., Inc.*, 186 B.R. 364, 367-68 (S.D.N.Y. 1995). According to the district court, Federal argued that the directors gained personal advantage prior to DSCO's collapse because they retained their jobs, retained an opportunity to expand DSCO and secured the opportunity to increase their personal gain through the transaction.

The district court disagreed, opining that the "Loss" must be "based upon or attributable to" the personal profit or advantage of the directors. *Id.* at 369. Here, it found there was no evidence of a causal connection between the directors' alleged "advantage" and the "Loss" claimed by the trustee. *Id.* Also, the district court reasoned that Federal's interpretation ignored the principle that a corporation is a separate entity, and that the "personal profit or advantage" referenced in the exclusion should be interpreted to apply to some "more direct" personal benefit than the type of derivative corporate benefits averred by Federal as the basis for invoking the exclusion. *Id.*

The district court offered a similarly narrow reading of the "Dishonesty Adjudication" exclusion, which barred coverage for "Loss" in connection with any claim against an "Insured Person brought about or contributed to by the dishonesty of such Insured Person. . ." *Id.* at 367. Pursuant to the exclusion, the Insured Person's dishonesty must be finally adjudicated, actively and deliberately pursued and material to the cause of action. *Id.* at 367-68. Accordingly, the issue presented to the court was how to apply the exclusion where the jury in the underlying matter rendered only a general verdict.

Federal argued that the court should apply the exclusion here because the underlying facts and legal theories presented to the jury could have resulted in a specific finding of dishonesty. Federal also asserted that it would be unfair not to apply the exclusion because Federal was not and never would be in a position to request a special verdict form. The district court disagreed, stating that the exclusion required an adjudication of dishonesty, and that the general verdict permitted the jury to find liability without finding "active and deliberate dishonesty." The district court also found that applying the exclusion in this context would not be unfair to Federal because Federal wrote the exclusion and could account for the risk of similar circumstances either by drafting different language or by pricing the exclusion differently. *Id.* at 370.

The Second Circuit endorsed the district court's reasoning, finding that Federal had not proven that the directors gained any personal profit or advantage from their "misguided behavior," and the jury verdict did not establish dishonesty. 1999 U.S. App. LEXIS 13954 at 2.