

Guilty Plea Triggers Dishonesty Exclusion; Insurer Entitled to Recoup Defense Costs

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The United States District Court for the Eastern District of Pennsylvania, applying Pennsylvania law, ruled that a dishonesty exclusion barred coverage for the costs of defending a criminal action and related securities and derivative litigation. *Herley Indus., Inc. v. Fed. Ins. Cos., Inc.*, 2009 WL 2596072 (E.D. Pa. Aug. 21, 2009). The court also ruled that the insurer was entitled to recoup defense costs it previously had advanced to the insureds.

In June 2006, the United States brought criminal charges against the insured company and its chief executive officer in connection with the company's bid to supply certain military equipment. The United States alleged that the defendants obstructed a federal audit, committed a fraud against the United States and made false statements to the government to inflate the cost of a contract to supply equipment. Shortly thereafter, the company, its chief executive officer (CEO) and other officers and directors of the company were named as defendants in securities and derivative lawsuits based on similar allegations. In 2008, the CEO pled guilty to a superseding information in the criminal action charging him with a misdemeanor of failing to keep a company tax record as required by federal law. The company pled guilty to charges that it obstructed federal auditors by withholding cost and pricing data.

The insurer initially entered into an interim funding agreement with the company to advance defense costs in connection with the claims against the insureds under a policy providing D&O, entity securities and fiduciary liability coverage. Following the guilty pleas, the insurer stopped advancing defense costs and took the position that a dishonesty exclusion in the policy barred coverage. The exclusion precluded coverage for claims "based upon, arising from, or in consequence of any deliberately fraudulent act or omission or any willful violation of any statute or regulation by [an] Insured Person, if a judgment or other final adjudication establishes such a deliberately fraudulent act or omission or willful violation." The insurer also demanded the return of more than \$2 million in defense costs it previously had advanced.

The court first ruled that the dishonesty exclusion in the policy barred coverage for the CEO's defense of the criminal action. The court rejected the insured's argument that the CEO's guilty plea to a misdemeanor offense was unrelated to the initial charges, which were dismissed, and that the plea did not constitute an adjudication to which the exclusion could apply. The court determined that the prior charges and guilty plea

were "unquestionably related" and that the entire criminal action constituted the relevant "claim" against the CEO. In addition, the court determined that the guilty plea established the CEO's willful violation of federal statute.

The court also ruled that the dishonesty exclusion barred coverage for the company in both the criminal and civil litigation. The court rejected the insured's argument that the company's guilty plea was distinct from a final adjudication on the merits. The court reasoned that, under Pennsylvania law, a guilty plea is equivalent to conviction by trial and is conclusive evidence of criminal acts. The court also ruled that the civil actions were "based upon, arising from, or in consequence of" the deliberately fraudulent misconduct to which the company pled guilty. The court determined that, under Pennsylvania law, "arising out of" requires "but for" causation and concluded that, but for the company's deliberately fraudulent misconduct established in the criminal proceeding, the civil actions would not have been filed.

Finally, the court ruled that the insurer was entitled to recoup amounts it had advanced under the interim funding agreement. The court noted that the policy required the insured to repay defense costs to the insurer upon a determination that such defense costs are not insured. Because it found no coverage for the defense costs at issue, the court ruled the insured was required to repay the amounts advanced by the insurer.