

Fraud Exclusion Triggered and Partial Rescission Permitted Due to CFO's Guilty Plea

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Applying Maryland law, a federal district court has held that an excess policy's fraud exclusion barred coverage for an information security technology company's CFO after she pled guilty to backdating stock options. The court also held that the insurer was entitled to rescind partially the policy as to the CFO and the company. *Fed. Ins. Co. v. SafeNet, Inc.*, 2011 WL 4005353 (S.D.N.Y. Sept. 9, 2011). The court further held that the security company's failure to comply with a consent-to-settle provision precluded coverage for its settlement of a securities class action.

In 2006, the security company provided notice of circumstances to its insurers regarding its public disclosure of irregularities in its previously-filed financial statements. Shortly thereafter, a securities class action was filed against the company. The company then became involved in several government investigations into its stock option grants as well as shareholder derivative suits. In 2007, the security company's CFO pled guilty to securities fraud related to backdating of stock options, admitting that she had acted "willfully and with intent to defraud." The excess insurer then informed the security company that coverage was not available in certain respects and that it intended to pursue rescission of the policy, but that coverage might still be available for some insured persons. Without seeking the excess insurer's consent, the security company entered into a \$25 million settlement of the securities class action. The excess insurer then filed suit against the security company, its CFO, and its CEO, seeking a declaration concerning coverage and its right to rescind the policy.

As a threshold issue, the court rejected the insureds' argument that the government investigations and shareholder derivative suits fell under the renewal policy issued by the excess insurer, rather than the policy in effect when the company provided the initial notice of circumstances in February 2006. The excess policy provided that after notice of circumstances was provided, "a Claim which is subsequently made against such an Insured . . . alleging, arising out of, based upon, or attributable to such circumstances or alleging any Wrongful Act which is the same or related to any Wrongful Act alleged or contained in such circumstances, shall be considered made at the time such notice of circumstances was given." Relying on this provision, the court held that the stock options backdating claims related back to the notice of circumstances submitted in February 2006.

The court then considered whether to apply the excess policy's fraud exclusion, which precluded coverage "for Loss in connection with any Claim made against an Insured . . . arising out of, based upon or attributable to the committing of any deliberate criminal or fraudulent act by the Insured if a judgment or final adjudication . . . adverse to the Insured(s) establishes that such deliberate criminal or fraudulent act was committed." The court held that the CFO's guilty plea was a judgment that triggered the fraud exclusion as to her, but that the exclusion did not bar coverage for the security company because the excess policy allowed for imputation only of "facts" and "knowledge" to the security company and not a judgment.

In addition, the court determined that because the insurer did not issue a blanket coverage denial, the security company was not excused from complying with the excess policy's consent-to-settle provision. The court noted that the insurer had indicated it was investigating rescission but that coverage might be available for certain insured persons. Accordingly, the court determined that the security company was not entitled to coverage for the \$25 million securities class action settlement because it failed to obtain the insurer's consent.

Finally, the court held that the insurer was entitled to rescind the excess policy as to the CFO because the application for the policy incorporated the security company's public financial statements, and the CFO's guilty plea established that she knew those statements to be inaccurate when they were issued. The court also noted that the excess policy permitted imputation of the CFO's knowledge to the company for purposes of the insurance application. Consequently, the insurer also was entitled to rescind the policy as to the security company.