

Personal Profit Exclusion Bars Coverage for All Directors and Officers Where CEO Found Liable

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The United States Court of Appeals for the Fifth Circuit, applying Texas law, has held that the personal profit exclusion in a D&O policy bars coverage for litigation against a number of directors and officers of an insured company, including those who reached settlements in the underlying litigation, since a jury found in the underlying litigation that the CEO had engaged in, and personally profited from, the sale of stock through fraudulent means. *TIG Specialty Ins. Co. v. Pinkmonkey.com Inc.*, 2004 WL 1429933 (5th Cir. July 14, 2004).

An insurer issued a D&O policy to a company that sold shares of its stock and stock of another corporation to various third parties. The policy contained a personal profit exclusion that precluded coverage for "any Claim made against any Insured arising out of [] the following:...any Claim based upon, arising from, or in consequence of an Insured having gained in fact any personal profit, remuneration, or advantage to which such Insured was not legally entitled." The policy also contained an endorsement providing entity coverage to the company for securities claims. The policy defined a "securities claim" as "[a] claim made against an Insured of the Company alleging a violation of the Securities Act of 1933, the Securities Exchange Act of 1934, and rules or regulations of the Securities and Exchange Commission adopted thereunder; similar federal and state or foreign statutes regulating securities; and any rules or regulations of any state or foreign jurisdiction, or any common law, relating to any transaction arising out of, involving, or relating to the sale of securities." The policy also provided that "[a]ll Claims arising from the same Wrongful Act or interrelated or continuous Wrongful Acts of one or more Insured shall constitute a single claim."

The underlying plaintiffs filed suit against the company, its former CEO and other directors and officers of the company, alleging violations of Texas securities laws, including control person liability, deceptive trade practices and negligent misrepresentation. Four of the defendants settled before trial. At trial, the jury found that the company, through the former CEO and another officer, had sold the stock through fraudulent means and that the former CEO profited from the sale. The insurer denied coverage for all insureds based on the personal profit exclusion in the policy. Coverage litigation ensued.

The Fifth Circuit ruled in favor of the insurer, holding that the personal profit exclusion applied to bar coverage for claims against the former CEO and the other directors and officers. The court first determined that the former CEO had received a personal profit or advantage, relying on the jury's determination in the underlying case. The court next held that the former CEO was not legally entitled to the profits. In so ruling, the court stated that "[a] defendant is not legally entitled to an advantage or profit resulting from his violation of law if he could be required to return such profit." The court observed that one of the remedies available in the underlying case was "rescission, which requires the return of any money paid." The court therefore concluded that the personal profit exclusion applied to the former CEO because he had gained a personal profit to which he was not legally entitled.

The court next held that the personal profit exclusion barred coverage for the other directors and officers of the company even though it had not been established that they received personal gain or advantage. The court first observed that "[t]he exclusion does require that the claim be based upon *the Insured, that Insured, or such Insured*, having gained a personal profit or gain, but based upon *an Insured* having gained a personal profit." The court concluded that this language demonstrated that the exclusion was intended to apply to all insureds and not merely to the insured who personally profited. The court also noted that "the Personal Profit Exclusion does use the specific term 'such Insured' to indicate the same insured as previously referred to, when it states that the claim must arise from 'an Insured having gained in fact any personal profit...to which *such Insured* was not legally entitled.'" The use of more specific language within the same provision further indicates that 'an Insured' does not necessarily refer to the same insured against whom the claim was brought."

Having determined that the exclusion applied to all insureds, the court addressed whether the allegations against the other directors and officers were based on the former CEO having gained personal profit to which he was not legally entitled. The court first determined that as directors and officers of the company, the allegations made against them were allegations against insureds under the policy. The court then noted that one of the underlying causes of action against the other directors and officers was control person liability. The court explained that "[t]he rationale behind control person liability is that a control person is in a position to prevent the securities violation at issue." The court concluded that the allegations against the other officers and directors arose out of the former CEO's improper personal gain because the allegations were based on the former CEO's fraud, which led to his illegal personal profit.

Finally, the court held that coverage for the allegations against the company was also barred by the personal profit exclusion because the allegations against the insureds and the allegations against the company "arise from the same Wrongful Act and constitute a single claim. As such, the claim against the Company is also a claim against an Insured." The court concluded that because the exclusion applied to bar coverage for the allegations against the directors and officers of the company, the personal profit exclusion barred coverage for the company.

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