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NEWSLETTER

Delaware Federal Court Holds that Dishonesty Exclusion Cannot Apply to Securities Claims

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Personal Profit Exclusion Only Applies to a Direct Claim for Illegal Profit, and Insured v. Insured Exclusion Inapplicable to Bankruptcy Trustee's Claim

The United States District Court for the District of Delaware, applying Delaware and Illinois law, recently addressed the scope of the insured v. insured exclusion in a bankruptcy adversary proceeding, and the dishonesty and personal profit exclusions in a securities class action. *Alstrin v. St. Paul Mercury Ins. Co.,* No. 98-683-RRM, 2002 U.S. Dist. LEXIS 719 (Jan. 16, 2002). In the first ruling of its kind, the court held that an insurer cannot rely on the dishonesty exclusion to bar coverage for securities claims even if fraud is alleged on the part of the directors and officers. In addition, the court determined that the personal profit exclusion applies only where the underlying claim alleges that the profit or gain itself was illegal and seeks disgorgement of the profit. Lastly, the court found that the insured v. insured exclusion does not apply to a claim against a debtor's directors and officers by the representative of the bankruptcy estate.

This dispute centered on the availability of coverage under a directors and officers liability policy for a securities class action and related bankruptcy adversary proceeding. Shareholders of the debtor and the bankruptcy estate representative sued the directors and officers for the allegedly improper corporate restructuring of the debtor, which resulted in the split-off of the valuable portion of the debtor and left the shareholders of the debtor with the failing portion of the company. The class action and adversary proceeding were ultimately settled, and the directors and officers filed a declaratory judgment action seeking coverage under their liability policies. The directors and officers moved for partial summary judgment against one of the insurers that issued a run-off endorsement (National Union Fire Insurance Company of Pittsburgh, Pa.). The court granted the motion for partial summary judgment.

The court first held that the dishonesty exclusion could not bar coverage for securities claims. The policy excluded from coverage claims "arising out of, based upon or attributable to the committing in fact of any criminal or deliberate fraud." The insureds claimed that this exclusion should not be read to apply to securities claims because to do so would eliminate the explicit grant of coverage for securities claims in the policy. The court agreed. It reasoned that "[e]ven though certain securities claims do not require intentional misconduct, applying the intentional fraud exclusion to the securities coverage at issue would eviscerate coverage for the majority of securities claims." Moreover, the court contended that "[n]o insured would expect such limited coverage from a policy that purports to cover all types of securities fraud claims." The court did not grapple

with the public policy implications of its ruling. Nor did the court fully analyze the limitations on the dishonesty exclusion, including the "in fact" requirement and the requirement that criminal conduct or "deliberate fraud" occur before the exclusion applies. Indeed, the court failed to consider that a broad category of securities claims (including those involving culpable recklessness) would be still covered even if the dishonesty exclusion barred coverage for those claims that fell within its terms.

The court also held that the personal profit exclusion did not apply. The exclusion in the policy at issue barred coverage for claims "arising out of, based upon or attributable to the gaining in fact of any profit or advantage to which an insured was not legally entitled." The insureds claimed that the class actions did not allege that their profit or gain was illegal, but rather that they disseminated false or misleading disclosures in violation of federal securities laws. Moreover, the insureds claimed that the insurer had to prove that an illegal profit or gain actually occurred. National Union countered that, based on the allegations in the underlying litigation, an inference could be drawn that the insureds profited from the transaction at issue.

The court found merit in the insured's argument. The court determined that for the exclusion to apply, the underlying action must allege that the profit or gain itself was illegal and seek to disgorge the illegal profits or gain. Proof only that the insured undertook "an illegal act that produces a profit or gain to the insured as a by-product" is not sufficient. Thus, the court concluded that the exclusion "would be applicable in cases of theft, such as insider trading, but is inapplicable to illegalities such as securities misrepresentations to which a private gain might be incidental." Otherwise, the court maintained, the coverage provided by the policy "would be rendered valueless by [the] exclusion," as "[a]lmost all securities fraud complaints will allege that the defendants did what they did in order to benefit themselves in some way." The court's analysis fails to consider the broad preamble to the exclusion ("arising out of, based upon or attributable to"), which encompasses cases that include an element of personal profit regardless of whether there is a claim "for" personal profit, and it also fails to consider the public policy implications of its ruling.

Lastly, the court held that the insured v. insured exclusion does not apply to a claim brought by a bankruptcy estate representative against the former directors and officers of the debtor. The court found that the debtor and the estate representative are distinct entities. According to the court, the claims brought by the estate representative are brought on behalf of the debtor's creditors and not the debtor alone. The court also asserted that the purpose for the exclusion-avoidance of collusive suits-is not implicated in the context of a claim by a bankruptcy estate representative. The court concluded that the estate representative is "a genuinely adverse party" to the former directors and officers.

This holding departs from other recent precedent reasoning that the terms of the exclusion, and not its perceived purpose, govern the application of the insured v. insured exclusion. *See, e.g., Level 3 Communications, Inc. v. Fed. Ins. Co.*, 168 F.3d 956, 958 (7th Cir. 1999). It also disregards precedent noting that the purported collusive nature of a suit is not the sole purpose behind the insured v. insured exclusion. *Federal Deposit Ins. Corp. v. Zaborac*, 773 F. Supp. 137, 143 (C.D. Ill. 1991) ("Certainly, one of the purposes of the insured versus insured exclusion clause could be to prevent collusive lawsuits; however, that is not the only possibility."), *aff'd mem.*, 998 F. 2d 404 (7th Cir. 1993); *Niemuller v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 1993 WL 546678, at *5 5 (S.D.N.Y. 1993)(rejecting argument that exclusion is limited to collusive suits).