

Dishonesty and Profit Exclusions Bar Coverage for Suits Against Former City Employee for Approving Excessive Salaries

October 2013

The United States District Court for the Central District of California, applying California law, has held that dishonesty and profit exclusions barred coverage for civil suits alleging that an insured former city employee approved excessive salaries and benefits for city employees and conspired to hide the information from the public. *Rizzo v. Ins. Co. of the State of Penn.*, 2013 WL 4675063 (C.D. Cal. Aug. 30, 2013). The court also held that the California Insurance Code barred coverage for the defense of a state criminal prosecution of the former employee.

An insurer issued a policy to the City of Bell, California. The policy defined “insured” to include individuals who were “elected or appointed officials of [the city] . . . while acting on behalf of the Named Insured.” In September 2010, the Attorney General of the State of California (the AG) brought suit against the city's former chief administrative officer—an appointed official and employee of the city—for misuse of city proceeds by approving contract terms for himself and others that were excessive and wasteful and for conspiring to conceal those acts from the public. In the same action, the city filed a cross-claim against the former employee. The AG also filed three criminal complaints against the former employee for misappropriation of public funds and conspiracy.

The insurer agreed to provide a defense for the civil action under a reservation of rights but refused to defend the employee against the criminal complaints, and the former employee filed suit against the insurer for breach of the duty to defend and breach of the duty of good faith.

The court first held that the former employee was an “insured,” as defined in the policy. The insurer argued that the former employee was not an insured because the alleged acts of approving excessive salaries and covering up those acts were outside the scope of his employment duties. The court held that the alleged acts were performed in his capacity as the city's chief administrative officer because the former employee was charged with approving employment terms and because the alleged abuse of that discretion did not “evince a complete departure from his job duties that was unforeseeable in the context of the City's usual course of business.” The court also rejected the insurer's argument that it had no duty to defend the former employee in the civil actions because the former employee's actions were “antagonistic to the [insured city's] interests.”

It held that neither the policy's terms nor public policy supported the insurer's argument and that the court was constrained not to "read additional terms into the contract that are not supported by the text."

The court also held that the civil actions sought "damages." Although that term was not defined in the policy, the California Supreme Court interpreted the term to mean "compensation, in money, recovered by a third party for loss or detriment that it has suffered through the acts of another" other than restitution. The AG's civil suit alleged violation of California Civil Procedure Code § 526a for waste of public funds, and the AG disclaimed that it was seeking damages from the former employee. The court reasoned that, although the statute only restrained the illegal expenditure of funds, the suit sought damages because an award to remedy harm from the approval of excessive salaries to other employees constitutes "damages." The AG's proclamation that it did not intend to seek damages from the former employee was not determinative because those representations did not preclude the AG from later seeking monetary amounts. The court likewise held that the city sought recovery of "damages" in its cross-claim because the city sought the award of monetary damages for the former employee's alleged wrongdoing.

The court then concluded that two policy exclusions barred coverage for the civil actions. The first exclusion barred coverage for claims "[a]rising out of an alleged willful commission of a crime by [the Insured] or other dishonest, fraudulent, or malicious act." The second precluded coverage for claims "[a]rising out of [the Insured's] wrongful act for gain, profit, or advantage to which you are not legally entitled." The insured contended that these exclusions first required a final adjudication, but the court held that the exclusions did not require a final adjudication to be implicated because the policy provided that the insurer was not required to defend an insured for claims falling within the exclusions.

The court held that the exclusions applied even though the civil actions alleged claims that "theoretically need not arise out of dishonesty, fraud, malice, or wrongful acts for gain, profit, or advantage." The civil actions alleged that the former employee negligently enriched himself and negligently approved contracts without first reviewing them. However, the court held that those covered allegations were "inseparably intertwined" with the non-covered allegations so that the exclusions were triggered.

The insurer was also found not to have a duty to defend the former employee against the criminal complaints. First, the court held that the policy's plain terms did not provide coverage for the criminal complaints. Second, the court held that Section 533.5 of the California Civil Code prohibited an insurer from providing a defense to state criminal prosecutions.

Because the court held there was no duty to defend any action, the court held that the insurer had no duty to indemnify the former employee and the court dismissed the insured's claim for bad faith since there was no reasonable potential for coverage.