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NEWSLETTER

Default Judgment Is Final Judgment for Purposes of Dishonesty Exclusion

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In an unpublished decision, the United States Court of Appeals for the Sixth Circuit, applying Tennessee law, has held that a default judgment of liability entered against a CEO in response to a complaint alleging fraud, civil conspiracy and willful violation of a statute provided a basis for insurers that had issued D&O policies to the CEO's company to disclaim coverage. *Rice v. Liberty Surplus Ins. Corp.*, 2004 WL 2413393 (6th Cir. Oct. 28, 2004).

In May 1999, an internet company and an auto racing team entered into a sponsorship agreement. The internet company failed to make a scheduled payment, and after the racing team notified it of the contract breach, the parties developed a workout agreement. As part of the workout agreement, the internet company pledged 500,000 shares of restricted stock to the racing team, which the company could repurchase for $3 per share during a 12-month period. The internet company then breached the workout agreement, leading to a disagreement as to whether the company still retained the right to buy back the shares. In August 2000, the internet company informed the racing team that it had found a buyer for the 500,000 shares. The racing team refused to sell and instead requested that the company issue a SEC Rule 144 letter to allow the racing team to sell the restricted stock. The Rule 144 letter was never issued, and the stock price eventually declined. The racing team filed a lawsuit against the internet company, its CEO and its general counsel alleging, among other things, that the CEO had tortiously interfered with a contract by instructing the general counsel not to issue the Rule 144 letter. A default judgment with respect to liability was entered against all three defendants. The CEO was unable to set aside the default judgment, and after a separate damages hearing, the district court

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entered a final judgment against him for $4.8 million.

Two insurers had issued primary and excess D&O policies, respectively, to the internet company. The primary policy included a dishonesty exclusion precluding coverage for "claims based upon, arising from, or in any way related to any deliberately dishonest, malicious or fraudulent act or omission or any willful violation of law by any Insured if a judgment or other final adjudication adverse to the Insured establishes such an act, omission or willful violation."

The Sixth Circuit held that the dishonesty exclusion barred coverage. It rejected the CEO's argument that the "final adjudication" condition in the dishonesty exclusion had not been met because the final judgment in the underlying action did not refer to the earlier default judgment. The court explained that the final judgment did not supersede the default judgment, but instead incorporated it, as "[f]inal judgments ...sweep up all prior orders entered in a case and make them eligible for appeal." According to the court, the default judgment was "a judicial or conclusive admission which may be avoided only by setting aside the default" and which became part of the court's final judgment as to all of the racing team's claims against the internet company "by operation of law." The court reasoned that, by virtue of the default judgment, the CEO had "impliedly confesse[d] all of the material allegations of fact contained in [the] complaint, except the amount of the plaintiff's unliquidated damages." In this case, those allegations included fraud, civil conspiracy and the willful violation of a statute. As a result, the court held that a judgment or final adjudication had established that the CEO had acted in a "deliberately dishonest, malicious or fraudulent" manner such that the dishonesty exclusion precluded coverage.