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The D&O Diary

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Court Holds Fraud Exclusion with "Final Adjudication" Language Precludes Coverage for Post-Conviction Appeal

By Kevin LaCroix on October 20, 2022

Most D&O insurance policies preclude loss resulting from fraudulent or criminal misconduct. However, most policies specify that the exclusion applies only if there has been a judicial determination that the precluded misconduct has taken place. What specific judicial determination is required in order to trigger the exclusion is a matter of policy wording. In an interesting recent ruling, Southern District of New York Judge **Denise Cote** reaffirmed her prior conclusion that a credit union executive's criminal conviction precluded coverage for the executive's cost of appeal – even though his appeal remains pending and even though the applicable policy had the "final adjudication" language. A copy of Judge Cote's October 18, 2022 opinion can be found **here**.

Background

Alan Kaufman was an executive at a credit union. He was charged criminally of accepting a gratuity in violation of applicable federal laws. The credit union's D&O insurer covered his

attorneys' fees incurred in defense against the criminal charges. On March 31, 2021, a federal jury convicted Kaufman of the charges. Kaufman appealed his conviction, and he asked the credit union's D&O insurer to advance his legal fees incurred in connection with the appeal. The appeal remains pending.

Kaufman, on the one hand, and the insurer, on the other hand, disagreed whether the credit union's D&O insurance policy excluded coverage for the appeal. In contending that the policy did not cover the costs of appeal, the insurer relied on a number of coverage defenses, including the argument that coverage for his appeal costs was precluded by the policy's fraud exclusion, which precludes coverage for any claim based upon "any deliberately dishonest, fraudulent, intentional or willful misconduct or act." Kaufman argued that this exclusion applies only after a "final adjudication" and that while his appeal was pending, the adjudication was not "final."

The insurer and Kaufman reached an agreement under which the insurer agreed to cover Kaufman's legal expenses provisionally while the appeal was pending, with the understanding that the insurer could recoup any legal fees it has paid should a court determine that the policy does not cover them. The insurer then filed an action seeking a judicial declaration that Kaufman's legal fees incurred on appeal are excluded under the policy. The insurer filed a motion for judgment on the pleadings.

In a prior September 28, 2022 opinion, Judge Cote granted the insurer's motion for judgment on the pleadings. Among other things, Judge Cote held that New York law considers a criminal trial to be a finally adjudicated upon conviction, and therefore the policy's fraud exclusion precluded coverage for Kaufman's appeal costs. Kaufman filed a motion for reconsideration of the September 28 ruling.

The October 18, 2022 Opinion

In an October 18, 2022 Opinion, Judge Cote denied Kaufman's motion for reconsideration of her ruling on the insurer's motion for judgment on the pleadings. In doing so, she emphasized that the standards applicable to a motion for reconsideration are "strict," and she also emphasized that

in his motion for reconsideration, Kaufman raised only arguments that the court had previously considered and rejected in connection with the September 28 ruling.

Kaufman had argued specifically with respect to Judge Cote's determination that the fraud exclusion precluded coverage that Judge Cote had relied on cases involving policies in which the exclusion at issue precluded coverage based upon a "final judgment" rather than a "final adjudication." He had argued that in cases involving the "final adjudication" language, of the type found in the policy at issue here, as opposed to exclusions involving the "final judgment" language, courts had held that costs of appeal following a criminal conviction are covered.

Judge Cote rejected this argument, specifically finding that "New York courts have drawn no distinction between the terms 'final judgment' and 'final adjudication.'" Kaufman had tried to argue that the cases Judge Cote relied on in support of this position were inapplicable because they both relied on a case involving a policy applicable only after a "final judgment."

Judge Cote rejected this argument, saying that "the fact that New York courts use the term 'final adjudication' even when referring to a policy that contains the term 'final judgment' indicates that they do not distinguish between the terms." She added that "even if New York courts had not used the phrases 'final adjudication' and 'final judgment' interchangeably, Kaufman has still failed to provide any reason why 'final adjudication' should be interpreted differently from the term 'final judgment' here."

Discussion

There are very good reasons why the fraud exclusions found in the typical D&O insurance policy apply only following a judicial determination. The fact is that the complaints in most D&O insurance claims raise allegations of fraud or of criminal misconduct. Criminal complains obviously raise allegations that, if proven, amount to criminal misconduct. If mere allegations alone were sufficient to trigger the fraud or criminal misconduct exclusion in a D&O policy, the policy would afford little protection and indeed it could be argued that the policy's coverage would be illusory.

In order to avoid this problem, the policy exclusions provide further that the allegations of misconduct must be proven in order for the exclusion to apply.

Which brings us to the question of coverage for costs of defense incurred on appeal following a criminal conviction. An appeal is part of a criminal defense. Assume for a moment that an appeal is successful and the criminal conviction is overturned – something that happens with enough frequency that it is an aspect of the process that needs to be considered and taken into account when it comes to the provision of a defense under a D&O insurance policy.

Numerous courts applying the laws of jurisdictions other than New York have concluded that D&O insurance policies with the "final adjudication" language – of the kind involved in the policy here – provide coverage for fees incurred in connection with an appeal following a criminal conviction. (Refer **here** for an example under California law.)

There are some very good reasons why D&O insurance policies are set up so that defense obligations continue following criminal convictions. The most important is that if the insurer could yank the coverage while a case is on appeal, the insured person would lose coverage at the precise moment when he or she needs it most. Imagine for a moment that the appeal is meritorious. Imagine also that without access to the insurance, the insured is unable to pursue the appeal. The result would be that a wrongful conviction would be allowed to stand. Simply put, the availability of insurance through the appeal stage is a fundamental part of providing an insured with a defense. If the insurance does not carry through the appeal stage, the insured person may be deprived a key element of his or her defense.

The "final adjudication" language is designed to – indeed is specifically intended to – ensure that coverage is not precluded prematurely while the criminal proceedings continue to be adjudicated, specifically included the exhaustion of all appeals.

To be sure, New York courts **have found** that for policies containing a "final judgment" exclusion trigger rather than a "final adjudication" exclusion trigger the fraud exclusion's preclusive effect

applies after a criminal conviction becomes a matter of judgment in the trial court, even if the conviction is appealed, because as a matter of New York law the entry of judgment following a criminal conviction is "final" even if the conviction is appealed.

But while this analysis may make sense as a matter of New York law and with respect to a D&O insurance policy with the "final judgment," the analysis does not thereby make sense, even as a matter of New York law, with respect to a policy that has the "final adjudication" language. Judge Cote's conclusion that New York courts treat "final judgment" and "final adjudication" as if the two phrases were interchangeable completely disregards the fact that not only are the two phrases worded differently, and that words have meanings that must be respected, it also disregards the fact that while New York law may hold that trial court's entry of a judgment following a criminal conviction may be a "final judgment," that does not mean, nor should it be interpreted to mean, that the "adjudication" is "final." It is not – the conviction can be appealed, and the insured executive should be able to count on getting his costs of appeal advanced by the D&O insurer.

Although Judge Cote may think, as a matter of New York law, that the phrases "final judgment" and "final adjudication" are interchangeable, D&O insurance practitioners most assuredly know that they are not. In fact, the use of the phrase "final adjudication" in D&O insurance policies became essentially universal once the problem of policies with the "final judgment" wording became apparent. The whole point of the "final adjudication" language was to circumvent the problems that the "final judgment" wording caused – that is, the problems associated with cutting off defense expense coverage when a criminal defendant seeks to appeal his or her criminal conviction.

It may be, after many years of the language of fraud exclusions in D&O insurance policies becoming fairly standard, that we need to go back and rephrase the language yet again to make it clear that the fraud exclusion is not intended to preclude coverage for defense expenses incurred on appeal following a criminal conviction. Such as, for example, additional language in the exclusion that specifies that "for purposes of determining the applicability of this exclusion, this exclusion shall not apply until all appeals have been fully and finally exhausted or the insured waives or otherwise does not pursue any remaining right of appeal." It seems to be a shame to have to start monkeying with the wording of the fraud exclusion again, but if courts really are

going sustain the delusion that there is no difference between the phrase “final judgment” and the phrase “final adjudication,” then further wording changes may be needed.

I welcome readers comments on this last point.
