Can An Act Be Both Negligent And Intentional?:

Liability Insurance And The Adjudicated Dishonesty Exclusion

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Introduction

Imagine a director of a publicly-held company is sued for her role in a failed business venture of that company. The complaint asserts fraud as its sole cause of action, alleging that the director “knew or should have known” certain representations made to the plaintiff were false, and that she “acted recklessly, fraudulently, and willfully.” The company maintains a directors’ and officers’ (“D&O”) liability policy for her benefit, but the policy contains the following common exclusion:

The INSURER shall not be liable to make any payment for LOSS in connection with that portion of any CLAIM made against the INSURED:

*   *   *

brought about or contributed to by the dishonesty of the INSURED if a judgment or other final adjudication adverse to the INSURED establishes that acts of active and deliberate dishonesty committed by the INSURED with actual dishonest purpose and intent were material to the CLAIM;

Whether this exclusion applies will depend on many factors arising in the defense of the claim, including any final trial or settlement.

This issue arises frequently when analyzing and interpreting “D&O” and professional liability policies. When analyzing coverage in any situation, one should keep in mind that a meaningful analysis must include careful consideration of the policy language (including any applicable definitions and/or exclusions), a thorough investigation of the factual circumstances comprising the claim, and an examination of the applicable case law. In the context of the hypothetical above, one should carefully examine the language in the complaint. Further, one should analyze how the policy’s dishonesty exclusion might apply if only the intentional tort of fraud is alleged.
An intentional tort is “a tort in which the actor is expressly or impliedly judged to have possessed intent or purpose to injure.” However, as the definition of an intentional tort demonstrates, an intentional act may be comprised of actual or implied intent. This definition establishes the potential for an intentional act to be multifaceted. Thus, when a complaint alleges an intentional act and may rely on implied intent, one must analyze whether an intentional act can also be characterized as reckless, or even negligent. This article examines some insurance coverage implications of this increasingly common issue.

I. The ‘Duty To Defend’ Policy

Many primary D&O and professional liability policies contain a “duty to defend,” obligating the insurer to manage and pay for the director’s defense in any lawsuit. This duty is separate from the duty to pay any liability that may result from the lawsuit. The scope of the duty to defend is broader than the duty to indemnify. In this regard, although most, if not all, D&O and professional liability policies exclude coverage for intentional acts in some form, the duty to defend may still be triggered when the only count in a complaint alleges a tort that is traditionally characterized as “intentional.” Consider the exclusion quoted above. In light of the adjudication requirement, and because the allegations of “should have known” and “recklessly” in the hypothetical above establish the potential for coverage, the duty to defend will likely be triggered and the insurer will have to defend the action until final adjudication. Moreover, if the judgment or verdict does not specifically delineate whether there was actual or implied intent (which will depend on the jury instructions), or the insured settles the case, the exclusion may not apply at all. On the other hand, if an adjudication establishes active and deliberate fraud or dishonesty, the insurer would be able to enforce the exclusion and might be able to seek reimbursement for the costs of defending the action (depending on the jurisdiction). For example, in Buss v. Superior Court, under California law, the court allowed an insurer to recoup allocated defense expenses, after settlement, in a “mixed” action of covered and non-covered claims.

II. The ‘Duty To Indemnify’ Policy

The scope of the insurer’s duty to indemnify the insured for the ultimate judgment is narrower, and can only be fully analyzed after the underlying case is resolved (by either an adjudication or a settlement).

In the case of an adjudication, the complaint and the actual facts of a case ultimately determine whether there is coverage under an insurance policy. Although the elements of a cause of action are usually clearly delineated, the actual findings in a judgment or verdict do not always specifically identify what standard was met (e.g., intentional, reckless or negligent). Moreover, although a complaint might include several counts against a director — some of which are easily categorized as intentional claims and some as negligence-based claims — a single claim can include allegations that encompass aspects of both intentional torts and negligence. For example, in the hypothetical above, there is only one count of fraud, which is traditionally viewed as an intentional tort. However, the complaint arguably encompasses reckless and negligent conduct in that it alleges that the insured “knew or should have known” that the representations made to the plaintiff were false and that the insured “acted recklessly, fraudulently, and willfully.”

The “active and deliberate” component of the exclusion quoted above clearly requires something more than a mere allegation of imputed intent. Exactly what meaning is to be given to “active and deliberate” is not clear when, in the context of the hypothetical, one count in the complaint is for an intentional tort, but the complaint seeks redress for conduct that might be characterized as less than “active and deliberate” (i.e., reckless or even negligent). An examination of concrete examples is helpful to understanding possible application to actual claims.

In the opening hypothetical, the complaint alleges that the director “knew or should have known” that the representations made to the plaintiff were false and that the insured acted recklessly.
An open-ended allegation that the director “knew or should have known” does not fit squarely within an exclusion that requires “active and deliberate fraud or dishonesty.” For example, when a plaintiff alleges that the defendant knowingly or recklessly participated in wrongful conduct, a fraud and dishonesty exclusion does not apply. In *Faulkner v. American Casualty Co.*, the Maryland Deposit Insurance Fund Corporation (“MDIF”) sued Community Savings & Loan, Inc. and its employees, alleging multiple incidents of negligence, misappropriation and breach of fiduciary duty. After receiving a judgment in its favor, the MDIF brought suit against American Casualty Co. to recover proceeds under its D&O policy. The court held that the policy covered the conduct. It relied on the language of the insurance policy, which excluded coverage for claims “brought about or contributed to by the dishonesty of the Directors or Officers . . . [when] a judgment or other final adjudication thereof adverse to the Directors or Officers shall establish that acts of active or deliberate dishonesty . . . with actual dishonest purpose and intent . . . .” The court also compared the exclusion to the allegations in the pleading, specifically that the defendants “knowingly and/or recklessly” participated in the issuance of materially false and misleading reports. Under that language, the court reasoned that at least one count of the complaint stated a claim covered by the policy. The court stated in dictum, however, that the insurer could have denied coverage if the complaint simply alleged that the defendant *knowingly* participated.

On the other hand, a wrongful purpose can meet the requirements of the exclusion. In *International Surplus Lines Insurance Co. v. Heard County*, Heard County began condemnation proceedings on a tract of land, but the underlying court set aside the condemnation, finding that Heard County had acted in bad faith. Heard County was subsequently sued for unlawful exercise of eminent domain. Heard County settled the case and instituted an action for indemnification for the loss pursuant to a policy for Public Officials and Employees Liability Insurance. The insurer moved for summary judgment on the basis of an exclusion for a claim when “a judgment or other final adjudication thereof adverse to the insureds shall establish acts of active and deliberate dishonesty committed by the insureds with actual dishonest purpose and intent . . . .” The trial court denied the motion, and the insurer appealed. The court of appeals held that the trial court should have granted the motion for summary judgment. The court of appeals stated that “bad faith” was equivalent to “active and deliberate dishonesty committed with . . . actual dishonest purpose and intent.” The court followed precedent that defined “bad faith” with conscious wrongdoing and a dishonest intent.

Under a typical fraud and dishonesty exclusion, a judgment or final adjudication of some kind must establish the wrongful conduct. In *National Union Fire Insurance Co. v. Continental Illinois Corp.*, two insurers brought a declaratory judgment action to avoid liability under D&O policies for the settlement of some underlying claims. The policies at issue excluded from coverage any claim:

> brought about or contributed to by the dishonesty of the Insureds; however, notwithstanding the foregoing, the Insureds shall be protected under the terms of this policy as to any claims upon which suit is brought against them, by reason of any alleged dishonesty on the part of the Insureds, unless a judgment or other final adjudication thereof adverse to the Insureds shall establish that acts of active and deliberate dishonesty committed by the insureds with actual dishonest purpose and intent were material to the cause of action so adjudicated.

The insurers argued that they had the right to a separate adjudication as to whether the insureds committed the acts alleged in the underlying litigation in such a manner that the policy excluded coverage. The court held that the insurers could not separately litigate the issue of dishonest purpose and intent. Relying on cases in other jurisdictions, the court reasoned that the policy’s use of “thereof” referred to the underlying suit. The court further reasoned that the language of the policy was ambiguous, and that such ambiguity must be construed against the insurer.
addition, the court asserted that because only a small percentage of lawsuits end in a full trial, the insurers could have anticipated the obvious situation of a settlement when they drafted their policy provisions, so their failure to address it in the policy could fairly be held against the insurers.17

The adjudication requirement does not simply mean that evidence of the wrongful conduct appear on the record of an adjudication. Instead, the typical exclusion requires that the adjudication establish the wrongful conduct as a material issue in the case, and the case itself must also be adverse to the insured.18 Because of the specificity of the typical exclusion, the insured must be a defendant in the case to satisfy the “adverse” requirement.19 In addition, the adjudication must rely on the material finding of wrongful conduct.20 Lastly, as the opinion in National Union Fire Insurance Co. demonstrates, if there is an adjudication requirement, the adjudication must almost always occur in the underlying case rather than in coverage litigation.21

Alternatively, if a criminal proceeding has already established fraud or dishonesty, an insurer might argue that the criminal proceeding fulfilled the adjudication requirement. In some jurisdictions, the courts have determined that the criminal convictions were adjudications of dishonesty for purposes of the respective exclusions.22 However, they have not uniformly applied the exclusion to exclude coverage for the civil suits.23 Those courts have held that the issues in the criminal proceedings must be identical to those in the civil suits. For that reason, one must identify which issues were litigated in the criminal proceedings and which issues are dispositive in the civil suit, and carefully analyze whether those issues are the same.

An insurer faced with a claim for fraud would like to document “active and deliberate” fraud with a specific finding in the underlying action, but applicable jury instructions are often unclear and allow the jury to hold a defendant liable without specifying between intentional or reckless conduct. For example, the jury instructions for the intentional tort of fraud include the following elements:

A false statement is made with intent to deceive if it is made with knowledge that it is false. Moreover, even though you do not find that defendant knew (his, her) statement to be false, you may . . . infer that defendant intended to deceive, provided you find that the statement was false and that defendant made it recklessly, with the pretense of knowledge that it was true when in fact (he, she) knew that (he, she) had no such knowledge.24

These are the New York Pattern Jury Instructions, but other states have similar instructions.25 The actual jury instructions may be changed, and special verdict forms may be used to flesh out with particularity the nature of the jury’s findings; but neither the plaintiff nor the director defendant may find such clarity helpful, and the director may want to avoid such clarity because of the insurance implications. The insurer is obviously not a party to the litigation, and must be extremely careful that its desire to achieve clarity on the point not prejudice the director’s defense in any way.

Basically, if an insured is found liable for intentional misrepresentation, it will be difficult to determine whether the jury decided on the basis of the insured’s intent or on the basis of mere recklessness. Because courts apply policy exclusions strictly, a verdict that relies upon an open-ended jury instruction might not have adjudicated an act that meets the “active and deliberate” standard.2 Furthermore, many courts have held that additional litigation is typically not available to determine whether the fraud and dishonesty exclusion applies if the policy has an adjudication requirement.2 One should also note, however, that some dishonesty exclusions change this requirement of adjudication, by stating explicitly that the necessary adjudication can arise either in the underlying proceeding against director, or in a subsequent coverage action with the insurer.
III. Issues Presented By Settlement

Consider again the hypothetical provided at the beginning of this article, but now add a cause of action for negligence. Again, the D&O policy excludes “active and deliberate fraud” and dishonesty. One must now determine if there are any coverage implications if the director settles based on these allegations.

With the addition of a count of negligence, the duty to defend is likely invoked. If the parties settle before adjudication, it is difficult, if not impossible, for an insurer to argue that the case was settled on the basis of fraud as opposed to negligence. Even if there is an adjudication, absent specific findings by the trier of fact, it is difficult to say what portion is allocable to fraud, and what portion to negligence.

Many of the issues discussed under the first hypothetical relating to a duty to indemnify policy are not applicable if a complaint alleges counts of both intentional and negligent conduct. Because courts require an adjudication to enforce the exclusion, the settlement of a suit alleging fraud or dishonesty can, as a practical matter, preclude application of an adjudication-based exclusion even if the reality was that truly dishonest, fraudulent conduct occurred. However, one should also note, that when a complaint only alleges one count of purely intentional acts, a settlement might not defeat the exclusion.

An allocation issue under the second hypothetical also arises if there is an adjudication on all counts, and the insurer is able to establish that the intentional conduct falls within the language of the exclusion (but the insurer would still have to overcome the challenge of arguing that the jury instructions established conduct excluded under the policy). In this situation, an insurer can attempt to argue that the policy only covers the counts of negligence. As noted above, however, such an argument might prove difficult to make (especially when the verdict or judgment in the underlying trial is unclear). Finally, if there is an adjudication of fraud and no finding of negligence, the insurer will have the same arguments addressed in the discussion of the first hypothetical above.

Conclusion

When evaluating coverage under a D&O or professional liability policy, one should examine intentional act exclusions carefully, as they might require proof that is difficult to obtain. When the allegations of a complaint include elements of intentional and reckless or even negligent acts, one must tread carefully when analyzing coverage issues. The duty to defend will virtually always be triggered where a count of fraud includes allegations of “willful and reckless” conduct or that the defendant “knew or should have known” that the representations were false. The duty to indemnify is determined after the matter has reached a conclusion, with the benefit of all the evidence and findings developed. Only a clear and final adjudication of the requisite “active and deliberate” dishonesty in the underlying case may meet the strict requirements of many exclusions. A settlement may eliminate any opportunity for the necessary adjudication, unless the exclusion expressly permits the adjudication to take place in subsequent coverage proceedings.

ENDNOTES


2. See Maryland Cas. Co. v. Vonnahmen, 102 F.3d 277 (7th Cir. 1997).
3. 16 Cal. 4th 35 (Cal. 1997).


5. However, when a fraud and dishonesty exclusion applies to the insured’s conduct, coverage may be denied for the negligence of the supervisor as well as the intentional conduct of the insured. See Walter O. Langholz Estate v. Acceleration Nat’l Ins. Co., 471 N.W.2d 319 (table), 1991 WL 100382 (Wis. App. 1991).


7. See State Farm Fire & Cas. Co. v. Mhoon, 31 F.3d 979, 985 (10th Cir. 1994). (finding that recklessness in a discrimination case to be the functional equivalent of willfulness).


11. Id. at 1185.

12. Id. at 1197.

13. Id.

14. Id. at 1198.

15. Id.

16. Id.

17. Id. at 1191.


20. See Arnold Agency v. W. Virginia Lottery Comm’n, 526 S.E.2d 814 (W. Va. 1999) (refusing to apply the findings of a criminal proceeding regarding the same conduct because the elements of the crime differ from the requirements of the exclusion).


25. For example, the jury instructions for intentional misrepresentation might include the following elements:

The defendant must have known that the misrepresentation was false when made [or must have made the representation recklessly without knowing whether it was true or false];

The defendant made the misrepresentation with an intent to defraud the plaintiff, that is, [he][she] must have made the representation for the purpose of inducing the plaintiff to rely upon it and to act or to refrain from acting in reliance thereon.


29. See generally supra note 27.


31. See generally Int’l Surplus Lines Ins. Co. v. Heard County, 344 S.E.2d 712 (Ga. Ct. App. 1986) (enforcing the exclusion where the settlement concerned a transaction related to a prior action in which the court found “bad faith” on the part of the insured).