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CORPORATE INSURANCE LAW

Expert Analysis

Southern District Finds That Final Adjudication Limitation in Conduct Exclusion Does Not Require Exhaustion Of All Appeals

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Directors and Officers (D&O) liability insurance policies typically contain standard conduct exclusions that bar coverage for loss arising out of a deliberately fraudulent or deliberately criminal act or omission or willful violation of law as well as loss arising out of the gaining of any profit to which an insured was not legally entitled. Over the last couple of decades, these conduct exclusions have been narrowed for the benefit of the insureds in a number of ways.

To avoid penalizing innocent insured persons for the bad conduct of other insured persons, conduct exclusions in many policies have been modified by non-imputation language intended to limit the application of the exclusion to the bad actor and the insured entity.

Additionally, final adjudication limitations have been introduced so that the conduct exclusions only bar coverage where a court has issued a final ruling holding that the insured did actually engage in the alleged bad conduct.

A final adjudication limitation creates a significant benefit because it provides the insured with the right to advancement of defense costs during the pendency of a legal proceeding even where the claims against the insured allege fraud or intentional or criminal conduct.

Many policies will permit the insurer to clawback defense costs advanced if a final adjudication against the insured confirms the alleged bad conduct, but if the case is settled without a final ruling, no such clawback is permitted.

Some insurers have also added the phrase "non-appealable" to the limitation to make it expressly clear that conduct exclusions are applicable only where a "final non-appealable adjudication" confirms the alleged bad conduct. This modification is intended to make sure the insured has access to advancement of defense costs

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throughout the appeals process—another significant benefit to an insured defending against allegations of fraud or criminal conduct.

The importance of expressly including the term "non-appealable" in the limitation on the application of conduct exclusions was confirmed recently by a ruling issued by the United States District Court for the Southern District. In *Cumis Specialty Insurance Co. v. Kaufman*, Judge Denise L. Cote, when addressing the application of a conduct exclusion, held that "final adjudication" is interpreted the same as "final judgment" and neither term requires that all appeals have been exhausted. *Cumis Specialty Insurance Co. v. Kaufman,* 2022 WL 4534459, 21CV11107 (S.D.N.Y. September 28, 2022).

The Cumis Specialty Action

The *Cumis Specialty* action involved a dispute over whether an insurer was obligated to advance defense costs to an insured person for appeal of a criminal conviction. The insured, Kaufman, was convicted by a jury in the Southern District of two counts of accepting a gratuity in violation of federal law restrictions governing officers, directors, employees, agents or attorneys of financial institutions. Judgment was entered against Kaufman on Oct. 13, 2021 and he was subsequently sentenced. Following sentencing, Kaufman appealed his conviction to the U.S. Court of Appeals for the Second Circuit.

Cumis Specialty had advanced defense costs to Kaufman throughout the criminal proceeding in accordance with the terms of the insurance policy. However, following the judgment, the insurer asserted that coverage for post-conviction legal fees was excluded by the conduct exclusions in the applicable policy.

In their Corporate Insurance Law column, Howard Epstein and Theodore Keyes discuss 'Cumis Specialty Insurance Co. v. Kaufman', where the U.S. District Court for the Southern District held that the final adjudication limitation in conduct exclusion cases does not require exhaustion of all appeals.

Cumis Specialty agreed to continue to advance legal fees during the appeal provided that Kaufman agree to repay the fees if it was determined that the conduct exclusions barred coverage.

After that agreement was reached, Cumis Specialty filed a declaratory judgment action seeking a declaration that legal fees incurred following sentencing are subject to the conduct exclusions and barred from coverage. The insurer then filed a motion for partial summary judgment seeking a ruling that Kaufman's conviction constituted a final adjudication establishing the requisite criminal conduct and triggered application of the conduct exclusions.

Application of the Conduct Exclusions

According to Judge Cote's opinion and order, the conduct exclusions in the Cumis Specialty policy barred coverage for loss related to any claim "based upon…any deliberately dishonest, fraudulent, intentional or willful misconduct or act" as well as any claim arising from the insured "gaining any profit, unjust enrichment, remuneration, or advantage" to which the insured was not legally entitled.

However, the policy provided that conduct exclusions were only applicable where "a final adjudication" established that the misconduct, act or violation was committed by the insured or that the insured was not legally entitled to the profit received. *Cumis Specialty Insurance Co., Inc. v. Kaufman,* 2022 WL 4534459 at *1.

In opposition to Cumis Specialty's motion, Kaufman contended

that there had been no final adjudication because his appeal was still pending—and consequently the conduct exclusion did not bar coverage for the legal fees incurred to prosecute his appeal. He argued that the term "final adjudication" is distinct from the term "final judgment" and that "final adjudication" means that all appeals have been exhausted.

Judge Cote rejected Kaufman's position. The judge explained that, under New York law, imposition of a sentence constitutes the final judgment against a criminal defendant. She further explained that New York courts have used the terms "final judgment" and "final adjudication" interchangeably and, therefore, sentencing of Kaufman constituted a final adjudication. Finally, Cote also rejected any suggestion that the language of Cumis Specialty's conduct exclusions were ambiguous.

Consequently, the judge granted Cumis Specialty's motion for partial summary judgment finding that the insurer was not obligated to pay defense costs incurred on appeal because coverage for the post-judgment costs was barred by the conduct exclusions. She also held that Cumis Specialty was entitled to recoup any post-sentencing defense costs that had been paid on behalf of Kaufman.

On Reconsideration

Kaufman filed a motion for reconsideration but fared no better there. On that motion, Kaufman emphasized his argument that a criminal case has not been finally adjudicated until all appeals are resolved. Cote again rejected the argument, reiterating that Kaufman had provided no reason to interpret "final adjudication" different from "final judgment" and that New York courts have drawn no distinction between the two terms.

Therefore, the conviction and sentencing constituted a final adjudication sufficient to trigger application of the conduct exclusions and bar coverage of defense costs incurred during the appeal. *Cumis Specialty Insurance Co. v. Kaufman,* 2022 WL 106409903, 21CV11107 (S.D.N.Y. October 18, 2022)

Non-Appealable Modifier

Based on Cote's ruling, it certainly appears that she would have reached a different conclusion had the conduct exclusions in the Cumis Specialty policy been applicable only in the event of a "non-appealable" final adjudication. In that case, the insurer would likely have been required to fund Kaufman's defense through the appeal. Of course, depending on the policy language, it is possible the insurer would have had a right to recoup defense costs in the event that the final appeal was unsuccessful.

Looking Forward

D&O policies with conduct exclusions that are only triggered by final "non-appealable" adjudication are not uncommon. The *Cumis Specialty* case serves as a reminder to insureds that this qualifier is very important. It remains worthwhile for policyholders to have experienced insurance brokers and/or counsel review the terms of their D&O insurance policies to make sure these and other provisions are consistent with the preferred terms available in the market.

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