LOS ANGELES
Daily Journal
www.dailyjournal.com
TUESDAY, APRIL 4, 2107

PERSPECTIVE

Insurers cannot escape coverage without a 'final adjudication'

By Fiona A. Chaney

In *Stein v. Axis Insurance Co.*, B265069 (Cal. App. 2nd Dist. Mar. 8, 2017), an unpublished opinion, the California Court of Appeal recently addressed an important question: When is a "final determination" final?

Many directors and officers (D&O) insurance policies include exclusions for liability that arises from a director or officer's fraud, dishonesty, self-dealing, personal profit or otherwise intentional wrongful conduct. However, many D&O policies require a "final determination" or "final adjudication" of such intentional wrongful conduct before they preclude coverage. Some exclusions go even further and require a finding that such acts occurred and that finding is "material" to the cause of action being adjudicated. Typically, the "final adjudication" must take place in the underlying lawsuit rather than in a parallel coverage action or other lawsuit. *See Silicon Storage Tech., Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 13-CV-05658-LHK. (N.D. Cal. Nov. 19, 2015) (requiring "final adjudication" to take place in underlying D&O proceeding rather than in a parallel coverage action or other lawsuit). To avoid confusion, some exclusions explicitly preclude an insurer from establishing the alleged intentional wrongful conduct in a subsequent coverage lawsuit.

An issue that arises is whether there is a "final adjudication" or "final determination" before the matter is decided on appeal. In *Stein*, Heart Tronics, Inc., purchased a D&O policy from Houston Casualty Co. (HCC). Under the HCC policy and its definition of "claim," HCC was required to pay defense expenses incurred by Heart Tronics's officers and directors, in any civil or criminal proceedings, including appeals. The HCC policy included a "Willful Misconduct Exclusion," that stated in pertinent part: "Except for Defense Expenses, the Insurer shall not pay Loss in connection with any Claim ... brought about or contributed to by any dishonest or fraudulent act or omission" but "only if there has been: ... a final adjudication adverse to [the] Insured Person in the underlying action." The exclusion also stated that "if it is finally determined that this ... Exclusion ... applies," the insured would be required to repay the defense expenses paid by HCC.

An insurer should not be permitted to abandon its insured while a case is on appeal because the insured may not have the funds to otherwise pursue the appeal himself, which could result in the wrongful conviction standing.

In 2011, Heart Tronics's founder and outside general counsel, Mitchell Stein, was indicted by a federal grand jury on 14 counts, including securities fraud and money laundering. In 2013, a jury found Stein guilty on all counts. He was sentenced to 17 years in prison and ordered to forfeit over $5 million. Stein appealed. In January, the 11th U.S. Circuit Court of Appeals affirmed his conviction but vacated the sentence and remanded the matter for resentencing. In February, Stein moved for an en banc rehearing before the 11th Circuit.

After Stein was convicted, he tendered his appeal to HCC. The insurer took the position that the exclusion applied "because under federal law, a trial court judgment is deemed to be a final adjudication until reversed on appeal." Stein sued HCC. The trial court sustained HCC's demurrers without leave to amend and dismissed the case. The Court of Appeal reversed, in part, and soundly rejected HCC's argument for application of the exclusion on several grounds.

First, the court relied on the plain language and the cannons of contract interpretation. In examining the policy language, the court found that the HCC policy provided coverage for "loss," which was defined to mean "any amount," including defense expenses, the insured would be obligated to pay as the result of a claim. Further, it found that "claim" included any civil or criminal proceeding and expressly included "an appeal from any such proceeding," and the exclusion carved out defense expenses. The court also noted another provision in the HCC policy that explicitly excluded defense costs from coverage and that because the exclusion at issue "did not explicitly exclude defense expenses on appeal implies the parties did not wish it to do so."

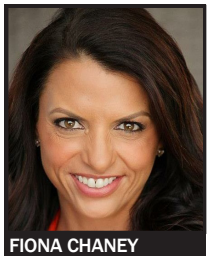
Second, and also in reliance on the plain language of the HCC policy, the court concluded that "nothing in the policy indicates that the parties intended that the phrase 'final adjudication' carry the same meaning in the exclusion as it carries in federal law."

Third, the court reasoned that [*"a thing that is 'final until reversed' is not final."*] It stated that an "appellate court can render an adjudication as well as a trial court can, with the added benefit [of] greater finality."

Fourth, the court found that even if the exclusion comes into play when a final adjudication determines culpability, it is irrelevant because the exclusion explicitly does not apply to defense expenses.

Fifth, the court discredited HCC's argument that "courts have repeatedly held that the exhaustion of all appeals is unnecessary to satisfy exclusions that require a 'final adjudication'" because HCC cited only two trial court cases for the proposition.

Insureds should not lose their valuable coverage when their claims are on appeal or settled without a "final adjudication" of wrongdoing. Indeed, an insurer should not be permitted to abandon its insured while a case is on appeal because the insured may not have the funds to otherwise pursue the appeal himself, which could result in the wrongful conviction standing. Given this vulnerability, the ongoing defense obligation is critical. Accordingly, *Stein* should serve as a stern warning to insurers that absent a true "final adjudication," they must continue to pay defense costs until an insured's direct appeals have been exhausted.



FIONA CHANEY

Fiona A. Chaney *is a partner at Liner LLP.*

UPDATE: On April 6, 2017, the court ordered partial publication of the opinion, which includes the final adjudication discussion from this article. In addition, the court ordered modification of certain portions of the opinion, including the modification from "a thing that is 'final until reversed' is not final" to "even under federal law, an adjudication that is 'final until reversed' is not final for all purposes."