

Fourth Circuit Court of Appeals Puts Teeth into the "In Fact" Exclusions of a D&O Policy

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In *Farkas v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA*, No. 12-1481, 2013 WL 1459248 (4th Cir. Apr 11, 2013), the Fourth Circuit Court of Appeals affirmed a decision that put teeth into the "in fact" exclusions of a directors and officers liability policy. The U.S. District Court for the Eastern District of Virginia construes the "in fact" exclusion for criminal conduct favorably to insurers, holding that the exclusion was triggered by a jury verdict convicting the insured. The decision, *Farkas v. National Union Fire Insurance Co. of Pittsburgh, PA*, 2012 WL 966577 (E.D. Va. March 21, 2012), provides guidance to liability insurers regarding this important exclusion.

Farkas, an executive at a mortgage corporation, was indicted for wire, bank, and securities fraud. He sought coverage under a National Union Directors and Officers policy for defense costs incurred in the criminal proceeding. National Union advanced defense costs while reserving rights based upon policy exclusions for "loss" arising out of the "gaining in fact of any profit or advantage to which the insured was not legally entitled" or "the committing in fact of any criminal fraudulent or dishonest act, or any willful violation of any statute, rule, or law."

After his conviction, Farkas contended that National Union was obligated to pay defense costs related to his appeal. He argued that the "in fact" exclusion did not apply until all post-judgment proceedings were concluded and the courts determined that his conviction was "final." The court held that the "in fact" exclusion was triggered by the jury verdict and that National Union was not obligated to advance defense costs for Farkas's appeal. Moreover, the court held that the conviction relieved National Union from funding defense costs incurred by Farkas before the verdict but not yet paid. National Union had advised Farkas that the verdict triggered the "in fact" exclusion, that National Union would no longer advance defense costs, and that National Union invoked its right to recoup defense costs it had previously advanced. The court agreed with National Union's position.

Various jurisdictions have construed "in fact" exclusions. Some courts hold that the exclusions may be triggered as early as the filing of an indictment or other complaint. Some courts read "in fact" exclusions to require a factual determination by a tribunal. In positive language for insurers, the *Farkas* court notes that "[n]one of these cases define a final adjudication as an appeal." The opinion also holds that Farkas' counsel "were always on notice that National Union reserved its rights to invoke the exclusions." The court granted National Union's motion for summary judgment, finding that Farkas was not entitled to coverage for any defense costs regardless of when they were incurred, and that National Union was entitled to recoup the funds it did advance. The exclusions preclude "any payment" arising "in fact" out of excluded conduct. Accordingly, "Farkas' conduct was never actually covered under the Policy, and he was therefore never entitled to the monies advanced to him."