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A Short Primer On The Personal Profit Exclusion

By Eric Caugh and Elizabeth Kniffen
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Many liability insurance policies — including directors and officers (D&O), errors and omissions (E&O) and professional liability policies — contain exclusions that bar coverage for claims "based on or attributable to an insured gaining in fact a personal profit or advantage to which the insured is not legally entitled."

The purpose of these so-called personal profit or illegal profit exclusions is to prevent an insured from reaping a windfall by receiving insurance coverage for ill-gotten gains that the insured profited from and is forced to disgorge.

While the intent of the personal profit exclusion is clear, its application is not as straightforward. This article provides a brief overview of the main coverage issues that may arise when the personal profit exclusion comes into play and identifies the key questions that should be addressed when analyzing the applicability of the personal profit exclusion.

Who Gained the Profit and Who is Seeking Coverage?

The first questions to address when analyzing whether the personal profit exclusion applies are "who gained the profit?" and "who is seeking coverage under the policy?" The answers to these questions are critical to determining whether the personal profit exclusion applies, especially where the complaint alleges that one insured gained an illegal profit, but a separate insured is seeking coverage under the policy.

As an initial matter, the party alleged to have gained an illegal profit must be an insured. If the underlying claim does not allege that an illegal profit was gained by an insured, then the exclusion does not apply.[1]

In the event there are multiple insureds, but not all insureds received an illegal profit, coverage is not necessarily excluded as to *all* insureds. The result will depend on the specific language of the exclusion.

Some versions of the personal profit exclusion apply only where "the insured" against whom the claim is made is also "the insured" who allegedly gained a profit or advantage to which that insured was not legally entitled. Where this language is used, the exclusion applies to bar coverage only for claims against the specific insured who allegedly gained the illegal profit, *i.e.*, where the insured seeking coverage is also the one that allegedly gained an illegal profit.[2]

Other versions of the exclusion apply to claims based on “an insured” or “any insured” receiving an illegal profit. These versions are broader in their application because they exclude from coverage all claims seeking recovery of an illegal profit as long as one insured gained an illegal profit.[3]

By reviewing the exclusion and addressing these questions early in the coverage analysis, one can quickly ascertain whether the exclusion contains the broader or the narrower specifying language and, based upon the allegations in the underlying complaint regarding who purportedly gained the illegal profit, determine whether the exclusion is applicable.

If the policy at issue contains the narrower personal profit exclusionary language and the underlying complaint does not contain sufficient facts to determine whether the insured seeking coverage was also the insured who gained the illegal profit, the exclusion will not apply.

Is the Underlying Claim or Loss “Based on or Attributable to” the Insured Receiving an Illegal Profit, or Is the “Profit” Merely Incidental to Other Claims?

The next question to address is whether the underlying claim is actually “based on or attributable to” an insured receiving an illegal profit. For the exclusion to apply, the underlying claim must allege that an insured received some profit or gain from their actions.[4]

Additionally, the alleged illegal profit must be the basis of the underlying claim. If the alleged profit or advantage is merely incidental to the underlying claim, then the claim is not “based on or attributable to” the allegedly illegal profit and, accordingly, the exclusion would not apply.[5]

To determine whether the underlying claim or loss is “based on or attributable to” the illegal profit, courts often look at the causes of action in the underlying claim to determine whether the receipt of an illegal profit is an element of the underlying claim.[6] Indeed, as one district court observed:

> "[The exclusion] by its terms, requires a profit or gain that is illegal; not an illegal act that produces a profit or gain to the insured as a by-product. This exclusion, therefore, would be applicable to cases of theft, such as insider trading, but is inapplicable to illegalities such as securities misrepresentation to which a private gain might be incidental. …
>
> "The proper inquiry, therefore, must focus not only on the factual allegations, but on the elements of the causes of action that are alleged. If an element of the cause of action that must be proved requires that the insured gained a profit or advantage to which he was not legally entitled, then, if proved, this exclusion would be applicable."[7]

Thus, if an illegal profit is an element of the underlying claim, the claim is based on or attributable to an illegal profit. However, if the purported profit or advantage is merely incidental to the underlying claims or the unintended consequence of the conduct that gave rise to the claim, then the exclusion does not apply. *Id.*

Is the Insured Legally Entitled to the Profit?

A related question that is so apparent that it risks being overlooked is whether the insured is legally entitled to the profit or gain. Only profits or advantages to which the insured is not legally entitled trigger the personal profit exclusion.[8]

However, if the insured was legally entitled to the profit or advantage gained, the personal profit exclusion does not bar coverage.[9]

Did the Insured Gain the Profit "In Fact"?

Probably the issue that has generated the most controversy in recent years relating to the applicability of the personal profit exclusion is whether the underlying allegations of illegal profiteering need to be fully adjudicated and proven to trigger the exclusion. In other words, what level of evidence is necessary to establish that the personal profit exclusion applies?

Litigation relating to this standard-of-proof issue has resulted from the differing language in the various personal profit exclusions found in liability policies. Some policies specifically state that the exclusion applies only if a final adjudication determines that an insured gained a profit to which it was not entitled.[10] Other versions of the exclusion require the insured to have gained an illegal profit "in fact."[11]

If an exclusion requires a final adjudication that the insured gained an illegal profit, the burden is quite high on the insurer to establish the applicability of the exclusion. In those circumstances, there will have to be a judgment or other judicial finding in the underlying lawsuit that the insured gained a profit to which it is not legally entitled or, alternatively, the insured will have to admit that it received a profit to which it is not legally entitled.

Many policyholders have argued that the same high level of evidentiary proof should apply if the exclusion requires that the insured gain an illegal profit "in fact."

However, most courts that have considered the issue have concluded that the "in fact" version of the personal profit exclusion does not require proof that the insured must have been "adjudged" or "adjudicated" to have gained an illegal profit.[12]

Those courts generally required some evidence beyond the mere allegations in the underlying complaint to support the application of the exclusion, but they stopped short of requiring a trial or judgment on the merits. *Id.* The practical result of the "in fact" language is that, in most circumstances, an insurer likely will be unable to disclaim its

duty to defend based on the allegations in the underlying complaint absent some additional evidence that the insured gained an illegal profit.

Conclusion

Addressing these fundamental questions early in the coverage analysis will help determine in short order whether the personal profit exclusion applies to bar coverage for a particular claim or whether the claim falls outside of the plain language of the exclusion.

--By Eric E. Caugh and Elizabeth V. Kniffen, Zelle Hofmann Voelbel & Mason LLP

Eric Caugh is a partner and Elizabeth Kniffen is an associate in Zelle Hofmann's Minneapolis office.

[1] *See Westport Ins. Corp. v. Black, Davis & Shue Agency, Inc.*, 513 F.Supp. 2d 157 (M.D. Pa. 2007) (personal profit exclusion did not apply where the underlying complaint alleged that "certain persons" appropriated insurance premiums for their own personal benefit but did not allege that those persons were insureds).

[2] *See TIG Specialty Ins. Co. v. Pinkmonkey.com Inc.*, 375 F.3d 365, 371 (5th Cir. 2004)(the terms "the Insured," "that Insured," or "such Insured" would "indicate the same insured as the claim is brought against …").

[3] *See, e.g., Westport Ins. Corp. v. Hanft & Knight, P.C.*, 523 F. Supp. 2d 444, 460-61 (M.D. Pa.2007)(personal profit exclusion applied to bar coverage for "innocent" co-insured).

[4] *See Rector, Wardens, and Vestryman of St. Peter's Church in City of Philadelphia v. American Nat'l Fire Ins. Co.*, CIV.A. 00-2806, 2002 WL 59333 at *7 (E.D. Pa. 2002) *aff'd*, 97 F .App'x 374 (3d Cir. 2004) (personal profit exclusion did not apply where underlying complaint did not allege that insured officers of church received personal gain from funds purportedly diverted from a trust).

[5] *See In re Donald Sheldon & Co., Inc.*, 186 B.R. 364, 368-69 (S.D.N.Y. 1995) *aff'd*, 182 F.3d 899 (2d Cir. 1999) (the personal profit exclusion "quite readily may be construed to exclude coverage only when the loss is based upon the illegal personal profit … derived by the insured" and not where the insured obtained incidental gains from acts that caused the loss); *Harrisburg Area Cmty. . Coll. v. Pac. Employers Ins. Co.*, 682 F. Supp. 805, 813 (M.D. Pa. 1988) (Funds received by college from federal grant program did not constitute profit or gain to college because the funds were put directly into

accounts for the prisoners' benefit);

[6] *See In re McCook Metals, L.L.C.*, 07 C 0621, 2007 WL 1687262 at *4-5 (N.D. Ill., June 7, 2007) (personal profit exclusion does not bar coverage where at least one claim for breach of fiduciary duty did not require proof that the insured gained an illegal profit); Alstrin v. St. Paul Mercury Ins. Co., 179 F. Supp. 2d 376, 399-401 (D. Del. 2002).

[7] *Alstrin*, 179 F. Supp. 2d at 400.

[8] *Alstrin*, 179 F. Supp. 2d at 400 (failure to allege that purported profits were illegal and to seek disgorgement of the profit are fatal to the application of the personal profit exclusion); *Pinkmonkey*, 375 F.3d at 370 (Insurer must establish that insured was not legally entitled to profit and an insured is "not legally entitled to an advantage or profit resulting from his violation of law if he could be required to return such profit".

[9] *See Int'l Ins. Co. v. Johns*, 685 F. Supp. 1230, 1237 (S.D. Fla. 1988) *aff'd*, 874 F.2d 1447 (11th Cir. 1989) (personal profit exclusion in D&O policy inapplicable because officers were legally entitled to "golden parachute" payments made by company).

[10] *See Fed. Ins. Co. v. SafeNet, Inc.*, 817 F. Supp. 2d 290, 295 (S.D.N.Y. 2011)(exclusion requires final adjudication that insured gained an illegal profit); *Pendergest-Holt, et al., v. Certain Underwriters at Lloyd's of London, et al*., 681 F. Supp. 2d 816, 823 (S.D. Tex. 2010)(same).

[11] *See, e.g., Wintermute v. Kansas Bankers Sur. Co.*, 630 F.3d 1063, 1070-71 (8th Cir. 2011) (insurer not liable for loss based upon insured "gaining in fact any personal profit or advantage to which [she was] not entitled") *Brown & Lacounte, L.L.P. v. Westport Ins. Corp*., 307 F.3d 660, 662 (7th Cir. 2002) (exclusion applies to claims resulting from any insured "having gained in fact any personal profit or advantage…").

[12] *See PMI Mortgage Ins. Co. v. Am. Int'l Specialty Lines Ins. Co.*, C 02-1774 PJH, 2006 WL 825266 at *4-7 (N.D. Cal. Mar. 29, 2006); *Wintermute*, 630 F.3d at 1070-71.