



United States District Court,  
S.D. New York.

In re DONALD SHELDON & CO., INC., Debtor.  
FEDERAL INSURANCE COMPANY, Plaintiff-  
Appellee-Cross Appellant,

v.

Donald T. SHELDON, and Mary Schad, Defend-  
ants,

Don L. Horowitz, Trustee for the Liquidation of  
Donald Sheldon & Co., Inc., Defendant-Appel-  
lant-Cross Appellee.

**No. 94 Civ. 8336 (LAK).**

Sept. 6, 1995.

Chapter 7 trustee brought adversary proceeding against officer and director liability insurer to recover for liability of debtor's officer pursuant to prior judgment in adversary proceeding for breaches of fiduciary duties. The Bankruptcy Court, Conrad, J., granted summary judgment dismissing trustee's claim on ground that illegal personal gain exclusion applied. On cross appeals, the District Court, Kaplan, J., held that: (1) illegal personal gain exclusion did not apply to trustee's judgment, and (2) dishonesty adjudication exclusion did not apply to trustee's judgment.

Vacated and remanded.

West Headnotes

**[1] Insurance 217** **2380(1)**

217 Insurance

217XVII Coverage--Liability Insurance

217XVII(B) Coverage for Particular Liabilities

217k2377 Directors' and Officers' Liabilities

217k2380 Particular Exclusions

217k2380(1) k. In General. **Most**

**Cited Cases**

(Formerly 217k430(3))

Under New York law, "personal profit or advantage," under illegal personal gain exclusion in officers' and directors' liability policy, required some more direct benefit to officers from their violations of new capital rule and illegal hypothecation of fully paid customer securities than their ability to remain employed until bankruptcy, and their retention of unrealized opportunity to expand corporation and to increase value of their stock in long term; thus, illegal personal gain exclusion didn't apply to judgment of Chapter 7 trustee of debtor corporation for damages awarded against officers of debtor for breaches of their fiduciary duty for violations of net capital rule and illegal hypothecation of securities. 17 C.F.R. § 240.15c3-1.

**[2] Insurance 217** **1835(2)**

217 Insurance

217XIII Contracts and Policies

217XIII(G) Rules of Construction

217k1830 Favoring Insureds or Beneficiaries; Disfavoring Insurers

217k1835 Particular Portions or Provisions of Policies

217k1835(2) k. Exclusions, Exceptions or Limitations. **Most Cited Cases**

(Formerly 217k146.7(6))

Under New York law, exclusionary clauses in insurance contracts are construed strictly to give interpretation most beneficial to insured; construction favorable to insurer will be sustained only if the sole construction that fairly can be placed upon words employed.

**[3] Insurance 217** **2117**

217 Insurance

217XV Coverage--in General

217k2114 Evidence

217k2117 k. Burden of Proof. **Most Cited Cases**

(Formerly 217k492.1)

Under New York law, insurer claiming that loss is excluded by policy term has burden of demonstrating that term expressly excludes loss; exclusions are not extended by interpretation or implication.

#### [4] Corporations 101 1.3

101 Corporations

101I Incorporation and Organization

101k1.3 k. Distinct Entity in General, Corporation As. [Most Cited Cases](#)

Distinction between corporation as entity and its owners and agents generally is accepted characteristic of corporate law.

#### [5] Insurance 217 2405

217 Insurance

217XVIII Coverage--Fidelity and Guaranty Insurance

217k2404 Risks Covered and Exclusions

217k2405 k. In General. [Most Cited Cases](#)  
(Formerly 217k430(2))

Under New York law, dishonesty adjudication exclusion in officers' and directors' liability policy did not apply to judgment of Chapter 7 trustee against officers of debtor for violation of net capital rule and illegal hypothecation of fully paid customer securities, where jury charge permitted jury to find self-dealing by officers without finding active and deliberative dishonesty, and explicit language of exclusion required actual dishonest purpose and intent to be established by adjudication.

#### [6] Insurance 217 2405

217 Insurance

217XVIII Coverage--Fidelity and Guaranty Insurance

217k2404 Risks Covered and Exclusions

217k2405 k. In General. [Most Cited Cases](#)  
(Formerly 217k430(2))

Securities and Exchange Commission (SEC) ruling declaring conduct of debtor's officer to be at least reckless in failing to monitor his subordinates prop-

erly while his attention was on other matters did not establish officer's actual "dishonest" purpose and intent, as required to trigger dishonesty adjudication exclusion in officers' and directors' liability policy, but only officer's blindness and self-interest.

#### [7] Corporations 101 310(1)

101 Corporations

101X Officers and Agents

101X(C) Rights, Duties, and Liabilities as to Corporation and Its Members

101k310 Management of Corporate Affairs in General

101k310(1) k. In General. [Most Cited Cases](#)

In any jurisdiction, "bad faith" for purposes of business judgment rule need not be premised on malevolence or culpable mental state; sufficiently severe lack of judgment caused, for example, by absence of information, may establish "bad faith."

\*365 [John W. Schryber](#), [Jay G. Strum](#), Kaye, Scholer, Fierman, Hays & Handler, New York City, for appellant-cross appellee.

[Glen Feinberg](#), Nina Cangiano, [Harold J. Moskowitz](#), Wilson, Elser, Moskowitz, Edelman & Dicker, New York City, for appellee-cross appellant.

### OPINION

[KAPLAN](#), District Judge.

Mary Schad and Donald Sheldon, both former directors of Debtor Donald Sheldon & \*366 Co. ("DSCO"), were found liable to the Debtor in the amount of \$16 million in an adversary proceeding for breaches of their fiduciary duty. The Debtor's Trustee brought a second adversary proceeding against Federal Insurance Company ("Federal") to recover the liability of Sheldon and Schad pursuant to a directors and officers insurance policy on which they were insured persons. Federal denied liability, claiming that the loss was excluded from coverage by Illegal Personal Gain and Dishonesty

Adjudication exclusions in the policy.

Bankruptcy Judge Conrad granted summary judgment dismissing the Trustee's claim. He ruled that Federal was not liable because the Illegal Personal Gain exclusion applied, although he found that the Dishonesty Adjudication exclusion did not. These cross-appeals followed, each party challenging the aspect of Judge Conrad's ruling adverse to its interests.

### *Facts*

#### *The Failure of DSCO*

The liability of Sheldon and Schad arose from circumstances that led to DSCO's bankruptcy.

DSCO, a subsidiary of the Donald Sheldon Group, Inc. ("Group"), a holding company, was a broker-dealer in securities. Sheldon was the chairman and president, and Schad was the chief financial officer. Both held Group stock.

As a broker-dealer of securities, DSCO had two principal sources of income-profits on securities sold to customers and interest earned on securities it purchased for its own account. The inventory of securities that DSCO offered to the public was purchased with funds advanced by DSCO's primary lender, Security Pacific. The securities thus acquired were held by Security Pacific in a "clearance loan" account at the bank and constituted the collateral that secured DSCO's obligation to pay the bank the amounts the bank had advanced for the acquisition of the securities plus carrying charges. Under the terms of the agreement between Security Pacific and DSCO, the bank had the right to call its loan and liquidate any collateral in the clearance loan account if DSCO was in violation of the SEC's net capital rule, 17 C.F.R. § 240.15c3-1 (1994).

DSCO sales personnel solicited sales to the firm's customers of securities held in the clearance loan account. Pursuant to the SEC's customer protection

rule,<sup>FN1</sup> DSCO had 72 hours after receipt of payment from a customer to redeem the purchased securities from Security Pacific's lien by paying Security Pacific the amount Security Pacific paid to buy the security plus interest. DSCO would profit from the transaction to the extent it was able to sell the securities in the clearance loan account for more than the amount it had to pay Security Pacific to redeem them. If securities were not redeemed as required by the customer protection rule, DSCO would be collateralizing its borrowings from hypothecation of customer securities. In the months preceding DSCO's collapse, the firm on at least several occasions failed promptly to redeem customer securities from Security Pacific and was admonished by the National Association of Securities Dealers.

<sup>FN1.</sup> 17 C.F.R. § 240.15c3-3(D)(2) (1994).

In July 1985, DSCO transferred \$4.2 million to Donald Sheldon Government Securities ("GSI"), a troubled Group subsidiary (the "GSI Loan"). (D-35, ¶¶ 65, 97; D-38, ¶ 15)<sup>FN2</sup> The object of the transaction was to permit GSI to pay off its outstanding debts to Security Pacific and another firm in order to facilitate a merger that, it was hoped, would save GSI. The merger never occurred, however, and GSI went into receivership not long after the loan was made. It was liquidated under Chapter 7 shortly thereafter. DSCO thus was not able to collect on the loan.

<sup>FN2.</sup> Citations to the Record on Appeal are designated "D-#," referring to the numbered exhibit in the record.

At the time DSCO made the GSI Loan, DSCO was thinly capitalized as a result of its aggressive expansion. Although the loan was carried as a receivable on DSCO's books, the intercompany account was not counted for purposes of the net capital rule. As DSCO had a net intercompany payable of \*367 \$1.5 million before the GSI Loan, the net effect of the transaction was to reduce DSCO's net capital by \$2.7 million. Consequently, DSCO's net capital dropped below \$25,000. This triggered a default on

DSCO's loan agreement with Security Pacific, which shortly thereafter liquidated the securities it held as collateral.

The liquidation of the collateral did not simply offset DSCO's indebtedness to Pacific. It resulted in a catastrophic loss because many of the securities belonged not to DSCO, but to DSCO's customers. DSCO, and later the Trustee, was liable to its customers for the loss of these securities. The combined losses to DSCO from its unrecoverable loan to GSI and its liability to customers for Pacific's liquidation of securities caused DSCO to liquidate under the Securities Investors Protection Act.

#### *The SEC Proceeding*

The first action arising from DSCO's failure was brought by the SEC against Sheldon for certain regulatory violations. It focused specifically on DSCO's persistent failure to redeem its customer's securities. An administrative law judge found that Sheldon's behavior was "at least reckless in failing to investigate problems brought to his attention and to keep himself informed of the basic financial information concerning the companies ..." (D-22, at 3-4) The decision was affirmed by the Commission, which emphasized that Sheldon's culpability rested primarily on his lack of involvement in the company. (D-29, at 15)

#### *The Trustee's Action*

The Trustee subsequently sued Sheldon and Schad for breach of fiduciary duty, alleging that they "knew or should have known" that the GSI Loan would result in violation of the net capital rule and that DSCO had been engaged in illegal hypothecation of fully paid customer securities. (D-35, ¶¶ 5-6) In addition, the Trustee claimed that the loan to GSI violated Sheldon's and Schad's duties of loyalty because they allegedly had personal interests in the transaction by virtue of their ownership of Group stock. The Trustee claimed as damages both the losses described above and the losses caused by

the bankruptcy itself, including money owed to creditors and loss of goodwill.

The case was tried in the Bankruptcy Court before Judge Conrad and a jury, which returned a general verdict holding both Sheldon and Schad liable to the Trustee and awarding damages against Sheldon in the amount of \$9.4 million. Schad, who declared personal bankruptcy after the jury determined liability but before they considered damages, subsequently was found liable for \$9.4 million by the Bankruptcy Court.

#### *This Action and the Decision Below*

The Trustee sued Federal in the Bankruptcy Court to recover on DSCO's directors and officers liability policy the sums owed by Sheldon and Schad as a result of the Trustee's successful action against them.

Federal's policy indemnified Sheldon and Schad for "all Loss ... which [they] bec[ame] legally obligated to pay on account of any claim(s) made against [them] ... for a Wrongful Act ..." (D-23, ¶ 1.1) "Wrongful Act," insofar as is relevant here, was defined as "any ... breach of duty committed ... by any Insured Person ... in the discharge of his duties to the Insured Organization in his Insured Capacity." (*Id.* at 9.1) Sheldon and Schad were Insured Persons under the policy and there is no dispute that they were acting in their Insured Capacity when they breached their fiduciary duties to DSCO. Hence, the liability of Sheldon and Schad to the Trustee is covered unless, as Federal claims, it is excluded under the terms of the policy.

The contract contained two exclusions relevant here:

"[Federal] shall not be liable ... to make any payment for Loss in connection with any claim(s) made against any of the Insured Person(s):

"(D) brought about or contributed to by the dishonesty of such Insured Person if a judgment or

other final adjudication adverse to such Insured Person established that the acts of active and deliberate dishonesty were committed or attempted by such Insured Person with actual dishonest purpose and \*368 intent and were material to the cause of action so adjudicated.

“(E) based upon or attributable to such Insured Person having gained any personal profit or advantage to which he was not legally entitled regardless of whether or not (1) a judgment or other final adjudication established that such Insured Person in fact gained such personal profit or other advantage to which he was not entitled, or (2) the Insured Person has entered into a settlement agreement to repay such unentitled personal profit or advantage to the Insured Organization.” (*Id.* ¶¶ 3.2(D) & (E))

Federal moved for summary judgment on the theory that the verdict in the Trustee’s action against Sheldon and Schad established that the loss for which the Trustee sought recovery was excluded under the Dishonesty Adjudication exclusion (¶ D above). It argued, alternatively, that the loss was attributable to personal profit or advantage illegally obtained by Sheldon and Schad and thus was excluded under the Illegal Personal Gain exclusion (¶ E above).

Judge Conrad, ruling from the bench, held that the Dishonesty Adjudication exclusion did not apply. He said that “having listened to all the evidence, one could come out with a different conclusion that Mary Schad and Donald Sheldon were not dishonest. The jury verdict didn’t establish dishonesty. The jury returned a general verdict but didn’t specify the basis on which it found the business judgment rule inapplicable.” The Court below concluded that dishonesty was not established by the verdict in the Trustee’s action because the alternative grounds available to the jury in the charge permitted a finding of liability absent a finding of dishonesty within the meaning of the policy. (D-6, at 36) Judge Conrad, however, did find illegal personal gain to Sheldon and Schad: “Sheldon and Schad had personal advantage from the use of other

people’s money. That is what the trials were about.” (*Id.* at 37) In consequence, the Bankruptcy Court entered judgment dismissing the Trustee’s action against Federal.

The Trustee now challenges the Bankruptcy Court’s interpretation of the Illegal Personal Gain exclusion. Federal cross-appeals, challenging the Bankruptcy Court’s interpretation of the Dishonesty Adjudication exclusion.

### *Discussion*

#### *The Illegal Personal Gain Exclusion*

[1] Despite the fact that DSCO, GSI and Group ultimately lost money as a result of DSCO’s illegal hypothecation of customer securities, Federal maintains that Sheldon and Schad reaped personal gain from these activities in the months prior to DSCO’s collapse. The illegal hypothecation allegedly sustained DSCO as a viable entity during that period.<sup>FN3</sup> Sheldon and Schad are said to have obtained advantage from this by (1) remaining employed as corporate officers, (2) retaining the opportunity to expand DSCO, and (3) gaining the opportunity to increase the value of their Group stock in the long term. Federal argues that these gains to Sheldon and Schad, brought about by their status as officers, shareholders and, in the case of Sheldon, a director, constituted illegal personal gain within the meaning of the exclusion.

FN3. Federal points to no evidence that DSCO was kept alive solely by virtue of the illegal hypothecation and that it otherwise would not have been a viable company. Thus, there has been no showing that the alleged gains to Sheldon and Schad in fact were caused by the illegal hypothecation. Given that the Illegal Personal Gain exclusion is an “in fact” exclusion, i.e., it does not turn on a prior adjudication, the failure to establish causation alone would require denial of Federal’s motion for sum-

mary judgment. However, because the Court concludes that the Trustee is entitled to prevail here on other grounds, this issue need not be determined.

The Trustee maintains that the gains alleged by Federal did not trigger the Illegal Personal Gain exclusion as a matter of law. Rather, the Trustee interprets the policy to exclude coverage only when the insured gains by causing a loss to the company directly, e.g., by embezzling funds. The exclusion, he argues, does not defeat coverage where an officer or director obtained incidental gains from events that caused a loss to the company.

**\*369** [2][3] Under New York law, which applies here, exclusionary clauses in insurance contracts are construed strictly to give the interpretation most beneficial to the insured. A construction favorable to the insurer will be sustained only if it is the sole construction that fairly can be placed upon the words employed. *Kimmins Industrial Service Corp. v. Reliance Insurance Co.*, 19 F.3d 78, 81 (2d Cir.1994); *M.H. Lipiner & Son, Inc. v. Hanover Insurance Co.*, 869 F.2d 685, 687 (2d Cir.1989); *Filor, Bullard & Smyth v. Insurance Company of North America*, 605 F.2d 598 (2d Cir.1978), *cert. denied*, 440 U.S. 962, 99 S.Ct. 1506, 59 L.Ed.2d 776 (1978). An insurer claiming that a loss is excluded by a policy term has the burden of demonstrating that the term expressly excludes the loss—exclusions are not extended by interpretation or implication. *McCormick & Co. v. Empire Insurance Group*, 878 F.2d 27, 30 (2d Cir.1989); *Board of Education v. CNA Insurance Co.*, 647 F.Supp. 1495, 1502-03 (S.D.N.Y.1986), *aff'd*, 839 F.2d 14 (2d Cir.1988); *Seaboard Surety Co. v. Gillette Co.*, 64 N.Y.2d 304, 486 N.Y.S.2d 873, 876, 476 N.E.2d 272, 275 (1984); *see Lachs v. Fidelity & Casualty Co. of New York*, 306 N.Y. 357, 365-66, 118 N.E.2d 555, 559 (1954). Here it cannot be said that Federal's construction of the Illegal Personal Gain exclusion is the only one that fairly may be placed upon it.

First, the exclusion states that Federal is not liable

for “Loss in connection with any claims ... based upon or attributable to [the insured's] personal profit or advantage.” “Loss” is what the insured is legally obligated to pay on the claims against the insured in the underlying action. Thus the exclusion quite readily may be construed to exclude coverage only when the loss is based upon the illegal personal profit or advantage derived by the insured. Here, it is at least reasonably arguable that the alleged personal profits to Sheldon and Schad—their continued employment prior to bankruptcy and an unrealized opportunity to build a corporate empire—were not the basis of the liability for which recovery was sought. That liability was based on the direct and consequential damages caused by the GSI Loan and the illegal hypothecation of customer securities.

[4] Second, Federal's interpretation of the exclusion is at least somewhat at odds with a fundamental principle of corporate law. Federal argues in substance that gain to shareholders, directors and officers flowing from illegal gain by a corporation in which they have an interest is illegal *personal* gain to those parties. While that is true in a sense, the distinction between a corporation as an entity and its owners and agents generally is an accepted characteristic of corporate law. *See, e.g., Popkin v. Dingman*, 366 F.Supp. 534 (S.D.N.Y.1973); *Robbins v. Panitz*, 61 N.Y.2d 967, 475 N.Y.S.2d 274, 463 N.E.2d 615 (1984); *Reliance Group Holdings, Inc. v. National Union Fire Insurance Co.*, 188 A.D.2d 47, 594 N.Y.S.2d 20 (1st Dep't 1993); *Consolidated Charcoal Co., Inc. v. Tele-Star Media Corp.*, 119 A.D.2d 791, 501 N.Y.S.2d 416 (2d Dep't 1986); ROBERT CLARK, CORPORATIONS, § 1.2.3 (1986) (hereinafter “CLARK”). It is far from unreasonable to suggest that the Illegal Personal Gain exclusion, in referring to “personal profit or advantage,” adverts to something more direct than the sort of derivative benefit upon which Federal's position depends.

As the Illegal Personal Gain exclusion is reasonably susceptible of an interpretation favorable to the insureds, Federal's position is rejected on the basis of

familiar principles.

*The Dishonesty Adjudication Exclusion*

[5][6][7] The main question with respect to the Dishonesty Adjudication exclusion is how to construe the general verdict.<sup>FN4</sup> Here, the trial court charged the jury as follows:

FN4. Federal argued in its brief that the SEC ruling was an adjudication of dishonesty, an argument Federal's counsel did not press at oral argument. The SEC ruling, however, went no further than declaring Sheldon's conduct to be "at least reckless" in failing to monitor his subordinates properly while his attention was on other matters. Plainly, this ruling did not establish Sheldon's actual dishonest purpose and intent-as required by the exclusion clause-but only his blindness and self-interest. (D-29, at 13-15)

"The Business Judgment Rule presumes that Mary Schad and Donald Sheldon have acted properly and in good faith. It means that they may not be held liable unless the \*370 Plaintiff, Trustee here, first shows that Defendants engaged in either self-dealing, fraud or bad faith. In this case, Trustee Horowitz has claimed that Mary Schad and Donald Sheldon acted in bad faith and engaged in self-dealing. Therefore, in order for you to get to consider whether Donald Sheldon and Mary Schad breached their fiduciary duty to DSCO, you must first find that they acted in either bad faith, or engaged in self-dealing.

"Bad faith includes actions and conduct undertaken to mislead or deceive another. Bad faith includes a neglect or refusal to fulfill some duty or contractual obligation not due to an honest mistake, but rather due to some self-interest or sinister motive. Bad faith is not simply bad judgment honestly exercised. Rather, it implies the conscious doing of a wrongful act. It is different

from negligence, which implies inattention, because bad faith implies a state of mind affirmatively operating with selfish design or ill will. Thus, one could find, for example, that a company's internal policies and procedures were so restricted in scope, so shallow in execution or otherwise so pro forma or halfheartedly conceived or carried out, that it constitutes bad faith on the part of those responsible.

"Self-dealing includes action undertaken by a fiduciary who uses or obtains the property held in his or her fiduciary capacity for his or her own benefit. (D-26, at 1810-1811)

Thus, the verdict for the Trustee may rest on a finding of self-dealing alone. The charge, moreover, permitted the jury to find self-dealing without finding "active and deliberate dishonesty," which would be necessary to trigger the exclusion.<sup>FN5</sup>

FN5. The Trustee argues also that the jury did not have to find actual dishonest purpose and intent in order to find bad faith. In many jurisdictions, bad faith for purposes of the business judgment rule need not be premised on malevolence or a culpable mental state; a sufficiently severe lack of judgment caused, for example, by an absence of information, may establish bad faith. See, e.g., *Casey v. Woodruff*, 49 N.Y.S.2d 625, 643 (1944). However, the jury charge below did not articulate this possibility in explicit terms. One portion of it emphasizes that "bad faith implies selfish design or ill will." Given the Bankruptcy Court's holding with respect to the self-dealing ground in the charge, this Court need not determine whether the jury was required to find dishonesty pursuant to the bad faith charge.

Federal tacitly concedes as much. It nevertheless argues that the judgment should be construed as having decided the dishonesty issue against Sheldon and Schad as long as the evidence would have

permitted a finding of dishonesty, which it asserts was the case here. According to Federal, any other construction would be unfair because an insurer is not in a position to intervene in a proceeding to pose the question of dishonesty to a jury via a special interrogatory. Requiring a specific finding of dishonesty before applying the exclusion thus would leave the question of coverage in the hands of the parties to the case.

Federal's position is entirely without merit. The explicit language of the provision excludes coverage if actively dishonest acts and actual dishonest purpose and intent both are established by adjudication. As the exclusion requires that actual dishonest purpose and intent be "established" by adjudication, the exclusion certainly is susceptible to the interpretation, well developed in the law of collateral estoppel, that the judgment establishes dishonesty under the exclusion only if a finding of dishonesty was necessary to the judgment, *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 99 S.Ct. 645, 58 L.Ed.2d 552 (1979), which in this case it was not. The fact that this interpretation of the exclusion gives the parties to the underlying action some control over the insurer's liability-to the extent that the parties can affect the jury charge and evidence received-is not unfair to insurers. Contracts routinely have conditions of performance contingent on the behavior or conduct of only one of the contracting parties or of strangers to the contract. See II E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 8.2, at 345 (1990). The insurance company, which drafts, markets and prices its policies, is capable of ameliorating this risk either through its pricing of the policy or by redrafting the relevant exclusions. In consequence, Judge Conrad correctly held that the Dishonesty Adjudication exclusion does not apply here.

*\*371 Conclusion*

The judgment of the Bankruptcy Court is vacated and this case is remanded for entry of judgment against Federal and in favor of the Trustee.

SO ORDERED.

S.D.N.Y., 1995.

In re Donald Sheldon & Co., Inc.

186 B.R. 364

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**H**

United States District Court,  
S.D. New York.  
In re DONALD SHELDON & CO., INC., Debtor.  
FEDERAL INSURANCE COMPANY, Plaintiff-  
Appellant,  
v.  
Donald T. SHELDON, et ano., Defendants,  
and  
Don L. Horwitz, Trustee for the Liquidation of  
Donald Sheldon & Co., Inc., Defendant-Appellee.  
**No. 97 CIV. 9384(LAK).**  
**Bankruptcy No. 85-6538(AJG).**  
**Adversary No. 94-8368.**

May 11, 1998.

Chapter 7 trustee brought adversary proceeding against officers' and directors' liability insurer to recover for liability of debtor's officers pursuant to prior judgment in adversary proceeding for breaches of fiduciary duties. The Bankruptcy Court granted summary judgment dismissing trustee's claim on ground that illegal personal gain exclusion applied. On cross appeals, the District Court, [186 B.R. 364](#), vacated and remanded. On remand, the Bankruptcy Court entered order providing for judgment of liability in favor of trustee in an amount to be determined later. Insurer moved to vacate order and to reopen discovery. The Bankruptcy Court, [Arthur J. Gonzalez, J.](#), denied motion, and judgment later was entered in favor of trustee in the amount of \$10,604,039. Insurer appealed. The District Court, [Kaplan, J.](#), held that: (1) insurer made deliberate, tactical decision to proceed on record of underlying proceeding, and was not entitled to relief from judgment to reopen discovery; (2) alleged newly discovered evidence did not provide basis for relief; and (3) insurer could not, on its motion to vacate order, raise new theory as to why exclusion applied.

Affirmed.

## West Headnotes

**[1] Federal Civil Procedure 170A**  **2651.1**

170A Federal Civil Procedure  
170AXVII Judgment  
170AXVII(G) Relief from Judgment  
170Ak2651 Grounds  
170Ak2651.1 k. In General. [Most Cited Cases](#)

Chapter 7 debtor's officers' and directors' liability insurer was not entitled to relief from judgment to reopen discovery on coverage issue where insurer made deliberate, tactical decision to proceed on record of underlying proceeding, sought no discovery, and was not blocked from conducting discovery of debtor's officer by officer's disappearance during pendency of coverage litigation. [Fed.Rules Civ.Proc.Rule 60\(b\)](#), 28 U.S.C.A.

**[2] Federal Civil Procedure 170A**  **2651.1**

170A Federal Civil Procedure  
170AXVII Judgment  
170AXVII(G) Relief from Judgment  
170Ak2651 Grounds  
170Ak2651.1 k. In General. [Most Cited Cases](#)

Relief from judgment is extraordinary and available only in "exceptional circumstances." [Fed.Rules Civ.Proc.Rule 60\(b\)](#), 28 U.S.C.A.

**[3] Federal Civil Procedure 170A**  **2651.1**

170A Federal Civil Procedure  
170AXVII Judgment  
170AXVII(G) Relief from Judgment  
170Ak2651 Grounds  
170Ak2651.1 k. In General. [Most Cited Cases](#)

Relief from judgment cannot be used to overcome consequences of tactical judgments. [Fed.Rules Civ.Proc.Rule 60\(b\)](#), 28 U.S.C.A.

**[4] Federal Civil Procedure 170A**  **2656**

170A Federal Civil Procedure

170AXVII Judgment

170AXVII(G) Relief from Judgment

170Ak2651 Grounds

170Ak2656 k. Mistake; Inadvertence; Surprise; Excusable Neglect. [Most Cited Cases](#)  
Relief from judgment cannot be obtained by one who does not act with due diligence. [Fed.Rules Civ.Proc.Rule 60\(b\)](#), 28 U.S.C.A.

**[5] Federal Civil Procedure 170A** 2655

170A Federal Civil Procedure

170AXVII Judgment

170AXVII(G) Relief from Judgment

170Ak2651 Grounds

170Ak2655 k. Further Evidence or Argument. [Most Cited Cases](#)  
To obtain relief from judgment on basis of newly discovered evidence, moving party must demonstrate not only that evidence existed at time of prior action and that it justifiably was not available to movant, but also that evidence would be admissible and of such import as probably to have changed result in prior action. [Fed.Rules Civ.Proc.Rule 60\(b\)](#), 28 U.S.C.A.

**[6] Federal Civil Procedure 170A** 2655

170A Federal Civil Procedure

170AXVII Judgment

170AXVII(G) Relief from Judgment

170Ak2651 Grounds

170Ak2655 k. Further Evidence or Argument. [Most Cited Cases](#)  
Party could not raise new argument on the merits in its motion to vacate order. [Fed.Rules Civ.Proc.Rule 60\(b\)](#), 28 U.S.C.A.  
**\*690** [John W. Schryber](#), [Jay G. Strum](#), Kaye, Scholer, Fierman, Hays & Handler, New York City, for appellant.

[Glen Feinberg](#), [Nina Cangiano](#), [Harold J. Moskowitz](#), [Wilson, Elser, Moskowitz, Edelman & Dicker](#), New York City, for appellee.

**\*691 ORDER**

[KAPLAN](#), District Judge.

Mary Schad and Donald Sheldon, both former directors of debtor Donald Sheldon & Co., Inc. (“DSCO”), were found liable to the debtor in the amount of \$16 million in an adversary proceeding for breaches of their fiduciary duties. The debtor's trustee brought this action against defendant Federal Insurance Company (“Federal”) to recover the liability of Sheldon and Schad pursuant to DSCO's directors and officers liability insurance policy on which they were insured persons. Federal and the trustee cross-moved for summary judgment. Bankruptcy Court Judge Conrad granted Federal's motion, denied the trustee's motion, and dismissed the trustee's claim. On appeal, this Court reversed, held that Federal was liable, and remanded for the entry of judgment in favor of the trustee. *In re Donald Sheldon & Co.*, 186 B.R. 364 (S.D.N.Y.1995).

On September 18, 1995, Bankruptcy Judge Gallet on remand entered an order providing for a judgment of liability in favor of the trustee in an amount to be determined later. On March 15, 1996, Federal moved to vacate Judge Gallet's order and to reopen discovery on its contention-previously rejected by this Court-that it was not liable because the loss at issue fell within the “personal profit or advantage” exclusion in the policy. On December 26, 1996, Bankruptcy Judge Gonzalez, in a thorough 19-page decision, denied Federal's motion. On November 12, 1997, following the resolution of various additional matters not pertinent here, the Bankruptcy Court entered judgment in favor of the trustee in the amount of \$10,604,039, which consisted of the policy's \$7.3 million remaining limit of liability combined with prejudgment interest. Federal now appeals from the final judgment, contending that Judge Gonzalez abused his discretion in denying its motion to vacate the September 18, 1995 order. It contends that the order should be opened because it was prevented from conducting discovery of Donald Sheldon by virtue of his disappearance during the pendency of the coverage litigation, a circum-

stance that it characterizes as having denied it a full and fair opportunity to litigate its “personal profit or advantage” defense and as warranting *vacatur* on the basis of misconduct by Sheldon or on the theory that Sheldon's reappearance and acknowledgment of the existence of some documents that Federal did not see previously constitutes newly discovered evidence.

Judge Gonzalez's memorandum opinion soundly rejects each of Federal's contentions, and relatively little more need be said. This Court writes merely to emphasize a number of points of particular note.

*Federal Was Not Handicapped in Defending the Coverage Action*

Federal's contention that it somehow was handicapped in litigating the coverage action that resulted in this Court's previous opinion is utterly baseless. The record demonstrates quite convincingly that Federal (1) fought a vigorous and successful battle to prevent any discovery, and (2) made a quite deliberate decision to have the question of coverage decided solely on the record of the underlying action by the trustee against Sheldon and Schad.

This action was commenced in the district court in 1990 as a declaratory judgment action in which Federal sought a determination, *inter alia*, that the “personal profit or advantage” exclusion of its policy precluded its liability. Judgment was entered in the underlying action on March 1, 1993. The trustee filed its answer and counterclaims in this case on March 31, 1993. At about the same time, the trustee served a number of discovery requests, including a notice to take Sheldon's deposition in Miami, and moved to transfer this case to the Bankruptcy Court. Federal objected to the deposition of Sheldon and, indeed, to all discovery in the case. For a variety of reasons, none of the discovery or, at least, none relevant here went forward.

On April 1, 1994, Judge Leisure granted the trust-

ee's motion and sent the case to the Bankruptcy Court where it has been treated as an adversary proceeding in the DSCO liquidation. Once the matter reached the Bankruptcy Court, Judge Conrad held a status conference on April 20, 1994. Federal's counsel then announced that it wished to move for summary judgment on the coverage \*692 issues and objected to the trustee's efforts to conduct discovery. (D-73, at 4) Federal's position was that the issue of coverage was to be decided on the record of the underlying proceeding:

“MR. FEINBERG [Federal's counsel]: We see no need to take any of that discovery [sought by the trustee]. We see the issues in this case as very simple, there is no factual issue, there was an adjudication in this Court and there was an adjudication against Mr. Sheldon and the SEC.”*The question is on those facts which are undisputed facts, do the insurance policies' exclusion for dishonesty and personal profit apply? If they do, we win, if they don't, we lose.*

“It doesn't seem to me that there is any need to take discovery to matters such as drafting history of the insurance policy.”

“The policy is clear, we win, if it's ambiguous, they are going to say we lose anyway, so why do they need to take drafting history and other kinds of discovery.” (D-73, at 4-5) (emphasis added)

Judge Conrad responded that his instincts told him that the case would be resolved “without further discovery.” (*Id.* at 9)

Following the April 20, 1994 conference before Judge Conrad, the parties cross-moved for summary judgment on the coverage issues. Consistent with the position it took before Judge Conrad on April 20, Federal sought no discovery for the purpose of opposing the trustee's motion for summary judgment. It simply went forward and litigated the motions-and the subsequent appeal to this Court-on the basis that Federal was entitled to win if the facts in the underlying action came within the exclusions

and Federal's acknowledgment that it would lose if they did not.

In these circumstances, Federal's current claims ring very hollow indeed.

[1] To begin with, the foregoing demonstrates that the heart of Federal's position here-that it was blocked from conducting discovery of Sheldon-is doubly erroneous. Judge Conrad did not stop any discovery by Federal-Federal sought no discovery. In response to *Federal's* assertion that coverage would be determined, *one way or the other*, solely on the basis of the record in the underlying action, he simply indicated his belief that the matter probably could be resolved on summary judgment without discovery.

Second, nothing prevented Federal from responding to the trustee's cross-motion for summary judgment not only by contending, as it did, that Federal was entitled to judgment on the basis of the trial record in the underlying action, but alternatively that Federal should be granted a continuance or discovery, under [Fed.R.Civ.P. 56\(f\)](#), to meet the cross-motion in the event the court rejected Federal's primary position. Federal's contention that such an argument would not have met with favor before Judge Conrad is not persuasive, not only because Judge Conrad's remarks on April 20, 1994 do not justify Federal's argument, but in any case because Federal, if it seriously believed that discovery would have been important with respect to the cross-motion, should have protected its record. Further, the decision not to seek relief under [Rule 56\(f\)](#) quite likely was a tactical judgment. Seeking such relief would have been inconsistent with Federal's position that no discovery was necessary to decide coverage and thus would have undermined its efforts to block discovery by the trustee.

[2][3][4] Relief from a judgment is extraordinary and available only in "exceptional circumstances." *Nemaizer v. Baker*, 793 F.2d 58, 61 (2d Cir.1986); accord, e.g., *Paddington Partners v. Bouchard*, 34 F.3d 1132, 1142 (2d Cir.1994); *Andrulonis v.*

*United States*, 26 F.3d 1224, 1235 (2d Cir.1994); *Mendell v. Gollust*, 909 F.2d 724, 731 (2d Cir.1990); *Martin v. Chemical Bank*, 940 F.Supp. 56, 58-59 (S.D.N.Y.1996), *aff'd*, 129 F.3d 114 (2d Cir.1997) (table); *Frankel v. ICD Holdings S.A.*, 939 F.Supp. 1124, 1127 (S.D.N.Y.1996); *Pesca v. Board of Trustees*, 176 F.R.D. 110, 113 (S.D.N.Y.1997). It cannot be used to overcome the consequences of tactical judgments. *Andrulonis*, 26 F.3d at 1235; *Nemaizer*, 793 F.2d at 61, 63; *Martin*, 940 F.Supp. at 59; *Frankel*, 939 F.Supp. at 1127. Nor may relief be obtained by one who does not act with due diligence. \*693*Pesca*, 176 F.R.D. at 113; *Frankel*, 939 F.Supp. at 1127 (citing cases).

The foregoing demonstrates convincingly that Federal and its counsel made a deliberate decision to sink or swim on the record of the underlying proceeding. Even if that were not so clear, Federal certainly did not act with due diligence in seeking Sheldon's testimony-on the contrary, it resisted it-by failing to advance in a [Rule 56\(f\)](#) affidavit its contention that Sheldon's testimony was required in order to defend the trustee's cross-motion.

#### *There Is No Basis for Relief on the Newly Discovered Evidence Theory*

[5] The assertion that Sheldon's testimony, whatever it might be, and the cartons of unspecified documents allegedly in his possession would not warrant relief in any case. In order to obtain relief on the basis of newly discovered evidence, the moving party must demonstrate not only that the evidence existed at the time of the prior action and that it justifiably was not available to the movant-the latter of which is not so here for the reasons already discussed-but also that the evidence would be admissible and of such import as probably to have changed the result in the prior action. *E.g.*, *Frankel*, 939 F.Supp. at 1127 (citing cases). There simply has been no showing here that Sheldon has anything to say, or that the documents contain anything, that probably would have changed the result.

*Federal's Current Theory Is Newly Conceived and, At Least in Part, Contrary to the Law of the Case*

It is important also to recognize that Federal's application below represented an attempt to relitigate the coverage issue on an entirely new theory first conceived after Federal lost its prior appeal to this Court.

The theory of the underlying action against Sheldon and Schad was that they "knew or should have known" that the GSI Loan would result in a violation of the net capital rule, that DSCO had engaged in illegal hypothecation of customer securities, and that Sheldon and Schad breached their fiduciary duties because they had personal interests in the transaction by virtue of their ownership of Donald Sheldon Group ("Group") stock. *In re Donald Sheldon & Co.*, 186 B.R. at 367. Federal's position was that the loss was excluded by the "personal profit or advantage exclusion" clause because Sheldon and Schad obtained an advantage from the events at issue by "(1) remaining employed as corporate officers, (2) retaining the opportunity to expand DSCO, and (3) gaining the opportunity to increase the value of their Group stock in the long run." *Id.* at 368. In other words, its position was that the exclusion applied because Sheldon and Schad incidentally gained from the events that caused a loss to the company, not that the insured profited by causing a direct loss to the company as, for example, by embezzlement. *Id.* The Court ruled for the trustee, essentially on the ground that Federal's construction of the exclusion was not the only reasonable view of the meaning of the policy, a conclusion which required judgment for the insured. *Id.* at 368-69.

Federal now argues that Sheldon's testimony and documents would be important to litigation of this exclusion because there is reason to believe that they would produce evidence that Sheldon has assets, which in turn might lead to evidence or an inference that he profited more directly than Federal previously argued from the transactions that resulted in the loss to DSCO. (*See* Federal Br. 8-9)

As indicated above, Federal previously argued that the exclusion applied because Sheldon and Schad benefitted incidentally from the events that gave rise to the loss. No amount of proof that Sheldon and Schad so benefitted would avail Federal because the Court already has ruled that such a benefit would not trigger the exclusion.

[6] To be sure, Federal presumably seeks to show also that Sheldon and Schad obtained some direct benefit which caused the loss-i.e., was necessary to establish the underlying claim. But this is a brand new argument, and there is no reason why Federal should be permitted to raise it on a [Rule 60\(b\)](#) motion. Indeed, Judge Gonzalez, in rejecting a second motion to vacate the September 18, 1995 order, a ruling from which \*694 Federal does not appeal, squarely and correctly held that the failure of Federal's counsel to advance the argument earlier was not a sufficient basis for relief. (CD-11 at decision dated Oct. 8, 1998, at 11)

*Conclusion*

For all of these reasons, as well as most of those advanced by Judge Gonzalez, <sup>FN1</sup> the court below plainly did not abuse its discretion. Indeed, this Court would reach the same result were the matter before it *de novo*. The order appealed from is affirmed.

**FN1.** This Court expresses no opinion as to whether Sheldon's disappearance was misconduct upon which Federal may rely, as the other bases for affirmance make this issue immaterial. Similarly, as this Court would have denied relief even if the application had been made to September 18, 1995 order in conformity with the mandate of this Court.

SO ORDERED.

S.D.N.Y., 1998.

In re Donald Sheldon & Co., Inc.

222 B.R. 690, 41 Fed.R.Serv.3d 961

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