

Insurers May Not Solely Rely on Allegations of Underlying Complaint to Deny Coverage Under Three Policy Exclusions

May 2006

The United States District Court for the Northern District of California has granted summary judgment to an insured, holding that coverage under a financial institution professional liability policy and two excess follow-form policies was not precluded by the policies' profit or advantage exclusion, criminal or fraudulent act exclusion or prior knowledge exclusion. *PMI Mortgage Ins. Co. v. Am. Int'l Specialty Lines Ins. Co.*, 2006 WL 825266 (N.D. Cal. Mar. 29, 2006).

The court also determined that because material issues remained as to whether the settlement in the underlying litigation constituted a "loss" under the policy, the insurers' motion for summary judgment on that issue was inappropriate.

The primary insurer issued a financial institution professional liability policy to an insurance company in the mortgage loans industry. The insured was also covered by two excess policies, both of which applied in conformity with the terms, conditions, exclusions and endorsements of the primary policy. The primary policy defined "loss" as "damages, settlements and Defense Costs." Excluded from the definition of "loss" were "fees, commissions, or other compensation for any Professional Services rendered or required to be rendered by the Insured or that portion of any settlement or award in an amount equal to such fees, commissions, or other compensation," as well as "the multiplied portion of multiplied damages" and "matters that may be deemed uninsurable under the law." The policy contained three relevant exclusions, referred to by the court as the profit or advantage exclusion, the criminal or fraudulent act exclusion and the prior knowledge exclusion.

The underlying claimants brought a class action suit against the insured, alleging that its provision of mortgage insurance in certain circumstances violated the Federal Real Estate Settlement Procedures Act and asserting that the insured received impermissible kickbacks as part of these violations. Following the settlement of the underlying litigation, the company sought indemnification for the settlement amount from the three insurers, each of which denied coverage. The insured filed suit, seeking declaratory relief as to the insurers' duty to indemnify and asserting breach of contract for the insurers' failure to indemnify. In response, the insurers relied on the applicability of the profit or advantage exclusion, the criminal or fraudulent act exclusion and the prior knowledge exclusion as reasons for denying coverage, and also maintained that the

underlying settlement did not constitute a "loss" under the policy. All parties sought summary judgment.

The court rejected the applicability of each of the three exclusions. The profit or advantage exclusion precluded coverage for claims "arising out of, based upon or attributable to any in fact conflict of interest or the gaining in fact of any profit or advantage to which an Insured was not legally entitled." The crime or fraud exclusion precluded coverage for claims "arising out of, based upon or attributable to the committing in fact of any criminal or deliberate fraudulent act." The court disagreed with the insurers' contention that because the underlying litigation alleged that the insured had received unlawful kickbacks and committed criminal or fraudulent acts, the profit or advantage exclusion and the criminal or fraudulent act exclusion necessarily precluded coverage. The parties' arguments focused on the term "in fact," which was contained in both exclusions, with the company maintaining that the term inherently requires a final adjudication to establish the receipt of an unlawful profit or advantage or the commission of a criminal or fraudulent act under the exclusions. The insurers emphasized that the phrase "judicially determined," which required a final adjudication or factual determination, was already contained within the policy's subrogation provision. Thus, according to the insurers, the phrase "in fact" could not be interpreted in the same way. Surveying the case law, the court recognized that the Ninth Circuit had not spoken on the exact meaning of the term and that there was a split among the courts that had interpreted it.

Relying primarily on *St. Paul Mercury Ins. Co. v. Foster*, 268 F. Supp. 2d 1035 (C.D. Ill. 2003) and *Am. Chem. Soc'y v. Leadscope, Inc.*, 2005 WL 1220746 (Ohio Ct. App. May 24, 2005), the court concluded that the ordinary and popular meaning of "in fact" requires "an actual adjudication or determination of fact prior to application" of the relevant exclusions. Further, the court held that while the phrase "judicially determined" referred only to factual determinations undertaken by the judiciary, the term "in fact" "should be read to require *either* a final adjudication, including a judicial adjudication, *or* at a minimum, at least some evidentiary proof that the insured reaped an illegal profit or gain." Moreover, distinguishing *Brown & LaCounte LLP v. Westport Ins. Co.*, 307 F.3d 660 (7th Cir. 2002), relied upon by the insurers, the court emphasized that the underlying complaint did not directly allege the receipt of an illegal profit or advantage by the insured, and therefore, the actual illegality of the company's actions was still in dispute. Therefore, the court concluded that because the insurers simply relied on the allegations contained in the underlying complaint and could not provide proof of facts supporting an illegal profit or advantage or a criminal or fraudulent act, neither the profit or advantage exclusion nor the criminal or fraudulent act exclusion precluded coverage.

The court also rejected the application of the prior knowledge exclusion, which precluded coverage for claims "alleging any Wrongful Act which, as [of] the Continuity Date . . . , any Insured knew or could have reasonably foreseen could lead to a Claim." The court noted that the insurers had been unable to present any extrinsic evidence suggesting that the insured could have reasonably known by the continuity date that its acts would lead to the underlying class action claim.

In denying insurers' motion for summary judgment on the issue of whether the underlying settlement constituted a "loss" as defined by the policy, the court determined that the whole sum of the underlying settlement would constitute a covered "loss" under the policy until and unless the insurers could prove that some portion of the settlement did not fall within the definition of "loss." While the insurers contended that the settlement included amounts that class action plaintiffs had been overcharged in mortgage insurance premiums, which would be carved out by the definition, the court found that material issues of fact remained, since the company maintained that the settlement did not include such amounts and also disputed whether the settlement was a release of all federal and state law claims against it.