

# Dishonesty Exclusion Deemed Ambiguous

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In an unreported decision, the U.S. Court of Appeals for the Sixth Circuit, applying Ohio law, has held that a policy exclusion for dishonest and fraudulent wrongful acts is ambiguous because the term "wrongful act" was defined to include only negligent actions, and thus the exclusion as written could only apply to acts that were intentional and negligent at the same time, a nonsensical result. *Illinois Union Ins. Co. v. Shefchuk*, 2004 WL 1858705 (6th Cir. Aug. 17, 2004). The court also determined that policy exclusions based on the conduct of "an insured" only applied to a claim by the insureds whose conduct triggered the exclusion, and would limit coverage available to any other insured under the policy.

The insurer issued "broker-dealer financial services professional liability policies" to a financial services brokerage firm and an investment services firm. Two individual insureds under the policies were alleged to have either fraudulently or negligently caused firm clients to lose their investments. The primary issue considered by the Sixth Circuit was the effect of the following exclusion:

## **Dishonesty or Fraud/Personal Advantage/Non Public Information**

We do not cover claims which arise out of or are contributed to by a "wrongful act" that is committed by or at the direction of an insured and which is dishonest, fraudulent, criminal, malicious or knowingly wrongful. We do not cover claims arising out of the insured gaining any personal profit or advantage to which the insured was not legally entitled.

The court found this exclusion to be ambiguous because the policy at issue defined "wrongful act" as "any negligent breach of duty, error, misstatement, misrepresentation, omission...or other negligent act done or attempted by an insured, or by any person for whose acts the insured is legally responsible." The court reasoned that, because "wrongful act" encompassed negligent actions, the exclusion for dishonest "wrongful acts" applied only to actions that were both intentional and negligent at the same time—a nonsensical result. Such "logical incoherence" rendered the first sentence of the exclusion ambiguous and unenforceable and it could not be applied to exclude coverage for intentional dishonest acts, because such acts were, by definition, not negligent.

The court also considered whether policy exclusions barring coverage for claims arising out of the "willful violation of any laws, orders, rules or regulations...committed by or at the direction of an insured" would bar coverage for all insureds under the policy or only the specific insured whose conduct triggered the exclusion. In resolving this issue, the court relied upon the policy's severability clause, which provided that "[t]he inclusion

of multiple insureds will not affect the rights of any such persons or organizations to be protected by this policy. We will cover each person or organization just as if a separate policy had been issued to each."

The court concluded that provision rendered the phrase "an insured" ambiguous because otherwise the acts of one insured could bar coverage for another insured, contrary to the policy's indication that each insured would received coverage "as if [the insured] had been issued" a separate policy. The court thus concluded that the exclusion's effect was limited only to the single insured whose conduct triggered its terms.

Finally, in assessing which of the underlying lawsuits were subject to coverage, the Sixth Circuit held that the insurer's duty to defend arose "only when the allegations [of the underlying claims] potentially state a claim that" was within the relevant policy's coverage, meaning that coverage was triggered only where the underlying allegations could cause the insurer to "pay damages." Accordingly, where it was unclear whether underlying allegations alleged intentional actions or negligent actions, the insurer was required to defend the claim.

For more information, please contact us at 202.719.7130.