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NEWSLETTER

Intentional Acts Exclusion Bars Coverage for Fraud; Insurer Did Not Waive Exclusion by Omitting from Initial Denial

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In an unreported decision, a federal district court in New York, applying New York law, has held that the intentional acts exclusion in a professional liability policy issued to a securities broker/dealer bars coverage for the fraudulent sale of worthless investments. *Westport Resources Invest. Servs., Inc. v. Chubb Custom Ins. Co.*, 2003 WL 22966305 (S.D.N.Y. Dec. 16, 2003). The court also held that the insurer did not waive its right to rely on the exclusion by failing to raise it in its denial of coverage letter.

The insurer issued a claims-made professional liability policy to a securities brokerage firm and its representatives. The policy excluded coverage for intentional acts "brought about or contributed to" by "any knowing, intentional, fraudulent, or dishonest Wrongful Act by an Insured." The exclusion also contained a "safe harbor" provision, which stated that the exclusion "shall only apply to an Insured if it is established in fact that the Insured participated in or acquiesced in the knowing, intentional, fraudulent, or dishonest act, the willful or intentional violation, or the gaining of profit, remuneration or advantage...."

One of the insured's registered representatives convinced some of the firm's clients to invest in an investment vehicle, which was separate from the company's business. The representative was later convicted of fraud because the investments were worthless. The clients then began arbitration proceedings against the brokerage firm arguing that the company negligently supervised the representative.

The insurer denied coverage for the arbitration based on the fact that the representative's scheme was initiated before the retroactive date in the policy. The insurer also reserved on other potentially applicable policy terms, but did not specifically resume on the intentional acts exclusion. Coverage litigation ensued.

The court held that the intentional acts exclusion barred coverage. It rejected the brokerage firm's argument that coverage was available because the claim against it was for negligence, explaining that the intentional acts exclusion applied to fraud by an insured, including the representative, not the insured. The court reasoned that the "safe harbor" did not impose coverage because the representative was convicted of criminal fraud, and the safe harbor did not apply to claims "arising out of or resulting from, in whole or in part, an Insured's commission of...any...criminal act."

The court also held that the insurer did not waive the defense based on the intentional acts exclusion by failing to rely on the exclusion when it initially denied coverage. The court explained that waiver can not be used to create coverage where none exists. Relying on *Albert J. Schiff Associates, Inc. v. Flack,* 417 N.E.2d 84 (N.Y. 1980), the court stated "where the issue is the existence or non-existence of coverage (*e.g.*, the insuring clause and exclusions), the doctrine of waiver is simply inapplicable."

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