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NEWSLETTER

Other Decisions of Note

May 2008

Claim Not Covered Where Demand Was First Made Prior to Inception of Policy

The United States District Court for the District of Kansas, applying Kansas law, has held that a public official's liability policy did not cover a negligent misrepresentation claim arising out of a contract dispute with the insured city because the claim was not first made during the policy period and because the policyholder had a reasonable basis to conclude a claim or suit would be made based on the plaintiff's demands prior to the inception of the policy. *City of Shawnee v. Argonaut Ins. Co.*, 2008 WL 852055 (D. Kan. Mar. 28, 2008).

Prior to the policy's inception, the insured and the plaintiff exchanged several letters in which the plaintiff demanded compensation because the insured allegedly misrepresented that it would relocate certain utility lines and breached a contractual obligation to relocate the lines, resulting in higher costs of project completion for the plaintiff. The court concluded that the prior correspondence "constituted a written claim for 'damages' first made against the insured City before the policy period, not during it." The court therefore held that the underlying suit was not a claim first made during the policy period notwithstanding that the complaint was filed during the policy period.

The court also held that coverage was barred by an exclusion in a retroactive date endorsement that extended coverage to wrongful acts occurring after the retroactive date, but before the inception of the policy, subject to certain exclusions. One exclusion barred coverage where, prior to the policy's inception, "any Insured had a reasonable basis to believe that the 'wrongful act' might result in a claim or suit." Based on the correspondence discussed above, the court concluded that the policyholder had a "reasonable basis" to believe that the wrongful acts alleged by the plaintiff would result in a suit because the plaintiff stated on a number of occasions that it intended to file a "formal claim."

Claim for Bad-Faith Refusal to Advance Defense Costs Permitted to Proceed Despite Absence of Duty to Defend

The United States District Court for the Southern District of Ohio, applying Ohio law, has held that an insured pled facts sufficient to survive a motion to dismiss on its claim for bad faith against its insurer where the complaint alleged that the insurer refused to advance defense costs in bad faith pursuant to a D&O policy that "contemplated the advancement of defense costs" but did not contain a duty to defend. *Abercrombie & Fitch Co. v. Federal Ins. Co.*, 2008 WL 656029 (S.D. Ohio Mar. 11, 2008).

The insurer issued a D&O policy that expressly disclaimed a duty to defend. The insurer refused to advance defense costs for the underlying litigation and a related SEC investigation. The insured brought suit against the insurer alleging, *inter alia*, bad faith refusal to pay defense costs. The insurer moved to dismiss the bad faith claim, arguing that the policy provisions did not require it to advance defense costs. The insured countered that the policy required the insurer to pay defense costs that it became legally obligated to pay.

The court noted that several policy provisions contemplated that the insurer would advance defense costs despite the absence of a duty to defend. First, the policy specified that "[a]ny advancement of Defense Costs shall be repaid to the Company by the Insureds, severally according to their respective Interests, if and to the extent it is determined that such Defense Costs are not Insured under this coverage section." Moreover, the policy's allocation provision specified that the insurer "shall advance on a current basis Defense Costs allocated to the covered Loss" if the parties could agree on allocation. If no allocation agreement could be reached, the policy stated that the insurer "shall advance on a current basis Defense Costs which the [insurer] believes to be covered under this coverage section until a different allocation is negotiated, arbitrated or judicially determined." Finally, the policy provided that the insurer "may pay covered Loss as it becomes due . . . without regard to the potential for other future payment obligations."

After examining these policy provisions, the court held that "[w]hile the policy does not contain a duty to defend, . . . the policy clearly contemplates the advance payment of defense costs, whether by agreement or by other determination." The court then denied the motion to dismiss, stating that, "[b]ased on this policy language, the Court cannot conclude that there are no set of facts upon which [the insured] can base its claim for bad faith."

Illinois Court Holds that New York Law Bars Indemnification for Criminal Conduct

An Illinois intermediate appellate court, applying New York law, has held that an insurer had no duty to indemnify a policyholder that knowingly concealed the fraud of its client. *BDO Seidman, LLP v. Harris*, 2008 WL 696880 (Ill. App. Ct. Mar. 13, 2008).

The policyholder, a provider of tax accounting services, was charged with misprision of felony for "knowingly conceal[ing] the felony fraud of its client." The client was a structured-settlement company that assumed liabilities of defendants in personal injury cases and was required to invest its funds in United States Treasury instruments and use the proceeds to provide a return to the injured plaintiffs from the underlying settlements of the personal injury suits. The accounting firm had advised the settlement company that, if it intended to invest in other securities, it must purchase additional Treasury instruments in order to receive its tax exemptions.

The accounting firm ultimately resolved the misprision charge by a pretrial diversion agreement in connection with which it admitted to submitting its client's tax return and to failing to inform the Internal Revenue Service of information material to the determination of its client's tax return where it "knew and understood" that the client failed to purchase the Treasury instruments required in order to receive the claimed tax exemptions. In

addition, the accounting firm agreed to pay $16 million to a fund set up to benefit the victims of the client's fraud from its failure to purchase the Treasury instruments.

The policyholder sought indemnification for the $16 million under an E&O policy that provided that "[t]his policy excludes . . .[t]o the extent it is uninsurable: (a) any claim or claims for fines, penalties, punitive or exemplary damages imposed by a judgment or any other final adjudication."

The carrier denied coverage. The appellate court held that the denial was proper, stating that where the policyholder admitted to "knowingly concealing the felony fraud of its client . . . indemnification for such criminal conduct is barred by public policy." In its holding, the court relied on *Drexel Burnham Lambert Group, Inc. v. Vigilant Insurance Co.*, 595 N.Y.S.2d 999 (1993), for the proposition that "[i]ndemnification from insurers for admitted criminal conduct cannot be permitted . . . [and is] barred by considerations of public policy."