

Prior Knowledge Provision and Personal Profit Exclusion Bar Coverage for Claims Arising Out of Kickback Scheme

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The United States District Court for the Southern District of New York has held that a prior knowledge provision in the insuring agreement and a personal profit exclusion bar coverage for claims relating to an insured's scheme of paying kickbacks to third parties. *Am. Auto. Ins. Co. v. Advest, Inc.*, 2009 WL 3490060 (S.D.N.Y. Oct. 28, 2009). The court also held that the insurer was not estopped from raising these defenses because it had provided a defense subject to a complete reservation of rights.

The insured company was a registered broker-dealer insured under a securities broker/dealer professional liability policy. One of the insured's employees pleaded guilty to engaging in an illegal scheme in which the employee paid kickbacks to a third party in exchange for more favorable rates on securities. The insured company issued a report to the National Association of Securities Dealers (NASD) on December 13, 2004 advising the NASD of this scheme and noting that it may have incurred legal liability to the third party. Later, the third party sued the insured for liabilities arising from this scheme.

The policy's insuring agreement provided specified coverage for claims resulting from wrongful acts, provided that no insured had knowledge prior to the policy's inception of any wrongful act that could reasonably be expected to result in a claim. The policy incepted on January 1, 2005. The policy also excluded coverage for all claims "arising out of, attributable to, related to, or in any way connected with" activities through which the insured "gained in fact any personal profit or advantage to which the INSURED was not legally entitled."

The court first found that the claim did not fall within the policy's coverage grant because the December 14, 2004 report to NASD provided "undisputed evidence" that the insured company knew of the alleged wrongful acts and of the possibility of legal liability to third parties prior to the policy's January 1, 2005 inception date. The court also found that the personal profit exclusion barred coverage based upon evidence that the insured earned commissions from each unlawful trade and deposition testimony in which the insured admitted that it "would have made some profit" as a result of the scheme.

The court also rejected the insured's argument that the insurer should be estopped from denying coverage because the insurer knew about the insured's efforts to settle the case but did not caution that coverage might be unavailable. In rejecting this argument, the court noted (i) the lack of evidence that the insurer had led the insured to believe that it would not assert coverage defenses, and (ii) the fact that the insurer expressly had reserved its rights to deny coverage based on, among other things, the prior knowledge provision and personal profit exclusion.