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NEWSLETTER

Coverage Precluded By Insolvency Exclusion Where Claims Arose Out of Bankruptcy of Securities Broker

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The United States District Court for the District of Connecticut, applying Connecticut law, has held that coverage under a bankers professional liability policy was precluded by the policy's insolvency exclusion where the underlying claims "arose out of" the bankruptcy of a third-party securities broker or dealer. *Assoc. Community Bancorp, Inc. v. The Travelers Cos.*, 2010 WL 1416842 (D. Conn. Apr. 8, 2010). The court also held that coverage was barred by the professional services exclusion of the management liability coverage part of the policy.

The insureds were a bank holding company and its wholly-owned subsidiary, a nationally chartered bank. Investor customers of the bank filed four lawsuits against the insureds, each seeking return of lost funds and fees paid to the insureds after the investors lost all of their investments in connection with the Bernard Madoff ponzi scheme. The investors allegedly entered into a custodian agreement that directed the insureds to invest their funds in the scheme. When the scheme unraveled and the broker/dealer running the scheme filed for bankruptcy, the investors lost their investment and were unable to recover their lost investment from the broker/dealer, which resulted in the investors filing suits against the insureds to recover their investments. The insureds tendered notice of the underlying actions to its insurer, seeking payment of its defense costs in defense of the suits.

The insurance policy included both a bankers professional liability and management liability insuring agreement. The bankers professional liability coverage part contained an insolvency exclusion stating that the policy did not provide coverage for:

Loss [including Defense Costs] on the account of any claim made against any Insured . . . based upon, arising out of or attributable to the insolvency,. . . receivership, bankruptcy, or liquidation of, or financial inability to pay . . . by any . . . investment company, . . . or any broker or dealer in securities or commodities. . . .

In addition, the management liability coverage part included a professional services exclusion that provided:

The Insurer shall not be liable for any Loss on account of any Claim made against any Insured based upon, arising out of, or attributable to the rendering of, or failure to render, any service to a customer of the Company.

The insurer denied coverage for the underlying suits based on, among other things, the insolvency exclusion and the professional services exclusion.

The district court ruled in favor of the insurer, holding that the insolvency exclusion unambiguously barred coverage for the underlying suits. The court focused on the "arising out of" language in the insolvency exclusion, recognizing that Connecticut law "broadly" interprets "arising out of" and that the phrase does not require that "the insured's alleged conduct . . . be the proximate cause for the injury." In so holding, the court stated that:

Any reading of the plain language of the insolvency exclusion excludes coverage of the investors' claims. The underlying lawsuits are certainly connected with, incident to, or flow out of [the broker/dealer's] insolvency. Had [the broker/dealer] not become insolvent and lost the investors' money, the investors would have had no damage and thus no reason to file suit against [the insured].

The court thus found that a "causal connection" existed between the insolvency of the scheme and the underlying claims and stated that it "will not torture the language of the exclusion in order to find an ambiguity where none exists." In reaching its conclusion, the district court relied on a litany of federal and state court cases in its interpretation and application of the insolvency exclusion to preclude coverage, including, among others, *Coregis Insurance Co. v. American Health Foundation*, 241 F.3d 123 (2d Cir. 2001), in which the court stated that "most courts have held that insolvency exclusions in such policies apply despite the fact that liability for such claims is premised on mistakes made prior to the insolvency by persons independent of the insolvent entity."

The district court rejected the insured's argument that the underlying claim was caused by an insolvency created by a third party and that, because the policy did not explicitly exclude such claims, the policy was ambiguous and should be interpreted in its favor. The court stated that it "can find no reasonable basis to write in a requirement that the insolvency be caused by the Insured." Moreover, the court noted that the insolvency exclusion excluded "any claim," which the "courts reads . . . to mean just that-*any* claim." In further addressing the insolvency exclusion, the court also rejected the insured's contention that the broker/dealer scheme was a "criminal enterprise," and thus the broker/dealer was something other than an "investment company" or "broker or dealer in securities" as required by the insolvency exclusion. The court recognized that the "the insolvency exclusion does cover 'sham investment companies,' because it covers claims arising out of

the insolvency of 'any . . . investment company . . . . Simply because ["any"] is a broad term does not mean that it is ambiguous."

The district court also held that the professional services exclusion in the management liability coverage part barred coverage for the insured's claims. The court rejected the insured's argument that the professional services exclusion "essentially eviscerates" the errors and omissions coverage, stating that the actions excluded by the professional services exclusion are covered by the professional liability coverage part, subject to that coverage part's terms, conditions and exclusions. The court held that "the investors were unambiguously 'customers' of the [insured] within the meaning of [the professional services] exclusion. The investors' claims arise out of the [insured's] 'rendering of, or failure to render' services . . . . Therefore, the investors' claims fall within the Professional Services Exclusion, and [the insured] cannot claim coverage under the Management Liability Agreement."