

An Insured's Pre-Inception Knowledge of His Thefts From Clients Bars Coverage For All Insureds

September 2010

Applying Alabama law, the United States District Court for the Northern District of Alabama has granted summary judgment to an insurer, holding that coverage for a series of employee thefts is precluded by the prior knowledge condition of the policy's coverage agreement. *Professional Asset Strategies v. Continental Cas. Co.*, No. 2:09-cv-1238 (N.D. Ala. Aug. 27, 2010). Wiley Rein LLP represented the insurer in this litigation.

The insurer issued a professional liability policy to the insured, an investment advisor, for claims arising out of the insured's acts or omissions in providing "professional services." The insuring agreement included a prior knowledge condition to coverage requiring that, prior to the policy's effective date, no insured (*i.e.*, "none of you") had a basis to believe that any act or omission might reasonably be expected to be the basis of a claim. The policy defined "you" to include any employee of the insured, "but only for professional services performed on behalf of the Named Insured." The policy also included an "innocent insured" provision that saved coverage for innocent insureds if coverage "that would otherwise be afforded" under the policy would be excluded as a result of any "dishonest, illegal, fraudulent, criminal or malicious act" of another insured.

An employee of the investment firm committed a series of thefts from the firm's clients, who also were members of the employee's family, prior to the policy's effective date. No one else at the firm knew about the employee's actions at the time. Upon discovery, the thefts resulted in multiple demands against the firm.

The court held that the prior knowledge condition to the insuring agreement precluded coverage for all claims arising from the thefts. First, the court rejected the investment firm's argument that the employee was not a "you" for purposes of the prior knowledge condition because his thefts did not constitute "professional services" performed on behalf of the firm. The court noted that the thefts occurred in the course of the employee's provision of professional services, and that if the thefts were not "professional services," then coverage would be unavailable because the demands would not constitute "claims" as defined in the policy.

Second, the court applied an objective standard and held that the employee knew or should have known that his thefts might lead to a claim under the policy. The court rejected the firm's argument that the employee reasonably might have believed that the clients, who were members of his family, would not discover his thefts

or would turn a blind eye if they did discover them. The court opined that the question is not whether the employee "reasonably could *not* have believed that his actions would result in a claim" but whether, objectively, he reasonably should have expected that his actions might result in a claim. The court concluded that a reasonable investment advisor would expect that his theft of client funds might result in a claim against his employer, and therefore the employee's prior knowledge of his thefts precluded coverage under the plain language of the prior knowledge condition.

The court then held that the innocent insured provision saves coverage for "innocent insureds" only where coverage that "would otherwise be afforded" is excluded by the policy's exclusion for "dishonest, illegal, fraudulent, criminal or malicious acts." The innocent insured provision was inapplicable here because the claims did not fall within the policy's coverage grant by virtue of an insured's *knowledge* of potential claims, not the character of the acts as "dishonest, illegal, fraudulent, criminal or malicious." Accordingly, coverage would not "otherwise be afforded" and was not precluded by the policy's dishonesty exclusion.