

No Coverage for “Innocent” Insureds Based on Broad Language of Customer Funds Exclusion

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The United States Court of Appeals for the Eighth Circuit has affirmed summary judgment in favor of an insurer, holding that a “Customer Funds Exclusion” in a professional liability policy issued to a title insurance agency unambiguously barred coverage for claims alleging that the agency and its employees misappropriated funds entrusted to the agency by a title insurer. *Bethel v. Darwin Select Ins. Co.*, 2013 WL 6050750 (8th Cir. Nov. 18, 2013). In addition, the court rejected the argument advanced by several individuals that they should be afforded coverage as “innocent insureds,” ruling instead that the plain language of the “Customer Funds Exclusion” barred coverage for any claim that arises out of any loss or improper use of client funds, regardless of whether that loss was caused by a “guilty” insured, an “innocent” insured, or even a non-insured. *Id.*

The policyholder, an insurance agency, entered into an agreement whereby it agreed to serve as an agent for an insurance company. Under that agreement, the agency was responsible for recording mortgages, deeds, and mortgage satisfactions as well as paying fees associated with those recordings, and it also paid off mortgages on behalf of the insurer and its customers in order to facilitate refinancing transactions. To enable the agency to make those payments, the insurance company entrusted it with millions of dollars, which the agency was required to segregate into a separate account. Approximately 14 months into the agreement, the insurance company terminated the parties' relationship and filed a lawsuit against, among other parties, the agency and two individual insureds, alleging a wide-ranging fraudulent scheme to misappropriate funds entrusted to the agency. The complaint also contained counts for negligence and breach of contract based upon the same alleged scheme. The insurer refused to defend the action, contending that the entire complaint fell within the “Customer Funds Exclusion” to its policy.

The Eighth Circuit Court of Appeals affirmed summary judgment on behalf of the insurer. The court applied the “Customer Funds Exclusion”—which barred coverage for “any Claim . . . based upon, arising out of, directly or indirectly resulting from, in consequence of, or in any way involving . . . any actual or alleged . . . loss, disappearance, pilferage or shortage of, or commingling or improper use of, or failure to segregate or safeguard, any client or customer funds, monies or securities”—to hold that there was no coverage for the underlying complaint. Observing that Minnesota courts have given the phrase “arising out of” broad

meaning, the court determined that the exclusion applied because there was a “direct cause-and-effect relationship between all actionable conduct alleged in [the] complaint and the loss or improper use of customer funds.” The court specifically rejected the insureds' argument that the alleged failure to record mortgage instruments could have occurred in the absence of fund misappropriation, concluding that the court would not “imagine a scenario” that was not pled in the underlying suit.

In addition, the court rejected the two individual insureds' attempt to invoke the “innocent insured” doctrine. In so ruling, the court distinguished prior case law applying policy language excluding conduct by “the insured,” concluding that the policy language here barred coverage for the acts of anyone—be it a “guilty” insured, “innocent” insured, or even a non-insured—since its terms barred coverage for “any Claim . . . based upon, arising out of, directly or indirectly resulting from, in consequence of, or in any way involving . . . any actual or alleged . . . loss” or improper use of customer funds.