

Insurer's Failure to Cite to Policy Exclusion in Reservation of Rights Letter Does Not Waive Coverage Defense

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In an unpublished decision, the U.S. Court of Appeals for the Second Circuit, applying New York law, has held that a professional liability insurer did not waive its right to deny coverage on the basis of an intentional acts exclusion by failing to include the defense in its original coverage denial. *Westport Res. Inv. Serv., Inc. v. Chubb Custom Ins. Co.*, 2004 WL 2166308 (2d Cir. Sept 23, 2004).

The insurer issued a claims-made professional liability policy to a securities brokerage firm that covered the firm against "Wrongful Acts" committed by employees or representatives of the firm. The policy contained an exclusion for claims "brought about or contributed to by...any knowing, intentional, fraudulent, or dishonest Wrongful Act by an Insured." The exclusion contained an exception for parties who did not participate in or acquiesce to such acts, but the exception did not apply to "[c]laims based on or directly or indirectly arising out of or resulting from, in whole or in part, an Insured's commission of...any criminal act."

One of the brokerage firm's registered representatives allegedly sold millions of dollars of unregistered and worthless securities to clients of the firm. The representative was convicted of fraud. In August 2001, two of the firm's investor clients brought National Association of Securities Dealers arbitrations against the firm, alleging that it negligently failed to supervise the agent. The firm tendered the claims to the insurer for defense and indemnity. The insurer declined to provide coverage because the wrongful acts allegedly were committed prior to the policy's retroactive date. At that time, the insurer did not specifically identify the intentional acts exclusion as a basis for denying coverage, but did reserve the right to invoke other policy exclusions in the future.

In affirming the district court's decision, the Second Circuit rejected the brokerage firm's contention that the intentional acts exclusion did not preclude coverage, and that the insurer had waived its right to assert such a defense by failing specifically to include it in its initial coverage denial letter. In doing so, the court first held that the exclusion clearly precluded coverage because "there is no question that the underlying claims brought against [the insured firm] were 'brought about or contributed to by' [the representative's] fraudulent conduct." Moreover, the court concluded that the exception to the exclusion did not apply because the representative's conduct was "undisputedly criminal," and the underlying claims in the arbitration were "

'based on' and directly 'ar[ose] out' of [his] conduct."

With respect to the insurer's failure to cite the exclusion in its initial coverage denial letter, the court explained that, under New York law, the doctrine that an insurer intends to waive a defense to coverage that is not asserted where other defenses are cited was subject to the "major limitation" that "where the issue is the existence or nonexistence of coverage (*e.g.*, the insuring clause and exclusions), the doctrine of waiver is simply inapplicable." The court concluded that the applicability of the intentional acts exclusion went to the existence or non-existence of coverage and that, as a result, the insurer had not waived its defense. The court further stated that to rule otherwise "would give [the brokerage firm] insurance that it never purchased, namely, coverage for the criminal acts of its representative."

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