

ALERT

Misappropriation and Personal Profit Exclusions Do Not Preclude Duty to Defend Negligent Supervision Claim

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A federal district court in New York has held that an insurer has a duty to defend negligent supervision claims against insured employer even though the alleged damages arise out of the intentional and fraudulent conduct of the insured's employee. *American Automobile Insurance Company v. Security Income Planners & Co., LLC*, 2012 WL 957528 (E.D.N.Y. Mar. 22, 2012).

An employee of the insured, an investment consulting firm, was sued by two clients, alleging that the employee had engaged in a systematic scheme by which he defrauded the clients out of their investment funds. The employee also was prosecuted and ultimately pleaded guilty to criminal charges relating to the fraud. Meanwhile, the clients filed an amended complaint, naming the firm as a defendant and asserting claims against the firm for negligent supervision. The insurer denied coverage for these claims on the grounds that the clients sought to recover from the firm the amounts misappropriated by the employee and from which the employee illegally profited. In taking this position, the insurer relied on two policy exclusions that precluded coverage for claims "based upon, arising out of . . . [a]ny commingling, misappropriation or conversion of funds" and for claims "based upon, arising out of any Insured gaining in fact any personal profit or advantage to which such Insured was not legally entitled."

In the coverage litigation that followed, the court rejected the insurer's position and concluded that the exclusions did not apply to the negligent supervision claims against the firm because neither improper personal profit nor misappropriation was an element of

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those claims. The court also pointed out that although the employee's conduct was intentional and fraudulent, the claims against the firm did not allege that the firm gained any improper personal profit through its failure to supervise or that the firm improperly commingled, misappropriated or converted funds.