

Allegations of Fraudulent Transfer Excluded under “Knowingly Wrongful Acts” and “Unlawful Profit” Exclusions in Legal Malpractice Policy

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In an unreported decision, a federal district court, applying New York law, has held that an insurer was not obligated to defend or indemnify a law firm that was sued for aiding and abetting a company's directors in breaching their fiduciary duties and for fraudulently transferring certain shares of stock to itself because the allegations fell within the "knowingly wrongful acts" and "unlawful profit" exclusions in the firm's legal malpractice policy. *Steadfast Ins. Co. v. Stook Stook & Lavan LLP*, 2003 WL 21243020 (S.D.N.Y. May 28, 2003).

A law firm purchased a claims-made professional liability policy. The policy barred claims "based on, arising out of or resulting from in fact: (1) any malicious, knowingly wrongful, or criminal act, error, omission, or breach of duty...; or (3) the gaining by any Insured...of any profit, gain or advantage to which such Insured or person was not legally entitled."

A committee of unsecured creditors for a bankrupt company, which had been represented by the law firm in earlier transactions, commenced a bankruptcy proceeding against the law firm. The creditors alleged that the law firm "conspired with and aided and abetted" the company's directors to breach their fiduciary duties to the creditors in connection with a distribution of certain common stock. The creditors also alleged that the law firm fraudulently transferred certain shares of stock to itself. After the creditors and law firm settled the dispute, the law firm and the insurer entered into coverage litigation.

The district court held, based on a comparison between the allegations in the underlying complaint and the terms of the policy, that no coverage was available. The court reasoned that the allegations that the law firm aided and abetted and conspired to breach a fiduciary duty required proof of actual knowledge and that they therefore fell squarely within the "knowingly wrongful acts" exclusion. The court determined that the allegations relating to the law firm's transfer of shares to itself alleged that the law firm received an unlawful advantage based on those transfers and therefore fell wholly within the "unlawful profit, gain, or advantage" exclusion. The court also rejected the law firm's argument that the insurer had waived its coverage defenses by failing to timely disclaim coverage, noting that the insurer "reserved its right to disclaim coverage by

issuing two reservation of rights letters notifying [the law firm] about its potential denial of coverage on the identical bases asserted in this litigation."

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