

Pennsylvania District Court Holds Sale of Unregistered Securities Does Not Constitute “Professional Services” and Bars Coverage Based on Insolvency Exclusion

November 2008

The United States District Court for the Middle District of Pennsylvania has held that a claims-made errors and omissions policy does not provide coverage for a broker/dealer's sale of unapproved and unregistered offshore securities because the activities do not fall within the policy's definition of "professional services." The court also held that because the underlying claims arose out of the bankruptcy of the offshore trust in which the claimants invested, they were barred by the policy's Insolvency Exclusion. The court also found no evidence of bad faith where the insurer engaged experienced outside counsel to conduct the coverage investigation and had meaningful contact with representatives of the policyholder before denying coverage. *Smith v. Continental Casualty Co.*, 2008 WL 4462120 (M.D. Pa. Sept. 30, 2008).

The insurer issued an errors and omissions policy to a life insurer and its registered broker/dealer subsidiary. The underlying plaintiffs sought retirement planning advice from a representative of the insured, who recommended investing in an offshore trust that was not approved by the insured as an investment vehicle. The claimants purchased interests in the trust, which subsequently declared bankruptcy, and lost all their savings. After settling their action against the investment adviser and obtaining an assignment of rights under the policy, the claimants brought the instant action against the insurer.

The court held that the policy did not afford coverage for the claim. First, the court found that "under the plain and unambiguous language of the policy" the policy, did not cover the underlying claims because it only applied to wrongful acts "arising from rendering or failing to render 'professional services.'" The policy defined "professional services" in relevant part as "the sale or attempted sale or servicing of variable annuities, variable life insurance and mutual funds, which are registered with the Securities Exchange Commission (SEC) (if required), through a Broker/Dealer that is a member of the National Association of Securities Dealers." The court held that because the offshore trust securities sold by the insured's representative were not registered with the SEC or sold through a NASD-registered broker/dealer, his advice did not constitute "professional services" covered by the policy. Similarly, the court held that an exclusion

barring coverage for claims "involving securities or products not approved by" the insured broker/dealer also precluded coverage because the insured had expressly informed the insurer that it had not approved the securities at issue for sale.

The court then considered the applicability of the policy's "Insolvency Exclusion," which was a matter of first impression under Pennsylvania law. The court noted that, "[w]hile most courts have interpreted this insolvency exclusion in the context of suits against insurance brokers who obtain coverage for a client with a subsequently failed insurance company . . . , the Seventh Circuit extended the reasoning of these decisions to claims against an investment advisor in *Transamerica Insurance Co. v. South*, 975 F.2d 321, 328-32 (7th Cir. 1992)." Relying on the analysis in *Transamerica*, the court reasoned that although the claimants "asserted several different theories of recovery . . . , each of their claims is premised on the fact that [the insured] directly or indirectly, placed their funds in Evergreen, which then went bankrupt and was unable to pay any return on their investment." Accordingly, all of the underlying claims "arose out of" the trust's insolvency and were excluded by the Insolvency Exclusion.

Finally, the court rejected plaintiffs' bad faith claim because they did not meet the "high burden" of showing "by clear and convincing evidence that the insurer (1) did not have a reasonable basis for denying benefits under the policy and (2) knew or recklessly disregarded its lack of a reasonable basis in denying the claim." The court found that the insurer clearly had a reasonable basis for denying coverage and that the insurer's engagement of experienced coverage counsel to evaluate the claims and conduct meetings with representatives of the insured belied the plaintiffs' claims of bad faith in investigating coverage.