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NEWSLETTER

"Prior Knowledge" Clause Bars Coverage for Claims Arising out of Ponzi Scheme Created By One of the Insured's Officers/Directors

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A federal district court, applying South Carolina law, has held that a "prior knowledge" provision bars coverage for claims brought against an insured financial planning and investment services company where the claims arose out of a Ponzi scheme that was created by one of the insured's officers/directors before the inception of the policies at issue. *Cont'l Cas. Co. v. Battery Wealth, Inc.*, No. 2:09cv00605 (WOB) (D.S.C. May 5, 2011).

In 2002, the insured, a provider of financial planning and investment services, recommended that clients invest in funds or pools managed by one of its officers/directors. Between 2002 and 2007, investors invested $6.5 million in the investment pools recommended by the insured. The investment pools, however, proved to be a fraudulent Ponzi scheme for which an insured officer and director was criminally prosecuted. There was no contention that other individual insureds had actual knowledge of the fraud. After defrauded investors asserted claims against the insured company and its directors and officers, the insurer sought a declaration that it owed no coverage for the claims under the Tax and Financial Service Professional Liability policies it issued to the insured for the periods May 1, 2006 to May 1, 2007 and May 1, 2007 to May 1, 2008. The investors intervened in the coverage litigation in support of the insured.

The district court concluded that coverage was barred by the policies' "prior knowledge" provision contained in the policies' coverage agreement. Under that clause, coverage was available only if, "prior to the effective date of this Policy, none of you had a basis to believe that any such act or omission, or interrelated act or omission, might reasonably be expected to be the basis of a claim." The term "you" was defined, in relevant part, as the insured company and "any person who is or becomes a partner, officer, director, associate, or employee . . . but only for the professional services performed on behalf of the" company. Because the defrauding officer/director fell within the definition of "you" and had knowledge of his own fraudulent acts (which began prior to the policies' inception), the court held that the "prior knowledge" clause barred coverage for the underlying claims, as the officer/director "had a basis to believe" that his acts "might reasonably be expected to be the basis of a claim."

In reaching its conclusion, the court rejected the investors' argument that their suit against the insured was not for fraud, but rather was for negligent mismanagement in making reports to its clients. The court explained that, because the officer/director had notice of his own fraud, he also knew that he and his partners were not reporting to their clients properly, which itself might lead to a claim. The court also concluded that the investors' argument that they were not seeking recovery under the Financial Planning Endorsement of the policies, but rather only under the basic coverage agreement for "claims" arising out of the insured's provision of "professional services," was without merit, as the insured's conduct only fell within the coverage provided by the endorsement.