

ALERT

Eleventh Circuit Affirms That an Insured's Pre-Inception Knowledge of His Thefts from Clients Bars Coverage for All Insureds

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The United States Court of Appeals for the Eleventh Circuit, applying Alabama law, has affirmed the trial court's grant of summary judgment to an insurer based on its holding that coverage for a series of employee thefts is precluded by the prior knowledge condition of the policy's insuring agreement. *Professional Asset Strategies, LLC v. Continental Cas. Co.*, No. 10-14302 (11th Cir. Nov. 17, 2011). Wiley Rein LLP represented the insurer in this litigation.

The insurer issued a professional liability policy to the insured, an investment advisor, for claims arising out of the insured's acts or omissions in providing "professional services." The insuring agreement included a prior knowledge condition to coverage requiring that, prior to the policy's effective date, no insured (*i.e.*, "none of you") had a basis to believe that any act or omission might reasonably be expected to be the basis of a claim. The policy defined "you" to include any employee of the insured, "but only for professional services performed on behalf of the Named Insured." The policy also included an "innocent insured" provision that saved coverage for innocent insureds if coverage "that would otherwise be afforded" under the policy would be excluded as a result of any "dishonest, illegal, fraudulent, criminal or malicious act" of another insured.

An employee of the investment firm committed a series of thefts from the firm's clients, who also were members of the employee's family, prior to the policy's effective date. No one else at the firm knew about the employee's actions at the time. Upon discovery, the thefts resulted in multiple demands against the firm.

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The trial court held that the prior knowledge condition of the policy's insuring agreement had not been met and, therefore, there was no coverage under the policy for any claim arising from the thefts. The Eleventh Circuit agreed, and affirmed the trial court's decision. Like the trial court, the appellate court rejected the insured's argument that its employee's conduct could not constitute "professional services" because he had acted outside the scope of his duties. The appellate court reasoned that the fact that "a person acted outside his authority does not mean he was not in the act of rendering professional services." The court also pointed out that, if the employee's acts were not "professional services," then coverage would be unavailable because the demands would not constitute "claims" as defined in the policy.

The court also rejected the insured's argument that a material fact existed as to whether the employee believed that his acts would result in a claim against the investment firm. The court explained that, under the policy's language, the relevant question "is whether an objective person in [the employee's] position should have expected that his actions might form the basis of a claim." According to the court, based on the stipulated facts, which showed that the employee expended some effort to hide his thefts, "a reasonable person could only expect that these acts might form the basis of a claim."

Finally, the court agreed that the innocent insured provision was inapplicable. The court explained that coverage was denied because an insured had pre-inception knowledge of acts that might reasonably be the basis of a claim, and not because the character of the known acts was "dishonest, illegal, fraudulent, criminal or malicious." Accordingly, the innocent insured provision was not triggered. In support of its conclusion, the court relied on the Fourth Circuit's decision in *Bryan Brothers, Inc. v. Continental Casualty Co.*, — F.3d —, No. 10-1439 (4th Cir. Mar. 24, 2011). In *Bryan Brothers*, the Fourth Circuit considered identical policy language and held that the policy's prior knowledge provision was a condition precedent to coverage that is not limited by the innocent insured provision.