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ALERT

Dishonesty Exclusion Precludes Coverage for Claim Based in Part Upon Knowingly Wrongful or Fraudulent Acts

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The United States District Court for the Eastern District of New York, applying New York law, has held that a dishonesty exclusion precluding liability "based in whole or in part" on knowingly wrongful or fraudulent conduct barred coverage for a lawsuit alleging at least some knowingly wrongful or fraudulent conduct on the part of the policyholder. *Silverman Neu, LLP v. Admiral Ins. Co.*, 2013 WL 1248629 (E.D.N.Y. Mar. 28, 2013). The court emphasized the broad scope of the lead-in language, holding that because some of the allegations in the complaint were based upon knowingly wrongful or fraudulent conduct, the insurer was completely relieved of its duty to defend.

An insurer issued a claims-made professional liability policy with a duty to defend to an accounting and auditing firm. The insured's audit clients included two debt management and credit counseling firms for which the insured filed IRS forms in support of their nonprofit status. The insured's clients were sued in a class action alleging violations of the Credit Repair Reorganization Act (CROA), which settled for approximately $260 million dollars. The class action court established a constructive trust for the amount of the judgment. Subsequently, a putative class of customers of the credit counseling companies filed a lawsuit against the insured auditing firm, among other defendants, for allegedly knowingly filing forms with the IRS that misstated the nature of the credit counseling firms' status and facilitated the firms' ability to market themselves. In the litigation against the insured, the plaintiffs sought recovery of proceeds from the constructive trust, from which the firm was allegedly paid monies, as well as recovery for violations of CROA.

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The insurer denied coverage for the underlying litigation on the basis of a dishonesty exclusion and a financial services exclusion; that the claims did not arise from a "professional incident" as required in the insuring agreement; and that the amounts sought in the underlying litigation did not qualify as "damages" under the policy's insuring agreement. The firm's successor entity then sued the carrier, seeking a declaratory judgment that the insurer had a duty to defend it in the underlying litigation.

On cross-motions for summary judgment, the court held that the insurer had no duty to defend on the basis of the policy's dishonesty exclusion. The court assumed *arguendo* that the claim implicated the policy's insuring agreement and that the claim was first made during the policy period. The dishonesty exclusion precluded coverage for claims "based in whole or in part on any knowingly wrongful, dishonest, fraudulent, criminal or malicious act committed by or at the direction of any 'Insured' in the course of providing 'professional services.'" The policyholder conceded that the complaint, at least in part, alleged fraud and knowingly wrongful acts, but argued that the insurer nonetheless had a duty to defend because the complaint could be construed as also alleging negligence. The court disagreed, attaching importance to the language "in whole or in part" in the exclusion. Because at least some of the allegations in the complaint were based on knowingly wrongful, dishonest or fraudulent acts, the insurer lacked a duty to defend notwithstanding other allegations of arguably negligent conduct.

The opinion is available here.