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SECOND CIRCUIT AFFIRMS S.D.N.Y. DECISION FINDING NO COVERAGE DUE TO "PRIOR KNOWLEDGE" EXCLUSION IN BROKER/DEALER PROFESSIONAL LIABILITY CLAIMS-MADE POLICY

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On November 16, 2010, the 2nd Circuit affirmed a decision by Judge Peter K. Leisure of the Southern District of New York granting the insurer's (Quanta) motion for summary judgment as to professional liability coverage. *See Quanta Specialty Lines Ins. Co. v. Investors Capital Corp.*, No. 10-0219, 2010 U.S. App. LEXIS 23594 (2d Cir. Nov. 16, 2010), *affirming*, No. 06 Civ. 4624 (PKL), 2009 U.S. Dist. LEXIS 117689 (S.D.N.Y. Dec. 17, 2009). In *Quanta*, the district court construed two consecutively issued broker/dealer and registered representative professional liability claims-made policies and held that Quanta was not obligated to provide coverage for either defense or indemnity to its insured (ICC) regarding arbitrations arising out of a former ICC broker's sale of certain unregistered securities. The court enforced the "prior knowledge" exclusion and held that ICC's knowledge of related claims asserted prior to the inception date of the earlier policy barred coverage. The District Court's opinion is notable in several respects, but primarily due to the court's thorough analysis of the "prior knowledge" exclusion and its adoption of a mixed subjective/objective test to determine an insured's prior knowledge of a claim.

Factual Overview

In June 2004, ICC was contacted by a securities investigator from the North Carolina Division of Securities (the Division) who requested information related to a former ICC employee-broker Jones who had worked with ICC from April 1998 to December 2001. Specifically, the Division requested information related to the sale of potentially unregistered BAB Productions securities (BAB) sold by Jones to an investor, Whitehead. The matter was eventually referred to an ICC attorney. In November 2004, the Division entered a Final Cease and Desist Order against Jones (who at that point no longer worked for ICC) prohibiting Jones from selling BAB securities, which the Division determined were unregistered.

Meanwhile, in October 2004, ICC had received a letter from an attorney on behalf of an investor (the Alston letter) claiming that Jones "under the supervision of ICC fraudulently sold unregistered [BAB] securities to Ms. Alston." The Alston letter enclosed a copy of the Division's Cease and Desist Order. An investigation by ICC's general counsel determined that Ms. Alston had actually not invested in BAB, and her attorney subsequently indicated that ICC could disregard Ms. Alston's letter and request for damages. An initial checklist prepared by an ICC attorney in response to the Alston letter indicated that the allegations should be reported to ICC's insurer.

The Policies

Thereafter, Quanta issued a claims-made policy providing ICC with professional liability broker/dealer, and registered representative coverage for the period of December 31, 2004 to December 31, 2005, along with a renewal policy for the following year. Section 1.A of the policies states in relevant part that the insurer will pay on behalf of the insured "Damages which the insured becomes legally obligated to pay because of a Claim that is both made against the Insured and reported to the Insurer in writing during the Policy Period …" A condition in the Insuring Agreement required that "[a]s of the inception date of this Policy … no Insured had knowledge or reasonable basis upon which to anticipate that the Wrongful Act or any Interrelated Wrongful Act could result in a Claim." The policies defined "Claim" as "a demand received by any Insureds for Damages (including pleadings received in a civil litigation or arbitration) for an actual or alleged Wrongful Act." The definition of claim excluded any governmental or agency proceedings or investigations. The policies also defined "Wrongful Act" and "Interrelated Wrongful Acts," and both policies contained a New York choice of law provision.

The Dispute

In August 2005 and April 2006, ICC was served with two separate NASD arbitration demands alleging that ICC was negligent in failing to supervise Jones in his sale of BAB securities. The investor involved in the original 2004 Division inquiry, Whitehead, later became a claimant in the arbitration. ICC did not advise Quanta of the 2004 Division inquiry until April 21, 2006, nor did ICC advise Quanta of the Alston allegations and the subsequent withdrawal of those allegations until May 8, 2006. ICC demanded coverage in response to the arbitrations, and Quanta disclaimed any coverage obligations. Quanta argued, *inter alia*, that the Alston letter and the subsequent arbitrations constituted a single claim that first arose prior to the inception date of the December 31, 2004 policy, and that as of the inception date of both policies, ICC had knowledge or a reasonable basis upon which to anticipate that a "Wrongful Act" or an "Interrelated Wrongful Act" could result in a claim.

The Alston Letter Constituted a Claim First Made Prior to The Policy Period

Applying New York law pursuant to the choice of law provisions, the court considered whether the Alston letter constituted a claim that arose out of the wrongful act alleged in the arbitrations. The court reasoned that the term Claim as defined in the policies was unambiguous under New York law, and that even though the Alston letter did not explicitly threaten a "lawsuit," it was still a claim because its purpose was a demand for damages. The court also noted that nothing in the definition of claim required that a lawsuit or other proceeding actually be threatened. The court bolstered its conclusion that the Alston letter constituted a claim by noting that ICC's attorney originally logged the Alston letter as reportable to its insurer.

The court also ruled that even though the Alston letter was subsequently withdrawn, it nevertheless constituted a claim because the definition of claim expressly included "actual or *alleged* Wrongful Acts." In the court's view, it made no difference that Alston never actually purchased BAB securities and that the allegations were ultimately discovered to be mistaken. The court noted that if it were to adopt ICC's position that an insurer has no duty to defend a groundless demand, an insured would be left defenseless whenever unfounded allegations were pursued against an insured.

The court then determined that because the Alston letter alleged ICC's negligent supervision of Jones, those allegations satisfied the policies' definition of "Wrongful Act." Finally, the court held that the Alston allegations and the arbitrations shared a "sufficient factual nexus" such that the Alston claim was related to the subsequent arbitration claims, and that the inaccuracy of the Alston allegations "does not erase the fact that they were made and were consistent with the factual allegations" in the later arbitrations. Indeed, the arbitrations alleged the purchase of BAB securities at a time coinciding with the time of purchase cited in the Alston letter.

The "Prior Knowledge" Exclusion: The Court Adopts A Mixed Subjective/Objective Analysis

Based on its analysis of the Division investigation and the Alston letter, the court held that as of the December 31, 2004 inception date of the first Quanta policy, ICC had knowledge or a reasonable basis upon which to anticipate that a wrongful act or interrelated wrongful act could result in a claim against it. The court began its analysis of the exclusion by noting that no New York court had addressed the proper standard for determining an insured's prior knowledge, although three recent S.D.N.Y. cases all applied an objective standard. One S.D.N.Y. case from 2006 relied on a decision from the Western District of Pennsylvania that applied an objective analysis inquiring into whether a reasonable insured aware of the facts could reasonably expect that a claim might result. *See Westport Ins. Co. v. Goldberger & Dubin, P.C.*, 255 Fed. Appx. 593 (2d. Cir. 2007), *affirming*, No. 04 Civ. 4384, 2006 U.S. Dist. LEXIS 31329, at *9, 16 (S.D.N.Y. Mar. 3, 2006) (citing *Mt. Airy Ins. Co. v. Thomas*, 954 F. Supp. 1073, 1080 (W.D. Pa. 1997)). The *Quanta* court explained that since the decision in *Mt. Airy*, the 3rd Circuit had adopted a two-step mixed subjective/objective analysis to construe prior knowledge exclusions under Pennsylvania law. *See Selko v. Home Ins. Co.*, 139 F.3d 146 (3d. Cir. 1998) (adopting test). The 2nd Circuit in *Westport* declined to predict whether New York courts would adopt a subjective or objective approach, and therefore the District Court in *Quanta* was free to conclude that the 3rd Circuit's mixed test was the most persuasive test and should govern.

Under the mixed test, a court first inquires whether the insured actually had knowledge of the relevant facts, and second, considers whether a reasonable person in the insured's position would have foreseen that those facts might form the basis of a claim. Applying the subjective test to the facts in *Quanta*, the court principally determined that because the same ICC attorney handled the initial North Carolina Division of Securities investigation as well as the Alston letter, ICC could not successfully claim that it was without knowledge as to relevant facts prior to the inception date of the 2004 policy. The court also cited several other examples to demonstrate ICC's subjective knowledge.

The court engaged in a somewhat lengthier analysis under the objective prong. ICC argued that because Alston withdrew her complaint and her lawyer orally assured ICC that it could disregard the allegations, there was no objective basis for a reasonable person in ICC's position to anticipate a claim. The court disagreed. The court noted that the District Court in *Westport* similarly rejected the insured's argument that, under an objective standard, it could not have reasonably foreseen that a wrongful act might form the basis of a claim. *See Quanta*, 2009 U.S. Dist. LEXIS 117689 at *52-53. There, the court held that the insured's subjective belief that a claim would not be brought based on the assurances of a potential adversary was irrelevant because a reasonable lawyer, under an objective standard, still would have foreseen a potential claim. *See Westport*, 2006 U.S. Dist LEXIS 31329 at *15-16. The court cited numerous other factors to demonstrate that it was objectively unreasonable for ICC to believe the matter was "dropped for good." The court ultimately held that the 2004 Division investigation taken in conjunction with the Alston letter's enclosed Cease and Desist Order – both occurring before the initial policy's inception – afforded an objectively reasonable basis upon which to anticipate a claim during the policy period.

The 2nd Circuit affirmed the District Court's grant of summary judgment in favor of Quanta in one paragraph, and for "substantially the reasons set forth by the District Court." Although the 2nd Circuit instructed that it was specifically affirming based upon the prior knowledge exclusion, the court said little else. The 2nd Circuit's use of the term "substantially" calls into question whether the court would also adopt the mixed subjective/objective analysis, or whether the court merely agreed with the District Court's analysis under the objective prong of its two-step analysis. As in *Westport*, the 2nd Circuit again declined to adopt a definitive standard for determining an insured's prior knowledge.

Other Recent Notable Decisions Addressing "Prior Knowledge" Exclusions

Between the time of the District Court's grant of summary judgment in *Quanta* and the 2nd Circuit's affirmance, the 2nd Circuit also summarily affirmed the March 2, 2009 ruling of then-District Judge Gerald Lynch of the Southern District of New York enforcing the prior knowledge exclusions of various excess policies to preclude D&O coverage arising out of the Refco scandal.[1] *See Murphy v. Allied World Assurance Co.*, 370 Fed. Appx. 193 (2d Cir. Mar. 23, 2010), *affirming*, *XL Specialty Ins. Co. v. Agoglia*, No. 08 Civ. 3821 (GEL), 2009 U.S. Dist. LEXIS 36601, (S.D.N.Y. Mar. 2, 2009). One of the prior knowledge exclusions at issue, by its very terms, contained both a subjective and an objective component. Interestingly, though, the court read both of the exclusions, regardless of minor differences in the exclusionary language, to require both subjective and objective components. *See Agoglia*, 2009 U.S. Dist. LEXIS 36601, at *18-20. The court's objective inquiry examined "whether a reasonable person would understand that, given the facts or circumstances, there may be grounds for a claim to be made under the Policy." *Id.* at *24. Judge Lynch held that the former CEO's guilty plea and admissions in a criminal prosecution, for obvious reasons, satisfied both the subjective and objective requirements of the prior knowledge exclusions.

In another case, *Executive Risk Indem., Inc. v. Pepper Hamilton, LLP*, 919 N.E.2d 172 (N.Y. 2009), the New York Court of Appeals enforced a claims-made policy's prior knowledge exclusion under Pennsylvania law. In *Pepper Hamilton*, a

1 Judge Lynch was elevated to the 2nd Circuit on September 17, 2009.

lawyer at the Pepper Hamilton law firm was not only aware that a client allegedly had been involved in securities fraud, the lawyer actually informed the firm of lawsuits that had been filed against that client (the law firm was not a named party in those suits at the time) and further warned that he was "not certain … whether [Pepper Hamilton] will be joined in the future." *Id.* at 175. Pepper Hamilton then failed to report this information to its insurers. The court, applying Pennsylvania law, set forth the 3rd Circuit's two-part test for construing prior knowledge exclusions, and held that the law firm's subjective knowledge "coupled with the fact that a reasonable attorney would have concluded that the law firm defendants would likely be included in the litigation because of their role in their client's business" clearly satisfied the two-part test. Notably, the court reversed the Appellate Division, which had previously held that the prior knowledge exclusion required that the "known-of act, error, omission or circumstance … be wrongful conduct on the part of the insured."

Conclusion

Quanta and the related cases provide lessons for both insurers and insureds. First, even withdrawn demands or entirely groundless allegations may constitute a claim for purposes of triggering reporting requirements under a claims-made policy. Similarly, informal assurances made to the insured that a claim or suit will not be brought are likely insufficient to defeat the application of a prior knowledge exclusion. Second, in the absence of a definitive standard by New York state or federal courts and based on the trend represented by the above-mentioned cases, an insurer should be prepared to prove both a subjective component and an objective component regarding the insured's prior knowledge. Even though the 2nd Circuit and the New York Court of Appeals have not yet expressly adopted the mixed subjective/objective test, the trend of these recent decisions indicates a willingness to apply the mixed test to ascertain an insured's prior knowledge. Third, as demonstrated by *Pepper Hamilton*, the known wrongful conduct that may trigger the prior knowledge exclusion is not limited to the insured's own conduct, but may be that of another. Finally, although insureds need not anticipate any and all possible claims that will ultimately be brought against them, when troubling facts surface, such as assertions by regulators or private parties concerning, for example, a broker's sale of unregistered securities, insureds are well-advised to avoid jeopardizing coverage by promptly disclosing any and all available information to their insurer.

To discuss any questions you may have regarding the opinions discussed in this Alert, or how they may apply to your particular circumstances, please contact Angelo G. Savino, a Member in our New York office, at asavino@cozen.com or 212.908.1248, who focuses his practice on Directors and Officers Liability Insurance.