

KD Alert: New York's Appellate Division Says No Coverage Under Financial Institution Bond For Madoff Losses

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In *Jacobson Family Investments, Inc. v. National Union Fire Insurance Company of Pittsburgh, PA*, 2015 Slip Op. 05273 (1st Dep't 2015), New York's Appellate Division was asked to interpret the coverage afforded under a financial institution bond for losses arising from the notorious Madoff Ponzi Scheme. A non-jury trial resulted in a \$7.6M damage award against the Insurer. On appeal, the First Department unanimously reversed, on the law, holding that the losses were not sustained solely as a result of Madoff's activities as an "Investment Advisor."

The Plaintiff investment vehicle was insured under a Financial Institution Bond issued by National Union, and sought coverage for losses sustained when its investments with Madoff disappeared. The First Department identified two (2) critical coverage issues to resolve in order to determine whether Plaintiff was entitled to coverage under the Bond's fidelity insuring agreement.

The first issue was whether Plaintiff's alleged damages qualified as a covered loss pursuant to Rider 14 of the bond which provided, in part, that covered losses included those "resulting directly from the dishonest acts of any Outside Investment Advisor, named in the Schedule below, solely for their duties as an Outside Investment Advisor, on behalf of the Insured..." [emphasis added]. It was undisputed that Madoff was listed as an Outside Investment Advisor on the relevant schedule that followed. However, the First Department held that the evidence presented during trial[1] indisputably established that in perpetrating his Ponzi Scheme, Madoff acted in a "hybrid capacity" as both an investment advisor and a securities broker. The Court reasoned that since Rider 14 limited coverage to losses where the identified Outside Investment Advisor acted "solely" in that capacity, any interpretation that allowed coverage for a situation in which Madoff acted, in part, as a securities broker would render the use of the term "solely" in Rider 14 superfluous and had to be rejected.

The second issue, which in light of the first ruling became less significant, was whether coverage under the bond was excluded under Exclusion x, for "loss resulting directly or indirectly from any dishonest or fraudulent act or acts committed by any non-Employee who is a securities ... broker." The First Department held that even if there were coverage under Rider 14, such coverage would have been excluded pursuant to Exclusion x. In so holding, the Court reasoned that Exclusion x did not provide that the nonemployee must have actually been "acting as" a securities broker at the time of the loss, it only required that the nonemployee "is" a securities broker. As the trial evidence established that Madoff was not Plaintiff's "Employee" (as that term is defined in the bond) and that he was a registered broker-dealer during the entire period he dealt with Plaintiff, Exclusion x was applicable.

Jacobson Family Investments, Inc. provides a powerful example of how the title or role that an alleged fraudster played with respect to a scheme can affect the rights of an insured to collect on a policy of insurance or bond. As such, it is important for insurers and their insureds to diligently investigate claims and obtain a complete understanding of an alleged scheme in order to accurately assess the coverage available for losses arising from that scheme.

[1] That evidence included that (1) in perpetrating the Ponzi scheme resulting in Plaintiff's losses, Madoff not only provided fraudulent investment advice, he also serviced a securities brokerage account for Plaintiff; (2) a Customer Agreement between Plaintiff and Madoff to service the brokerage account expressly referred to the creation of a broker/customer relationship; (3) in connection with the creation of the brokerage account, Plaintiff designated Madoff to act as its agent for purchases, sales or trades of securities on its behalf; (4) Plaintiff provided Madoff with funds through a brokerage account that were supposed to be used for purchases, sales or trades pursuant to the brokerage agreement, however Madoff misused those funds and provided Plaintiff with false brokerage account statements to conceal his malfeasance; (5) compensation was paid to Madoff in the form of commissions on the falsely reported trades; and (6) after criminal charges were brought against Madoff, Plaintiff filed a customer claim for compensation with Madoff's trustee pursuant to the Securities Investor Protection Act (SIPA), asserting that its funds were stolen by Madoff, as securities broker.