

No Imputation under Prior Knowledge Provision

November/December 2002

A Massachusetts bankruptcy court has held that a prior acts provision in a lawyer's professional liability policy does not preclude coverage "arising from an employee's undisclosed and undiscoverable knowledge of his or her wrongdoing." *Am. Guar. & Liability Ins. Co. v. Perrone (In re Perrone)*, Nos. 97-46312-JBR & 97-04324-JBR, 2002 WL 31386029 (Bankr. D. Mass. Oct. 18, 2002).

The insured was an attorney and issuing agent for a title insurance company. In an application for malpractice insurance, the attorney represented that he was not aware of any facts or circumstances that might give rise to a claim under the proposed insurance. Unbeknownst to the insured, one of his employees had been engaging in a scheme to defraud clients by diverting funds intended to pay off mortgages and using the funds for the employee's personal benefit. The employee's long-standing scheme to defraud was not exposed until after the policy was issued. Thereafter, the insurer denied coverage based on, *inter alia*, a prior knowledge provision. Coverage litigation followed.

The insurer argued that the malpractice policy provided coverage for claims made during the policy period for pre-policy errors or omissions only when "[t]he Named Insured, any partner, [or] employee...had no reasonable basis to believe that the Insured had breached a professional duty or to foresee that a claim would be made against the Insured." The insurer argued that the prior knowledge provision applied because the employee who had engaged in the fraudulent scheme had a "reasonable basis to believe that the insured had breached a professional duty or to foresee that a claim would be made against the insured."

The court rejected the insurer's argument. As an initial matter, the court held that because the prior knowledge provision was contained in the coverage grant, the attorney had the duty to prove that the prior knowledge exception to coverage did not apply. In holding that the provision did not apply, the court observed that the purpose behind the provision is to ensure that the loss covered by the policy is fortuitous and not a known loss. Because the insured was not aware of the employee's fraudulent scheme, the court reasoned that the loss in question was not a known loss and that the prior knowledge provision was not implicated. Moreover, the court reasoned that it was "inconceivable" that the employee would have disclosed her fraudulent conduct to the insured even if he had asked her whether she had a reasonable belief that a malpractice claim would occur prior to completing the application. The court, therefore, refused to impute the employee's knowledge to the insured. The court concluded, despite the plain language of the policy provision, that "the prior acts

provision does not preclude coverage arising from an employee's undisclosed and undiscoverable knowledge of his or her own wrongdoing."

For more information, please contact one of WRF's Professional Liability Attorneys at 202.719.7130