

"Eight Corners Rule" Prohibits Consideration of Extrinsic Facts; Prior Knowledge Exclusion Not Yet Applicable

May 2003

A federal district court, applying Texas law, has held that the "eight corners rule" bars the introduction of extrinsic evidence when determining whether the duty to defend has been triggered under a legal malpractice policy, unless such evidence pertains to a fundamental coverage issue, such as whether a policy exists or whether a named insured or specified piece of insured property has been specifically excluded from coverage. *Westport Ins. Corp. v. Atchley, Russell, Waldrop & Hlavinka, L.L.P.*, No. 5:01 CV 280, 2003 WL 1889004 (E.D. Tex. Apr. 10, 2003). In the opinion, the court also summarized the standard for applying the "prior knowledge" exclusion and determined that it would be premature to decide whether the insurer was obligated to indemnify the policyholder.

The insurer issued a claims-made legal malpractice policy to a law firm that contained a prior knowledge exclusion. The exclusion stated that the policy did not apply to claims "based upon, arising out of, attributable to, or directly or indirectly resulting from...any act, error, omission [or] circumstance...occurring prior to the effective date of this Policy if any Insured at the effective date knew or could have reasonably foreseen that such act, error, omission [or] circumstance...might be the basis of a Claim."

The law firm was sued for legal malpractice in connection with representation of a client before the IRS. The complaint contained allegations of breach of fiduciary duties, breach of contract, negligence and violations of the Deceptive Trade Practices Act. The law firm tendered the complaint to the insurer, which refused to defend or indemnify. The insurer filed a declaratory judgment action seeking a declaration that it had no duty to indemnify or defend based on the prior knowledge exclusion. The insurer subsequently filed a motion for summary judgment and the parties submitted a joint stipulation of facts in connection with the motion.

The court first discussed at length the scope of the prior knowledge exclusion. It concluded that the prior knowledge exclusion bars coverage in three situations:

(1) When the insured has subjective knowledge of an impending claim; (2) when facts subjectively known to the insured would lead a reasonable attorney to conclude that a grossly flagrant or glaring breach of duty occurred; or (3) where facts subjectively known to the insured would lead a reasonable attorney to conclude

that at least some breach of duty occurred *and* where those same facts also indicate that the client is dissatisfied to a point that would lead a reasonable attorney to conclude that the client likely would file a claim.

In reaching this conclusion, the court rejected the insurer's argument that the exclusion should apply whenever a reasonable attorney, examining the facts known by the insured, would conclude that a professional duty had been breached. The court explained that "[s]o long as the attorney was conscious, the insurer's approach would exclude coverage for any error that occurred prior to the beginning of the policy period, which period is invariably for only one year. This is because the 'reasonable attorney' would recognize most, if not all, instances in which any duty had been breached, even if many attorneys would not be aware that a breach had occurred."

The court then discussed at length whether it should consider a joint stipulation of facts by the parties in deciding the motion for summary judgment. The court concluded that the "eight corners rule," which generally prevents the court from considering documents beyond the complaint and insurance policy, should be applied strictly, and exceptions should be permitted only "in very limited circumstances" in which "'fundamental' policy coverage questions are resolved by 'readily determined facts.'" The court explained that "fundamental policy questions" in which extrinsic facts could be considered include: "(1) whether a person has been excluded by name or description from *any* coverage; (2) whether the property has been expressly excluded from any coverage; and (3) whether the policy exists." Moreover, a "determination of these 'fundamental coverage issues' must be able to be made by a *readily determined fact* that does not engage the truth or falsity of the allegations in the underlying petition." Absent such "fundamental coverage facts," extrinsic evidence should not be considered. Here, because the parties offered no extrinsic evidence concerning such fundamental coverage issues, the court refused to consider any evidence outside of the policy and the underlying complaint.

On the basis of those two documents, the court found that the exclusion was not triggered because nothing in the complaint alleged that any of the firm's attorneys had subjective knowledge that a claim would be filed against them before the inception of the policy period, and nothing in the complaint suggested that "any of the highlighted wrongs were so blatant that any lawyer would expect to see a claim because of them." Thus, the court found that the exclusion did not preclude the insurer's duty to defend. Moreover, the court noted that, even if the exclusion barred coverage for claims based on acts that occurred before the policy period, the duty to defend would still be triggered because the complaint alleged breaches of duties owed by the law firm to its clients both before and after the inception of the policy period.

The court also held that it was premature to decide whether the insurer had a duty to indemnify until after the resolution of the underlying litigation. The court noted that it had "found no Texas case in which the Court announced that...the duty to defend was triggered, and simultaneously decided that the duty to indemnify could not arise for lack of coverage." The court explained that Texas law allowed the insurer to avoid the duty to defend in only two situations: (1) where "'fundamental coverage facts' that may be readily determined by extrinsic evidence preclude both duties from arising," and (2) where "the suit against the insured, by its own allegations, proves that no coverage exists." Because the court did not find the presence of either of those

circumstances, the court refused to allow the insurer "to achieve in this action prematurely what it would be denied in state courts under state law." Further, the court explained that even if it found the issue to be a procedural one allowing for the application of federal law, the court would exercise its discretion and not grant relief as to the duty to indemnify because some of the issues it would address could overlap with those issues to be decided in the underlying litigation. The court did not want to interfere with the underlying litigation.

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