

Prejudice Irrelevant to Prior Knowledge Defense Under Lawyers' Professional Liability Policy

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The United States District Court for the Western District of Pennsylvania, applying Pennsylvania law, has dismissed a law firm's coverage action because the prior knowledge exclusion in the professional liability policy barred coverage. *Abood v. Gulf Group Lloyds*, 2008 WL 2641310 (W.D. Pa. July 1, 2008). In doing so, the court held that a policyholder's subjective beliefs and prejudice to the insurer are irrelevant to determining whether the prior knowledge exclusion bars coverage.

The insurer issued a claims-made lawyers' professional liability policy with a policy period of June 17, 2004, to June 17, 2005. The policy excluded coverage for any claim "[a]rising out of any error, omission [or] negligent act . . . occurring prior to [June 17, 2004,] if any insured . . . knew or could have reasonably foreseen [that it would] be the basis of a 'claim' or 'suit.'"

On June 8, 2005, a former client notified the insured attorneys of her intent to file a malpractice claim against them because the attorneys had failed to file the client's automobile accident personal injury complaint before the statute of limitations expired in February 2003. The attorneys informed the client in 2003 of their failure timely to file her complaint, but the client indicated that she would not pursue a malpractice claim because she could still recover underinsured motorist benefits. However, the client ultimately filed a malpractice suit against the attorneys in July 2005.

The attorneys advised the insurer of the claim in a June 10, 2005, letter. The insurer denied coverage based on the prior knowledge exclusion in the policy. The policyholders subsequently filed a declaratory judgment action against the insurer, arguing (i) that they had no knowledge prior to signing the application that they would be sued and (ii) that the insurer was not prejudiced by receiving delayed information regarding the lawsuit.

The court first ruled that the plaintiff in the underlying malpractice suit was not an indispensable party to the coverage litigation. The court noted that the claimant would be considered an indispensable party under Pennsylvania law, but held that federal law controlled this issue. The court applied Third Circuit law holding

that "a party is only 'necessary' [under the federal rules] if it has a legally protected interest and not merely a financial interest in the action." It found that the claimant held only a financial interest in assuring that she would be able fully to collect any damages in her malpractice suit and so was not an indispensable party.

The court then held that the prior knowledge exclusion barred coverage notwithstanding the underlying plaintiff's initial indication that she did not intend to file suit. It applied the two-prong test set out in *Selko v. Home Ins. Co.*, 139 F.3d 146 (3d Cir. 1998), which asks (1) whether "the insured knew certain facts" and (2) "whether a reasonable attorney in the position of the insured would have had a basis to believe [he or she] breached a professional duty." The court noted that under *Coregis Ins. Co. v. Wheeler*, 24 F. Supp.2d 475 (E.D. Pa. 1998), "any actions [by a claimant] that fall short of a waiver of future claims against an attorney will not extinguish the prior knowledge exception." In addition, the court concluded that Pennsylvania law did not require the insurer to show prejudice to apply the exclusion because "[a prejudice] requirement could result in attorneys becoming willfully blind to potential claims or purposefully failing to disclose a claim in the hopes that the insurer will be unable to show prejudice."

Applying these standards, the court found that the attorneys had knowledge of their failure to toll the statute of limitations and had advised the claimant in a letter of her right to contact other counsel. The court also found that the claimant's initial indication that she did not intend to pursue legal action could not be considered a release or waiver of claims against the attorneys. In light of these facts, the court dismissed the suit under Rule 12(b)(6) because it concluded that a reasonable attorney in the plaintiffs' position would have known that a malpractice lawsuit was possible.