

Existence of Circumstances That May Result in a Claim Constitutes Fact That Must Be Disclosed in Application for Legal Malpractice Insurance

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In an unpublished opinion, a federal trial court, applying Arizona law, has held that coverage was not available for a legal malpractice claim brought against a law firm where the firm failed to disclose in the policy application existing circumstances that a reasonable person would believe "may result in [the] claim." *James River Ins. Co. v. Herbert Schenk, P.C.*, 2006 WL 467938 (D. Ariz. Feb. 27, 2006).

The firm sought legal malpractice liability coverage from the insurer. The insurer's policy application required the firm to disclose "any circumstances, allegations, Tolling Agreements or contentions as to any incident which may result in a claim being made against the Applicant." The firm identified several potential claims in the application. After submitting the application, but prior to issuance of the policy, the firm received notice from a client that the client was terminating the firm's representation because the firm had, *inter alia*, failed entirely to communicate with the client and failed to perform promised legal services. The client sought return of its documents and asked the firm to write-off the client's outstanding legal bills.

The insurer subsequently provided the firm with a quote for the desired liability coverage that required the firm to submit a statement that it had no known claims or claims incidents arising since submission of its application. The firm submitted such a statement and did not advise the insurer of the dissatisfied client's letter. The insurer issued the policy, which stated that coverage "does not apply to any 'Claim' against the 'Insured' based on or directly or indirectly arising from . . . [a]ny claim . . . disclosed in the application for this Policy." The claimants subsequently filed a legal malpractice action against the firm, which sought defense and indemnity from the insurer.

The court concluded that the insurer was entitled to deny coverage for the claimant's suit against the firm because the firm's failure to disclose the circumstances surrounding its dispute with the client in the insurance application constituted "legal fraud." The court noted that legal fraud may be found where a policy application seeks "facts which are presumably within the personal knowledge of the insured and are such that the insurer would naturally have contemplated that the answer represented actual facts, and the answer is

false." The court explained that legal fraud does not require proof of an intent to deceive, in contrast to actual fraud, which must be proven where an insured's response to an application question "is merely an expression of opinion."

The court rejected the firm's argument that the application question at issue elicited only an expression of opinion. Applying a "reasonable person" test, the court concluded that an honest answer to the question—that the client's letter and incidents thereto might result in a claim—would constitute a statement of fact as a matter of law. The court further determined that, under Arizona Revised Statute Section 20-1009, the firm's misrepresentation was material to the acceptance of the risk, and that the insurer would not have provided coverage for the client's claim had it known the true facts. The court explained that the policy expressly provided that its coverage would not apply to claims disclosed in the application, as the firm's dispute should have been.

The court also dismissed the firm's counterclaims for breach of contract and bad faith as moot in light of its determination that no coverage was available for the client's claim under the policy. The court further noted that the firm's bad faith claim could not be supported because the insurer had provided the firm with a defense subject to a reservation of rights.