wiley

NEWSLETTER

Knowledge of Client's Misconduct Does Not Preclude Coverage under Prior Knowledge Exclusion

November 2008

The New York Supreme Court, Appellate Division, has held that a prior knowledge exclusion in a professional liability policy did not bar coverage for an insured law firm where the law firm had knowledge of its client's wrongdoing, but the evidence did not show that a reasonable professional would foresee that the client's wrongdoing would be the basis of a claim against the law firm. *Executive Risk Indem. Inc. v. Pepper Hamilton LLP*, 2008 WL 4308148 (N.Y. App. Div. Sept. 23, 2008). The court further held that the law firm's knowledge did not support rescission of the policy in the context of a summary judgment motion.

The insured law firm represented a company that provided student loans and pooled the loans into certificates or securities that it sold to investors. The law firm prepared private placement memoranda that the student loan company used to sell the pooled loans. The student loan company allegedly engaged in a fraudulent scheme to make the default rates of the loans in its securitized loan pool appear lower than they actually were. The student loan company eventually informed the law firm of its fraudulent practices, and the law firm withdrew from representation of the student loan company shortly thereafter. The student loan company subsequently was forced into bankruptcy, and, two years after the law firm was first informed of the student loan company's fraudulent practices, the bankruptcy trustee notified the law firm that it was considering bringing a claim against the law firm. The law firm then notified its insurers of the potential claim. The bankruptcy trustee eventually commenced an action again the law firm alleging negligence in the law firm's failure to discover the student loan company's fraud, as well as actual complicity in the fraudulent scheme.

Two of the law firm's excess insurers denied coverage on the basis of a prior knowledge exclusion, which provided that the policies did not apply to any claims "arising out of any act, error, or omission committed prior to the inception date of the policy which the insured knew or should have known could result in a claim, but failed to disclose to the Company at inception." The two excess insurers presented evidence showing that, prior to their policies' issuance, the law firm knew of its client's misconduct and of the likelihood that claims would be made against the firm itself. A third excess insurer sought rescission of its policies based upon the law firm's nondisclosure of the same information. The trial court granted summary judgment in favor of the

excess insurers, holding that the prior knowledge exclusion barred coverage and that the third excess insurer was entitled to rescind its policies.

The Appellate Division reversed. *Citing Coregis Insurance Co. v. Baratta & Fenerty, Ltd.*, 264 F.3d 302 (3d Cir. 2001) (summarized in the October 2001 issue of the *Executive Summary*), the court explained that determining whether the prior knowledge exclusion applied required a "mixed subjective/objective standard." This standard, the court explained, involves, first, a subjective inquiry as to whether the insured had knowledge of the relevant facts and, second, an objective inquiry as to whether "a reasonable lawyer would foresee that those facts might be the basis of a claim." The court held that the second, objective prong was not met. The court acknowledged that the evidence indicated that the law firm "subjectively either believed or feared that the firm might be subject to professional liability claims." The court determined, however, that "subjective belief that a suit may ensue based upon [the student loan company's] misconduct is not enough." The court explained that it found "nothing in the record constituting objective evidence permitting a reasonable professional to conclude that [the law firm] itself did anything that would subject it to suit or other claim."

The court explained that "the 'known of' act, error or omission at the heart of . . . a potential claim must be that of the insured, not that of its client." The court stated that "no wrongful conduct on [the law firm's] part [was] established as a matter of law so as to entitle the insurers to summary judgment declaring that the firm knew or should have known that a claim might be made against the firm." The court recognized that under the language of the prior knowledge exclusion at issue, the insurers were not required to establish that the law firm actually breached a professional duty but stressed that the policies could not be read to require the law firm "to notify its potential insurers of its client's misconduct and its own recognition that it may be subjected to legal claims brought by those injured as a result of its client's misconduct." Rather, "the firm must have itself acted improperly, so as to have itself created the possibility of a professional liability claim against it."

Likewise, the court held that the evidence did not support the third excess insurer's motion for summary judgment that it was entitled to rescind its policy because the evidence "simply shows that [the law firm] knew of [the student loan company's] misconduct and believed (correctly) that it might itself be subjected to lawsuits brought by parties injured by [the student loan company's] actions." "The questions of whether [the law firm] gave false answers on [the third excess insurer's] renewal application and whether any such false answers were given in bad faith," the court determined, "are questions of fact and cannot properly be determined as a matter of law." Furthermore, the court held that the third excess insurer did not establish the materiality of the omitted information as a matter of law. Although the third excess insurer submitted an affidavit of an underwriter asserting that the renewal application would have been handled differently had the information been disclosed, the court held that this was "not by itself sufficient to satisfy the insurer's burden."