

Prior Knowledge Limitation Is a Question of Law; Insurer Entitled To Withdraw Defense

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The United States District Court for the Western District of Washington has held that the applicability of a prior knowledge limitation in a lawyer's professional liability policy may be determined as a matter of law. *Carolina Cas. Ins. Co. v. Ott*, 2010 WL 1849230 (W.D. Wash. May 7, 2010). The court also held that the insurer did not lose its right to deny coverage and withdraw from the defense of the claim based on that limitation by having reserved its right to do so after defense counsel was in place.

The case involved an attorney who filed a complaint in state court on behalf of two clients in July 2003. The clerk of the court notified the attorney in February 2005 that the complaint would be dismissed for want of prosecution if further action in the matter were not taken within 30 days. Despite this warning, the attorney took no action, and the suit was dismissed in March 2005.

Two years later, in September 2007, after learning that their suit had been dismissed, the clients filed a grievance with the state bar association. Responding to the grievance, the attorney submitted two letters that he purportedly had sent to his clients in March 2004 and February 2005 confirming that they wished for their case to be put on hold and advising them that they were at risk of dismissal. The attorney later admitted that he had fabricated these letters. In November 2007, newly retained counsel for the clients requested that the attorney turn over all files concerning the state court action.

The attorney applied for professional liability coverage in April 2008. He did not disclose any facts regarding the dismissal of the state court action or the pending bar grievance. The insurer issued a policy for the period of April 16, 2008 to April 16, 2009. The policy provided coverage for "Claims" for "Wrongful Acts" first made and reported during the policy period, provided that prior to the effective date of the policy, "the Insured did not know, or could not reasonably foresee, that such Wrongful Acts might reasonably be expected to be the basis of a Claim."

The former clients filed suit against the attorney in March 2009, alleging professional negligence in connection with his handling of the state court action. The attorney tendered the suit to the insurer on March 16, 2009, which in turn appointed defense counsel. The insurer then retained coverage counsel, who on its behalf eight weeks later, sent a letter to the attorney reserving the right to deny coverage based on, among other grounds, the prior knowledge limitation.

The insurer filed suit on September 4, 2009, and subsequently moved for summary judgment. As an initial matter, the court rejected the argument that the insurer was estopped or otherwise waived the right to deny coverage and withdraw from the defense of the claim. Applying Washington law, the court held that waiver requires "substantial evidence" of intent by the insurer to relinquish a known right and found that no such evidence existed here. As to estoppel, the court noted that the insured must show "justifiable reliance" and "actual prejudice." According to the court, the eight weeks that elapsed between the appointment of defense counsel and the insurer's reservation of rights was not sufficient to make the required showing. The court also held that to the extent the insurer's claim handler might have obtained information from defense counsel that supported the insurer's coverage defense, this did not constitute bad faith such that the insurer was estopped from denying coverage. In reaching this conclusion, the court noted that the insurer had separate coverage counsel and that there was no evidence to suggest that the claim handler provided the information in question to that counsel.

Turning to the prior knowledge limitation, the court held that the phrase "reasonably foresee" denoted "an objective, reasonable attorney standard." As such, according to the court, the insured could not successfully defend "on the ground that he was uniquely unaware of ethical and fiduciary principles that all lawyers would know or that he did not understand the implications of conduct and events that any reasonable lawyer would have grasped." The court further noted that the standard did not require the prediction of a claim with "absolute certainty" and that the "foreseeability of a claim is distinct from the question of whether a foreseeable claim has any merit." The court also recognized that in certain cases, including this one, whether a claim was reasonably foreseeable may be question of law. Concluding that the limitation applied to bar coverage here, the court pointed out, among other facts, that a grievance had been filed with the bar association and that counsel had requested the attorney's file before the effective date of the policy.