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NEWSLETTER

Severability Provisions Do Not Apply to Prior Knowledge Exclusion

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The United States District Court for the Southern District of Texas has held that severability provisions in a lawyers professional liability policy do not apply to a prior-knowledge exclusion found in a separate section of the policy. *One Beacon Ins. Co. v. T. Wade Welch & Assocs.*, 2012 WL 1155739 (S.D. Tex. Apr. 5, 2012). In addition, the court denied the insured law firm's motion to dismiss, holding that the insurer's complaint seeking rescission sufficiently pleaded materiality of an earlier omitted sanctions order, even though the policy would not have afforded coverage for the type of fine in the prior order.

The insurer issued professional liability policies to the insured law firm in 2007 and 2008. Each application inquired whether any member of the firm ever had been the "subject of any complaint, grievance or action by any court, administrative agency or regulatory body." The policies each also contained a prior knowledge exclusion. After the policies incepted, sanctions were awarded against a client in two lawsuits the firm was handling, in one case resulting from motions filed in 2005. The client asked the law firm to enter into tolling agreements and the law firm tendered the matters for coverage. The insurer brought action against the firm and certain individuals seeking a declaration that the policies were void *ab initio* or, in the alternative, that the prior knowledge exclusions barred coverage for the underlying matters. The insureds moved to dismiss.

With respect to the insurer's count for rescission, the court rejected the insureds' argument that the insurer had failed to plead that any misrepresentation or omission was material. The insureds argued that their failure to disclose an earlier sanctions award from 2004, in which the firm was ordered to pay opposing counsel's attorneys fees, was not material because the policies expressly excluded coverage for attorneys fees. The court held that it was plausible that the insurer would have declined to issue the policy if the earlier sanctions award had been disclosed.

The court also rejected the insureds' arguments that the prior knowledge exclusion could bar coverage only for insureds that actually had prior knowledge of the relevant events. The insureds pointed to two severability provisions in each policy: one following the dishonesty exclusion and one contained in the policy's notice requirement. The court held that each severability provision clearly applied only to the section in which it was contained, not to all policy provisions.

The insureds further asserted that it was illogical that the policy would contain a severability provision protecting innocent insureds in the case of fraud or dishonesty by one insured but no severability provision to protect innocent insureds from operation of the prior knowledge exclusion when the policy application was negligently completed. The court noted that prior knowledge exclusion is "designed to ensure that only risks from unknown losses are insured." The court further reasoned that "[t]he firm has control over the extent of its inquiry into prior wrongful conduct."

Finally, the court disagreed that the application question requiring disclosure of past complaints, grievances or actions against the insured was ambiguous. The insureds argued that the insurer's broad reading of the question was "absurd" because it would require insureds to disclose even sanctions for trivial violations of court rules that were not within the policy's coverage. The court responded that "[i]t is reasonable . . . to inquire about such fines even if the policy does not cover them because [the insurer] may conclude that an attorney who is willing to disregard court rules . . . may also be willing to disregard other, more substantive rules."