wiley

NEWSLETTER

Texas Fortuity Doctrine Bars Coverage under Professional Liability Policy

January 2007

A Texas court of appeals has held that the fortuity doctrine precludes an insurer from owing a duty to defend under a claims-made professional liability policy. *Warrantech Corp. v. Steadfast Ins. Co.*, 2006 WL 3438033 (Tex. App. Nov. 30, 2006). In doing so, the court rejected the insured's contention that the doctrine only applies where a judgment had established the existence of a "known loss" or "loss in progress" prior to the inception of the policy.

The insurer issued a claims-made professional liability policy with coverage incepting on July 30, 2002. At the time the policy was issued, the policyholder was involved as a third party in an ongoing arbitration. The arbitration was between the insurer of the policyholder's warranty program and its reinsurers and arose from the insurer's effort to obtain reimbursement for amounts paid by the insurer to the policyholder for claims made by consumers under extended service plans administered by the insurer. According to the court, during the arbitration, it was established that the policyholder had used computer software to obtain reimbursements for unsubstantiated warranty claims. The policyholder had also hidden and denied the existence of the software during an audit initiated by the reinsurers and during the arbitration discovery process.

Shortly after the professional liability policy at issue incepted, the arbitration panel ordered the reinsurers to pay $39 million to the warranty insurer for amounts it had paid to the policyholder. The reinsurers then sued the policyholder for fraud and negligent misrepresentation. The professional liability carrier refused to defend the action. Coverage litigation followed.

The court first considered whether the fortuity doctrine barred coverage because the policyholder was aware of its actions regarding unsubstantiated warranty claims as well as the arbitration proceeding before the policy incepted. The insured contended that the fortuity doctrine should not apply to claims-made policies under any circumstances because "the very nature" of such policies anticipates that losses might occur before the policy's inception date. In response, the court noted that fortuity is required for all insurance contracts and rejected the corporation's assertion that fortuity would make a claims-made policy's coverage illusory. The court observed "it is not the existence of a loss but the insured's knowledge of the loss that triggers the fortuity doctrine." Furthermore, the court noted that other Texas courts had already applied the fortuity doctrine to claims-made policies.

The court then recited the history of the policyholder's conduct with respect to the warranties at issue in the arbitration, beginning in 1996, and concluded that, regardless of whether the loss caused by the reimbursement program was the result of intentional or negligent conduct, the corporation must have known about it before the policy took effect in 2002. Accordingly, the fortuity doctrine applied.

The court also rejected the policyholder's argument that the dishonesty exclusion precluded application of the fortuity doctrine. The exclusion applied to "any claim arising from any dishonest, fraudulent or criminal act... or those of a knowing wrongful nature," but required the insurer to defend until an adverse judgment against the corporation established "such behavior occurred." The insured argued that the exclusion meant the fortuity doctrine should not apply until knowledge of dishonest activity was established. The court found the exclusion "irrelevant" to the fortuity doctrine's application because the doctrine applied whenever an insured knew of specific loss before the policy incepted without regard to whether the insured had engaged in wrongful conduct in connection with such loss.