

ALERT

Prior Knowledge Condition Not Satisfied Where Insured Had Reason to Foresee Possible Claim Despite Belief that Claim Would be Meritless

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The U.S. Court of Appeals for the Tenth Circuit has held that an insured employer's knowledge of its employee's prior fraudulent acts gave the employer reason, prior to the policy's inception, to foresee a potential claim based on its negligent hiring and supervision of the employee. *Cohen-Esrey Real Estate Servs., Inc. v. Twin City Fire Ins. Co.*, 2011 WL 678383 (10th Cir. Feb. 28, 2011).

The insured employer managed an apartment building that provided rent-subsidized units to low-income tenants. For several years, one of the insured's employees conducted a fraudulent scheme whereby she rented units to non-subsidized renters and pocketed the subsidies. After her fraud was detected, the employer notified its then-current insurance carrier, but when the employer subsequently secured a replacement policy with a new insurer, it failed to notify that insurer of the employee's fraud. When the employer later received a claim for the return of the subsidies based on the employer's negligent hiring and supervision of the employee, the second insurer denied coverage because the employer had failed to satisfy the policy's condition precedent to coverage. This condition required that, prior to the policy's inception, "no partner, principal, officer, director or member of the Insured was aware of any Wrongful Act, fact, circumstance or situation that he or she knew or could reasonably have foreseen might result in a Claim under this Policy."

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The court ruled for the insurer, holding that the employer had failed to satisfy the policy's condition precedent to coverage. The court employed a two-prong, subjective-objective test to determine first what the insured employer knew, and then second, whether such knowledge would give a reasonable person in the insured's position a basis to foresee a potential claim. The court stated that not only had the employer known of the employee's fraud prior to the policy's inception, but the employer had also had knowledge of prior fraudulent acts by this same employee. Consequently, the court held, a reasonable person in the employer's position would have had a basis to foresee the possibility of a claim based on the employer's negligent hiring and supervision of the employee.

Moreover, the court rejected the employer's argument that it did not have reason to foresee a claim because it had plausible defenses to any such claim. The court held that "the threat of a claim, even an unfounded one, is relevant to the insurer's exposure. . . . The reality of modern American litigation, which is what insurance policies are designed to protect against, is that persons must be prepared to defend even against colorable albeit invalid claims." The court concluded that under the circumstances, no reasonable person could find that the condition precedent was satisfied.