This article appeared in the American Bar Association's Section of Litigation, Insurance Coverage Litigation, on May 5, 2016

INSURANCE 101: PROFESSIONAL LIABILITY POLICIES AND PRIOR KNOWLEDGE

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Professional liability policies—also known as errors and omissions (E&O) or malpractice policies—provide medical practitioners, lawyers, accountants, engineers, architects, and other professionals and their firms with a defense and, if necessary, indemnification for claims arising out of purportedly negligent acts, errors or omissions in the performance of professional services. Coverage is typically written for a term of one year on a "claims-made" or "claims made and reported" basis, with the policies covering claims made (or both made and reported to the insurance company, depending on policy language) during the policy term or any extended reporting period.

Professionals pay high premiums for their policies and naturally expect that they will be covered for claims that are made during the policy period. Virtually all professional liability policies, however, contain provisions that purport to limit or exclude coverage based on the policyholder's knowledge of acts or omissions that could give rise to a claim. These provisions include prior acts exclusions, which exclude coverage for claims arising out of an act, error, or omission, committed prior to the inception of the policy where the insured knew or could have reasonably foreseen that the act, error, or omission might result in a claim; "notice provisions," which typically require the policyholder to notify its insurance company upon becoming aware of any negligent act, error, or omission that reasonably could be expected to be the basis of a claim; and language contained in policy applications, which generally require the applicant to state whether it knows of any act, omission, error, or circumstance that might be expected to be the basis of a claim.

But what exactly constitutes knowledge sufficient to vitiate coverage for an otherwise covered claim made within the policy period? And what happens if one person has knowledge of a wrongful act but withholds that knowledge from his or her employers, partners, and insurance company?

What Constitutes Knowledge of a Potential Claim?

Professional liability policies typically exclude coverage for acts that occurred before to the inception of the policy, even if the actual claim for malpractice arises during the claims-made policy period, if the policyholder knew or "could have" foreseen that the act would give rise to a claim. But who gets to decide whether or not a reasonable policyholder could have foreseen a claim and what is the standard?

Many states apply a two-pronged test, in which a court will review the subjective knowledge of the policyholder and the objective understanding ascribable to a reasonable policyholder with that knowledge. For example, in *Liberty Insurance Underwriters Inc. v. Corpina Piergrossi Overzat & Klar LLP*,[2] a law firm represented a client in connection with a medical malpractice claim for personal injuries allegedly caused by vaccinations administered when the client was an infant.[3] During the course of the representation, an associate at the law firm wrote a letter to the client's father, informing him that the deadline to file a claim under the National Vaccine Injury Compensation Program (NVICP) was approaching, and requesting materials to complete the application.[4] The application was never filed, the deadline passed, and the firm ceased representation of the client. Shortly thereafter, the law firm purchased its first legal malpractice policy from Liberty Insurance Underwriters.

Some years later, the (former) client's new attorney advised the law firm by letter that he had been retained to prosecute a legal malpractice claim based on the

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failure to file the NVICP claim.[5] The law firm promptly provided notice to Liberty. Rather than defend, however, Liberty brought a declaratory judgment action against the law firm, arguing that the policy excluded coverage for "any claim arising out of a wrongful act occurring prior to the policy period if . . . you had a reasonable basis to believe that you had breached a professional duty, committed a wrongful act, violated a Disciplinary Rule, engaged in professional misconduct, or to foresee that a claim would be made against you."[6]

The law firm argued that even if the associate (and, by imputation, the law firm) knew of the NVICP and the deadline, the law firm did not know that the failure to file a timely administrative claim under the NVICP had the additional legal consequence of foreclosing any civil action for damages. Because they did not learn this fact until after the Liberty policy's inception, they argued, the known-claims exclusion should not apply to bar coverage.

The Supreme Court of New York agreed with Liberty, declaring that Liberty had no duty to defend or indemnify the law firm. On appeal, the Appellate Division, First Department, applied a two-pronged test in which the court "must first consider the subjective knowledge of the insured and then the objective understanding of a reasonable attorney with that knowledge."[7] More particularly, the court stated, "the first prong requires the insurer to show the insured's knowledge of the relevant facts prior to the policy's effective date, and the second requires the insurer to show that a reasonable attorney might expect such facts to be the basis of a claim."[8]

The court then held as follows:

> The insurer . . . objects that the attorneys are in essence seeking to be rewarded for their ignorance in connection with the medical malpractice action for which they were retained. The "reward" of coverage, however, is the necessary and intended consequence of a test with a subjective component. The insurer is in essence objecting to the practical reality that enables it to sell any malpractice coverage, including retroactive coverage on a claims made basis. To obtain protection from the consequences of their ignorance is a key reason why attorneys purchase and insurers are able to sell malpractice insurance. A purely objective test would provide insurers with far greater protection against the risks of both "adverse selection" and outright fraud. But if attorneys had to run that gauntlet to obtain coverage, they would have little or no reason to buy malpractice insurance. After all, the promised retroactive coverage would be illusory if it could be denied solely because a reasonable attorney would have known at the time of the act or omission that a malpractice claim could be made.[9]

The trial court's decision was overturned, and Liberty's motion for summary judgment denied.[10]

Sometimes, however, a court will find that based on the facts, there is simply no reasonable argument that a reasonable policyholder would not foresee that an omission might give rise to a claim. In *Becker v. Bar Plan Mutual Insurance Co.*,[11] an attorney, Seck, was hired to represent a friend and client, Becker, in making loans, which were to be secured by unencumbered collateral. Seck did not do a proper Uniform Commercial Code search and failed to identify the fact that collateral for the loan already had a lien on it. Becker sent the lawyer numerous emails identifying the error, expressing dissatisfaction, and terminating Seck's services. A year later, however, Becker sued Seck for malpractice. The claim was forwarded to Seck's professional liability carrier, which denied coverage based on the policy's prior acts provision. Litigation was filed, but the Court of Appeals of Kansas determined that coverage had been properly denied:

> In this case, it is clear that Seck subjectively knew on or before [the inception date of the policy] that she had breached her standard of care owed to Becker. Moreover, although there was an 8- or 9-month delay between when Becker terminated Seck's services . . . that delay does not outweigh the fact that Becker was out $5 million as a result of Seck's error. A reasonable attorney in this situation would not have expected Becker to simply ignore the $5 million loss just because the two people were family friends.[12]

Whose Knowledge Counts? When Wrongdoers Hide Wrongdoing

As the cases referenced above demonstrate, sometimes a policyholder does not recognize that an act, error, or omission is likely to give rise to a claim. The inquiry there is whether or not the failure to identify a potential claim was reasonable under the circumstances.

There are times, however, when negligent or dishonest parties—fearing censure, termination, embarrassment, or legal consequences—hide potentially actionable conduct from their employers, their partners, and their insurance companies. When the actionable conduct is discovered and the inevitable lawsuit is filed, will the wrongdoer's knowledge of his or her own misdeeds be imputed to the employer?

In most cases, no. The majority of courts hold that an employee's knowledge of the error or omission will not vitiate insurance coverage for the employer, where the very thing insured against was the alleged error or omission of the employee. To do so would be to severely and unreasonably curtail the scope of professional liability insurance.

This rule is well demonstrated in the New York case of *Holloway v. Sacks and Sacks*.[13] In *Holloway*, a law firm associate allegedly committed malpractice while commencing an action on behalf of a client. The firm discovered the malpractice in September 1996 and reported the misconduct to its professional liability insurance company. The insurance company denied coverage, however, because in March 1996, the law firm had submitted to the insurance company a renewal application in which it represented that inquiry had been made to all professional employees and no circumstances had been reported in response to that inquiry that would result in a claim for malpractice being made. The insurance company argued that while the firm may not have been aware of the alleged malpractice, the associate's knowledge of his own wrongdoing should be imputed to the firm as a whole, vitiating coverage. The Court disagreed:

> [T]he precise issue here is whether the defendants should have had actual or constructive knowledge of the former associate's misconduct. There was no actual knowledge on the part of the inquiring partner and there is insufficient evidence on which he or the firm could be deemed to have had constructive knowledge. The former associate concealed his misconduct and there is no basis for either imputing his knowledge to defendants or for finding that they should have known of such misconduct.[14]

The court therefore found that the law firm was entitled to a defense and indemnification for the underlying malpractice action.[15]

New York is not the only jurisdiction to hold that an employee's knowledge of his or her own misdeeds should not be used to vitiate insurance coverage for the employer. Indeed, the rationale behind this rule was well expressed by the Supreme Court of Ohio:

> Where the purpose of a policy of insurance is to protect an employer from losses caused by an error or omission in the performance of his duty by an employee, the doctrine of imputed knowledge will not operate to defeat recovery by the employer under the policy where there is an exclusion from liability clause based on notice to the employer and only the employee at fault has actual knowledge as to his own error or omission.[16]

Such a holding is the only logical holding:

> [I]t must be remembered that the insurer agreed to protect the insured against errors or omissions of the insured's employees. The knowledge in the instant case is not such as the ordinary employee would divulge to his employer. It is not the tendency of the average employee to disclose his errors or omissions to his employer. The ordinary employee will either seek to remedy the error or omission without the employer's knowledge or will try to conceal it from him.[17]

There are, of course, exceptions to this general rule. In the case entitled *Rosenberg & Estis v. Chicago Insurance Co.*,[18] the court held that a partner's knowledge of his own malpractice would not be imputed to his firm:

> It can be assumed that a "bad actor" does not advise his partners or employers of his bad acts, until they are otherwise uncovered. Were such imputation of knowledge to take place, the scope of [an E&O Policy] would be limited. Common sense dictates that such limitation was not in the parties' expectation when the policy was written.[19]

The court cautioned, however, that

> [o]bviously, if [the wrongdoer] gave [his firm] some notice of his wrongful actions, i.e., by admissions or otherwise, the issue would be decided in defendant's favor. . . . But then, the issue would not strictly speaking be one of "imputation." Further, [the law firm] appears to be a law firm with many attorneys. The matter would be different if it related to a single practitioner or possibly to a very small and well integrated firm. These are threshold factual issues which must be resolved before the issues of [the insurance company's] obligation to defend and indemnify can be resolved.[20]

Application Issues: Material Misrepresentations May Void Coverage

While it is the law in most jurisdictions that a wrongdoer's knowledge of his or her own misdeeds will not be imputed to employers or partners, this rule is not always sufficient to preserve coverage. That is because in some states, such as New York, an insurance company may rescind an insurance policy, with the policy deemed void ab initio, if it was issued in reliance on a material misrepresentation—even if the misrepresentation was entirely innocent. This, of course, can have the effect of leaving innocent policyholders without coverage, either because they unknowingly submitted an application containing a material misrepresentation or because someone else submitted an application containing a material misrepresentation, voiding coverage for everyone covered by the policy.[21]

Such was the case in the matter entitled *American International Specialty Lines Insurance Co. v. Towers Financial Corp.*,[22] in which the U.S. District Court for the Southern District of New York held that a directors' and officers' insurance policy would be deemed void ab initio because the application contained false information, even if that left innocent policyholders without coverage:

> [W]hile we sympathize with the innocent insureds' position and recognize that innocent employees are likely to suffer if the entire policy is voidable because of one man's fraudulent response, it must be recognized that plaintiff insurers are likewise innocent parties.[23]

The *Towers* court further noted that the innocent policyholder at issue could have protected himself by purchasing a policy that included a severability clause, so that a misrepresentation by one policyholder would only result in rescission for the party with actual knowledge of the misrepresentation.[24]

Not all jurisdictions apply such draconian measures when it comes to misrepresentations and innocent insureds. In the recently decided *Evanston Insurance Co. v. Agape Senior Primary Care, Inc.*,[25] the U.S. Court of Appeals for the Fourth Circuit, applying South Carolina law, refused to void coverage for innocent policyholders. In Agape, Evanston Insurance Company issued a renewal professional liability insurance policy to Agape Senior Primary Care, Inc., and certain of its employees—including Ernest Addo, a man who had stolen a doctor's identity and was fraudulently practicing medicine as a "physician" ostensibly insured by Evanston.[26] Once the fraud was uncovered, Evanston sought to rescind the policy as to Agape and all of its employees, based on Addo's fraudulent misrepresentation on the application.

The Fourth Circuit ruled against Evanston. First, the court noted that while generally a contracting party may void a contract based on a material misrepresentation, "[s]ome states, including South Carolina, statutorily modify the traditional contract principle in the insurance context by requiring the insured party to have intended to defraud the insurance company."[27] The court further held as follows:

> South Carolina law and principles of equity weigh in favor of allowing coverage for the innocent co-insured parties, who are the individual doctors, nurses, and Agape. South Carolina law disfavors rescission against the insured. In particular, under South Carolina law, three factors tip the equity scales in favor of Agape: (1) as the insurer and drafter, Evanston could have included forfeiture language in the policy; (2) neither Agape nor any of its employees had any knowledge of Addo's fraud, rendering them "innocent" under South Carolina law; and (3) the public interest would not be served through rescission.[28]

What Every Policyholder Needs to Know about "Prior Knowledge"

They say that knowledge is power, but this is not always the case when it comes to professional liability insurance. To maximize coverage, policyholders must familiarize themselves with all of their policy's provisions, including provisions that purport to limit or exclude coverage based on knowledge of prior events. Professional organizations must then take steps to protect their coverage, including routinely checking with partners and employees to determine whether they know of any act or omission that could give rise to a claim; putting monitoring or review systems in place to ensure employees do not hide evidence of their own negligence or wrongdoing, putting coverage at risk; purchasing policies that include a severability clause to ensure that one party's failure to disclose knowledge of a potential claim does not vitiate coverage for the entity and other innocent employees; and giving notice of potential claims as soon as practicable.

Keywords: litigation, insurance, coverage, errors and omissions, knowledge

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[2] 78 A.D.3d 602, 913 N.Y.S.2d 31 (1st Dep't 2010).
[3] *Liberty Insurance Underwriters*, 78 A.D.3d at 603, 913 N.Y.S.2d at 32.
[4] L*Liberty Insurance Underwriters*, 78 A.D.3d at 604, 913 N.Y.S.2d at 32–33.
[5] *Liberty Insurance Underwriters*, 78 A.D.3d at 603–4, 913 N.Y.S.2d at 32.
[6] *Liberty Insurance Underwriters*, 78 A.D.3d at 603, 913 N.Y.S.2d at 32.
[7] *Liberty Insurance Underwriters*, 78 A.D.3d at 604, 913 N.Y.S.2d at 33.
[8] *Liberty Insurance Underwriters* (citing *Exec. Risk Indem. Inc. v. Pepper Hamilton LLP*, 13 N.Y.3d 313, 322, 919 N.E.2d 172, 175, 891 N.Y.S.2d 1, 4 (2009)).
[9] *Liberty Insurance Underwriters*, 78 A.D.3d at 606, 913 N.Y.S.2d at 34.
[10] *See also Westport Ins. Corp. v. Lilley*, 292 F. Supp. 2d 165 (D. Me. 2003) (finding it reasonable that attorneys did not foresee a malpractice claim against them, even though a $1 million jury verdict initially won by attorneys was subsequently reduced to zero, because "[t]o say that the [policyholder attorneys] could have reasonably foreseen a claim against them . . . means that any trial attorney who loses a substantial jury verdict, whether representing plaintiff or defendants, should put his carrier on notice that the client may ultimately seek compensation from the lawyer. . . . Although any 'act or omission' by an attorney that did not result in a hugely favorable outcome to the client 'might' lead a client to make a claim and 'foreseeability' is a virtually limitless concept, the touchstone here is reasonableness, not conceivability.")
[11] *Becker v. Bar Plan Mut. Ins. Co.*, No. 113, 291, 2015 Kan. App. Unpub. LEXIS 1114 (Kan. Ct. App. Dec. 23, 2015).
[12] *Becker*, 2015 Kan. App. Unpub. LEXIS 1114, at *22–23.
[13] 275 A.D.2d 625, 713 N.Y.S.2d 162 (1st Dep't 2000).
[14] *Holloway*, 275 A.D.2d at 626, 713 N.Y.S.2d at 164.
[15] *Holloway*, 275 A.D.2d at 626, 713 N.Y.S.2d at 164.
[16] *American Fin. Corp. v. Fireman's Fund Ins. Co.*, 239 N.E.2d 33, 33–34 (Ohio 1968).
[17] *American Financial Corp.*, 239 N.E.2d at 36.
[18] Index No. 600938/2, 2003 N.Y. Misc. LEXIS 895, at *3 (N.Y. Sup. Ct. July 11, 2003).
[19] *Rosenberg & Estis*, 2003 N.Y. Misc. LEXIS 895, at *7.
[20] *Rosenberg & Estis*, 2003 N.Y. Misc. LEXIS 895, at *7–8.
[21] *See Cont'l Cas. Co. v. Marshall Granger & Co.*, 921 F. Supp. 2d 111, 120 (S.D.N.Y. 2013) (applying New York law and holding that "[i]f a policy was procured through a material misrepresentation, the insurer may rescind an

insurance policy as to all insureds—even those insureds with no knowledge of any misrepresentation”).

[22] 94 CIV. 2727, 1997 U.S. Dist. LEXIS 22610, at *31 (S.D.N.Y. Sept. 12, 1997).

[23] *Towers Financial Corp.*, 1997 U.S. Dist. LEXIS 22610, at *31 (citing *INA Underwriters v. Forde*, 630 F. Supp. 76, 77 (W.D.N.Y. 1985)).

[24] *Towers Financial Corp.*, 1997 U.S. Dist. LEXIS 22610, at *32–33. *See also Wedtech Corp. v. Fed. Ins. Co.*, 740 F. Supp. 214, 218 (S.D.N.Y. 1990) (“Where the insurance policy contains a severability provision, however, some of the officers and directors might still be entitled to coverage.”).

[25] No. 14-2268, 2016 U.S. App. LEXIS 703 (4th Cir. Jan. 15, 2016).

[26] *Agape Senior Primary Care*, 2016 U.S. App. LEXIS 703, at *1–2.

[27] *Agape Senior Primary Care*, 2016 U.S. App. LEXIS 703, at *10.

[28] *Agape Senior Primary Care*, 2016 U.S. App. LEXIS 703, at *11.