

ALERT

Insurer Deemed to Have Breached Duty to Defend Even Though Prior Knowledge Exclusion Barred Indemnity Coverage

January 5, 2012

Applying New York law, a federal district court has held that an insurer had no duty to indemnify a law firm in connection with a malpractice suit because even though the disaffected client did not make a “claim” until after the policy incepted, the firm had knowledge of the client’s dissatisfaction sufficient to trigger a prior knowledge exclusion. *Schlather, Stumbar, Parks & Salk, LLP v. One Beacon Ins. Co.*, No. 5:10-cv-167, 2011 WL 6756971 (N.D.N.Y. Dec. 22, 2011). However, the court nonetheless held that the insurer had breached its duty to defend by disclaiming coverage before obtaining a declaratory judgment that the policy afforded no coverage.

The policyholder law firm represented the underlying claimant in connection with a wrongful death action filed in 2004. The firm eventually advised the claimant that the suit had no merit, and subsequently dismissed the case. While the firm and the claimant disagreed regarding the precise sequence of events, the firm conceded that it had not notified the claimant of the dismissal. In 2007, one of the firm’s partners met with the claimant and discussed the claimant’s dissatisfaction with the firm’s performance.

The subject policy incepted in late 2008. Prior to inception, the firm answered “no” to the application question “Are you or any members or employees aware of any fact, circumstance or situation which may give rise to a claim?”

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The claimant filed suit against the firm in 2009. The insurer defended under a reservation of rights for about six months, then disclaimed coverage and withdrew the defense. The insurer based its coverage position on its belief that a letter the claimant sent in 2007 was a “claim,” and on the policy exclusion for “any claim arising out of a wrongful act occurring prior to the policy period if, prior to the effective date of the Policy . . . you had a reasonable basis to believe that you had committed a wrongful act or engaged in professional misconduct or you could foresee that a claim would be made against you.” Coverage litigation ensued.

The Policy defined “claim” as “a demand . . . for money” or the filing of litigation. The letter the claimant sent in 2007 expressed the claimant’s disappointment with the firm’s handling of her litigation, alleged several specific deficiencies in the firm’s performance (such as failure to respond to inquiries), requested attorney notes and an explanation of the firm’s conduct, requested that the firm’s file not be closed “until this matter is resolved,” and stated that the claimant’s “prayer is that your integrity will allow you to respond in a way that will not reflect poorly on your law firm or your name.” The court concluded that the letter was not a “claim” because it did not make an implicit or explicit demand for monetary relief. Moreover, the letter was by the claimant rather than an attorney, and did not request a meeting to discuss monetary relief.

The court further held that the prior knowledge exclusion barred indemnity coverage. The court first rejected the argument that only the knowledge of the signer of the application would be relevant. The court noted that both the partner who met with the claimant in 2007 and the partner who handled the litigation for the claimant were within the policy’s definition of “you,” and that knowledge of either sufficed to implicate the exclusion. The court then noted that the firm subjectively knew prior to the policy’s inception that the claimant was dissatisfied because the firm had dismissed her case without securing her consent. Turning to an objective analysis, the court held that because the applicable rules of professional conduct require keeping a client informed and allowing the client to decide how to settle or otherwise dispose of a case, a reasonable attorney with knowledge of the facts could expect a claim to arise.

Notwithstanding this holding as to indemnity, the court held that the insurer breached its duty to defend. The court opined that the prior knowledge exclusion did not “clearly” bar coverage until the court had granted the insurer’s motion for summary judgment, and further stated that the insurer could protect itself from having to defend for “too long” by filing a declaratory judgment action. The court held that the policyholder could recover as damages both defense expenses and damages for “loss of peace of mind and related security.” The court further directed the parties to “engage in meaningful settlement discussions as to the amount” of these damages.