
Irrelevant Innocence: The Interplay Between Innocent Insured Provisions and Prior Knowledge Provisions in Claims-Made Policies

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Introduction

Insureds often argue that there is an inherent tension between the nature of claims-made policies, which provide coverage for any claim made during the policy period regardless of when the wrongful acts occurred, and the prior knowledge provisions contained in most claims-made policies, which preclude coverage for claims based on wrongful acts that an insured knew about prior to the policy's inception. Courts generally hold that there is no such conflict, and that the inclusion of a prior knowledge provision in a claims-made policy is an appropriate measure to protect an insurer from having to provide coverage for foreseeable risks. Nonetheless, many insureds have tried to use "innocent insured" provisions, which save coverage for innocent insureds where coverage is unavailable as a result of the fraudulent or dishonest acts of a fellow insured, to avoid the application of prior knowledge provisions. Properly applied, however, most innocent insured provisions are not triggered where coverage is unavailable based on an insured's prior knowledge of wrongful acts, rather than on the criminal or dishonest nature of those acts. This article explains the appropriate interplay between innocent insured

and prior knowledge provisions in a claims-made policy.

The Interpretation and Application of Prior Knowledge Provisions

Claims-made policies provide coverage for claims made against the insured during the policy period, even where the claim is based on acts or omissions predating the policy. Accordingly, the inherent nature of the claims-made policy clearly implicates the possibility that an insurer will have to provide coverage for claims that arise out of circumstances known to the insured before the policy inception, in contravention of the fundamental "fortuity" requirement that underlies all insurance.¹ Indeed, "losses which exist at the time of the insuring agreement, or which are so probable or imminent [at that time] that there is insufficient 'risk' being transferred between the insured and the insurer, are not proper subjects of insurance."² To address this concern, "a predicate to claims-made coverage is that the insured neither knew of a claim nor could have reasonably foreseen that a known circumstance, act or omission might reasonably be expected to be the basis of a claim or suit."³

Frequently, prior knowledge provisions are drafted such that the knowledge of one insured is sufficient to trigger the provision with respect to all insureds

Prior knowledge provisions in claims-made policies address this concern by carving out from coverage claims arising out of acts or omissions that were known to an insured prior to the policy's inception, where a reasonable person would have expected such acts or omissions could form the basis of a claim. Generally, there are two types of prior knowledge provisions found in claims-made policies: provisions integrated into the policy's

insuring agreements and prior knowledge exclusions found within the policy's exclusions section. Whether the prior knowledge provision is included within the insuring agreements or as an exclusion should not generally determine the outcome in circumstances in which the insured's prior knowledge is placed at issue. Placement within the policy is relevant, however, in determining which party bears the burden of proof with respect to the applicability of the prior knowledge provision. If the prior knowledge provision is included in the insuring agreements, the insured should have the burden to show that the provision has been met—*i.e.*, an insured must show that it was not aware of a potential claim at the time the policy inception in order to trigger coverage under the policy. Conversely, if the prior knowledge provision is an exclusion, an insurer typically would have the burden to show that coverage for a particular claim is precluded based on an insured's prior knowledge.⁴

Of course, the starting point for any prior knowledge analysis is the language of the provision itself. Frequently, prior knowledge provisions are drafted such that the knowledge of one insured is sufficient to trigger the provision with respect to all insureds. For example, the provision might refer to the knowledge of "any" insured, or condition coverage on "no" insured having prior knowledge.⁵ Courts generally give effect to the plain language of such provisions and, accordingly, coverage is precluded for all insureds if any insured possessed the requisite prior knowledge.⁶

That said, a policy's prior knowledge provision may contain severability language, or the policy may contain a stand-alone severability provision, requiring a separate analysis of coverage with respect to each individual insured. In that instance, even where one insured had knowledge of a potential claim at the time the policy inception, courts generally hold that coverage would be preserved for other insureds who did not have such knowledge.⁷

In determining the applicability of a prior knowledge provision, the majority of jurisdictions apply a two-part test, which asks: (1) what facts were known to an insured prior to the policy's inception; and (2) whether those facts would provide a reasonable person with a basis to believe a claim might be made?⁸ Courts applying this methodology refer to it as an "objective standard" or a mixed "subjective/objective standard."⁹ Although there is a subjective component to the inquiry (*i.e.*, an insured's actual knowledge of certain facts), under this standard, an insured cannot avoid a prior knowledge provision by arguing that, based on the known facts, he or she subjectively did not believe a

claim would be made, or did not believe that a claim would have merit. It is sufficient that an insured had knowledge of facts that would lead a *reasonable* person to believe that a claim might be forthcoming.¹⁰

Courts consistently have held that an insured who engages in intentional wrongful conduct has knowledge of acts that would put a reasonable person on notice that a claim might be forthcoming

The key coverage dispute that arises in prior knowledge cases, therefore, is whether certain facts known to the insured prior to the inception of the policy would have put a reasonable person on notice of a potential claim. The determination of this issue is largely fact-specific, and often there is not definitive case law dictating a result in a set of particular circumstances. The exception is where intentional acts are at issue.

The Interplay Between Intentional Acts, Prior Knowledge and Innocent Insured Provisions

Courts consistently have held that an insured who engages in intentional wrongful conduct has knowledge of facts that would put a reasonable person on notice that a claim might be forthcoming.¹¹ For example, where an insured misappropriated funds or conspired to defraud a third party, that insured would be held, as a matter of law, to have knowledge of the potential for an adverse claim based on those wrongful acts.¹² Where those intentional acts took place prior to the policy's inception, an insured would have knowledge of a potential claim before the policy's effective date and, pursuant to the language of most prior knowledge provisions, there would be no coverage for claims arising from those acts. Moreover, unless the policy contains severability language specifically requiring a separate application of the prior knowledge provision to each individual insured, coverage would be precluded for all insureds based on the wrongful actor's knowledge of his or her own intentional conduct prior to the policy's inception.

Some insureds have argued that this result is unfair because it unjustly penalizes insureds who did not participate in and had no knowledge of the intentional wrongful conduct (*i.e.*, the so-called "innocent insureds"). To address this perceived inequity, insureds have attempted to rely on "innocent insured" provisions to preserve coverage where coverage is unavailable based on an insured's pre-inception date knowledge of his or her own inten-

tional wrongdoing. Indeed, this issue has come to the forefront in recent litigation.¹³

Each court squarely rejected the idea that an innocent insured provision, which is designed to preserve coverage for so-called "innocent insureds" where coverage would be unavailable as a result of the fraudulent or dishonest acts of a fellow insured, somehow trumps the application of the prior knowledge provision

In each of the illustrative recent cases, the district court held that the innocent insured provision at issue in the case was inapplicable where coverage was denied based on an insured's prior knowledge. Each court squarely rejected the idea that an innocent insured provision, which is designed to preserve coverage for so-called "innocent insureds" where coverage would be unavailable as a result of the fraudulent or dishonest acts of a fellow insured, somehow trumps the application of the prior knowledge provision. The court in *Professional Asset Strategies* aptly described the relationship between these policy provisions:

[N]o coverage exists if any [insured] had prior knowledge of the existence of a claim. Where there is no prior knowledge and coverage exists, the policy provides various exclusions, including one for dishonesty. . . . However, in cases where the exclusion is because of "criminal, dishonest, illegal, fraudulent or malicious" acts of [an insured,] the "innocent insured" provision kicks in to restore coverage. . . .¹⁴

The courts' decisions in these recent cases are consistent with prior decisions of other courts around the country, which likewise have held that innocent insured provisions operate only to save an otherwise covered claim from the preclusive impact of exclusions for fraudulent or dishonest conduct.¹⁵

Conversely, as to the application of prior knowledge provisions, the nature of the insured's conduct is irrelevant. The only issue is whether an insured had knowledge of facts that might lead to a claim at the time the policy incepted and, where an insured had such knowledge, no coverage exists regardless of whether the known prior acts or omissions were intentional or merely negligent

All of these courts reached the correct result. As a general matter, innocent insured provisions are

designed to preserve coverage for "innocent insureds" where coverage is denied because the underlying conduct giving rise to the claim at issue is criminal, dishonest, fraudulent, illegal, or malicious.¹⁶ In that circumstance, the innocent insured provision saves coverage for those insureds who did not participate in such conduct. In most instances, this means that the innocent insured provision acts as a limitation only on the policy's dishonesty exclusion, which otherwise bars coverage for such conduct.¹⁷

Conversely, as to the application of prior knowledge provisions, the nature of the insured's conduct is irrelevant. The only issue is whether an insured had knowledge of facts that might lead to a claim *at the time the policy incepted* and, where an insured had such knowledge, no coverage exists regardless of whether the known prior acts or omissions were intentional or merely negligent. Thus, the key inquiry in any prior knowledge analysis is a temporal one—when did the insured have knowledge of facts that might reasonably give rise to a claim? This makes sense in light of the prior knowledge provision's purpose to prevent an insurer from having to provide coverage for foreseeable risks.

Accordingly, where prior knowledge is implicated, the coverage analysis would be exactly the same if, instead of having committed theft or fraudulent acts, the "guilty" employee knew, before the effective date of the policy, that he or she had negligently made an error that harmed a client. In that event, there would be no coverage for any claim attributable to the employee's purely negligent acts because of the employee's pre-inception knowledge of acts and omissions that might reasonably be expected to be the basis of a claim. The innocent insured provision could not possibly come into play because none of the wrongful acts could be characterized as criminal, dishonest, illegal, fraudulent or malicious. There is no principled basis for a different result where an insured knows of criminal or fraudulent acts prior to the policy's inception. In either case, coverage is precluded because of an insured's prior knowledge; the particular character of the insured's wrongful acts is beside the point.

Conclusion

The inclusion of prior knowledge provisions in claims-made policies is necessary to protect insurers from having to provide coverage for foreseeable, non-fortuitous risks. Typically, innocent insured provisions, properly interpreted and applied, do not restore coverage where no coverage exists because of an insured's prior knowledge, regardless of the nature of the pre-inception conduct giving rise to the claim. Although "innocent insureds" argue that this result is

unfair where intentional wrongful acts are at issue, the fact that innocent insured provisions are inapplicable in this circumstances does not leave the “innocent insureds” without a remedy. To the extent that an insured is concerned about how a

policy’s prior knowledge provision potentially may be applied, an insured can negotiate for the inclusion of severability language in the prior knowledge provision itself, or for a separate stand-alone severability provision.¹⁸

¹ *Rohm & Haas Co. v. Cont’l Cas. Co.*, 781 A.2d 1172, 1176 (Pa. 2001); *Waller v. Truck Ins. Exch., Inc.*, 900 P.2d 619, 626 (Cal. 1995).

² 7 Leo R. Russ, *COUCH ON INSURANCE* § 102:8 (3d ed. 2009).

³ 5 Ronald E. Mallen and Jeffrey M. Smith, *LEGAL MALPRACTICE* § 36:14, at 90 (2010 ed.).

⁴ See 2 Allan D. Windt, *INSURANCE CLAIMS & DISPUTES: REPRESENTATION OF INSURANCE COMPANIES & INSURED* § 9.1 (2010) (burden is on the insured to demonstrate that a loss comes within the policy’s coverage provisions, but the insurer bears the burden of proving that a policy exclusion is applicable (citing cases)).

⁵ See, e.g., *Murphy v. Allied World Ass. Co.*, 370 F. App’x 193, 193 (2d Cir. 2010); *Bryan Brothers, Inc. v. Cont’l Cas. Co.*, 704 F. Supp. 2d 537, 540 (E.D. Va. 2010); *Prof’l Asset Strategies v. Cont’l Cas. Co.*, No. 2:09-cv-1238-AKK, 2010 U.S. Dist. LEXIS 115923, at *6 (N.D. Ala. Aug. 27, 2010); *Westport Ins. Corp. v. Hanft & Knight*, 523 F. Supp. 2d 444, 460–61 (M.D. Pa. 2007); *Coregis Ins. Co. v. Lyford*, 21 F. Supp. 2d 695, 697–99 (S.D. Tex. 1998).

⁶ See *supra* note 5.

⁷ See, e.g., *Steadfast Ins. Co. v. Stroock & Stroock & Lavan LLP*, 277 F. Supp. 2d 245, 248 (S.D.N.Y. 2003).

⁸ See, e.g., *Ross v. Cont’l Cas. Co.*, No. 09-7166 (D.C. Cir. Sept. 22, 2010), *aff’g* *Ross v. Cont’l Cas. Co.*, 420 B.R. 43, 49–50 (D.D.C. 2009) (holding that a prior knowledge provision in a lawyers professional liability policy barred coverage where, prior to the insurer issuing its first policy to the insured law firm, the insured attorney had reason to believe that a malpractice claim might be filed because he had failed to file a timely answer resulting in a default judgment against his client). See also *Colliers Lanard & Axilbund v. Lloyd’s of London*, 458 F.3d 231, 237 (3d Cir. 2006); *Selko v. Home Ins. Co.*, 139 F.3d 146, 149 (3d Cir. 1998); *Hanft & Knight*, 523 F. Supp. 2d at 456; *Cont’l Cas. Co. v. Graham & Schewe*, 339 F. Supp. 2d 723, 727 (E.D. Va. 2004); *Westport Ins. Corp. v. Lilley*, 292 F. Supp. 2d 165, 171 (D. Me. 2003); *Am. Spec. Risk Mgmt. v. Cahow*, 192 P.3d 614, 625–627 (Kan. 2008); *TIG Ins. Co. v. Blacker*, 54 Mass. App. 683, 688 (2002).

⁹ See *supra* note 8.

¹⁰ See, e.g., *Graham & Schewe*, 339 F. Supp. 2d at 727 (applying an objective standard to evaluate an insured’s prior knowledge in a professional liability insurance case) (Virginia law); *Worth v. Tamarack Am.*, 47 F. Supp. 2d 1087, 1096 (S.D. Ind. 1999) (applying an objective standard and asking whether a reasonable attorney in the insured’s position would have believed he breached a professional duty before the effective date of the policy) (Indiana law), *aff’d*, 210 F.3d 377 (7th Cir. 2000); *Int’l Ins. Co. v. Peabody Int’l Corp.*, 747 F. Supp. 477, 482 (N.D. Ill. 1990) (noting that the policy did not call for a “judgmental or subjective evaluation” but instead “required in traditional objective language that the insured have no knowledge of such act, error or omission on the effective date of the policy indicating the probability of a covered claim.”) (Illinois law); *Int’l Surplus Lines Ins. Co. v. Univ. of Wyo. Res. Corp.*, 850 F. Supp. 1509, 1521 (D. Wyo. 1994), *aff’d sub nom.* *Int’l Surplus Lines Ins. Co. v. Wyo. Coal Ref. Sys., Inc.*, 52 F.3d 901 (10th Cir. 1995) (applying objective standard and explaining that the prior knowledge exclusion “does not require that the person know that a claim has already been threatened, but only whether such a claim could reasonably be anticipated in the future” (footnote omitted)) (Wyoming law).

¹¹ See, e.g., *Bryan Brothers Inc.*, 704 F. Supp. 2d at 541 (employee’s embezzlement of client funds clearly gave her knowledge of a basis for a claim); *Westport Ins. Corp. v. Gionfriddo*, 524 F. Supp. 2d 167, 175 (D. Conn. 2007) (lawyer who admitted to converting client funds prior to the policy’s inception had to be aware of acts that could be expected to be the basis of a claim against him before the policy inception); *Westport Ins. Co. v. Lydia S. Ulrich Testamentary Trust*, 42 F. App’x 578, 581 (4th Cir. 2002) (an insured’s own knowledge of his theft of \$800,000 qualifies as a known circumstance that might be the basis of a claim); *Prof’l Asset Strategies*, 2010 U.S. Dist. LEXIS 115923, at *5–*6 (employee’s knowledge of his theft of client funds gave him knowledge of the basis for a claim against his employer); *Westport Ins. Corp. v. Law Offices of Gerald J. Lindor, P.A.*, No. 08-61644, 2009 U.S. Dist. LEXIS 22104, at *9–*10 (S.D. Fla. Mar. 18, 2009) (holding that attorney’s admission regarding misappropriation of client funds “forms the basis of the very type of wrongful act that attorney ‘knew or could have reasonably foreseen . . . might be expected to be the basis of a claim’”).

¹² See *supra* note 11.

¹³ See, e.g., *Bryan Brothers, Inc.* 704 F. Supp. 2d 537; *Navigators Specialty Ins. Co. v. Scarinci & Hollenbeck, LLC*, No. 09-4317(WHW), 2010 U.S. Dist. LEXIS 47124 (D.N.J. May 12, 2010); *Prof’l Asset Strategies*, 2010 U.S. Dist. LEXIS 115923. The authors’ firm, Wiley Rein LLP, represented the insurer in the *Bryan Brothers* and *Professional Asset Strategies* matters.

¹⁴ *Prof’l Asset Strategies*, 2010 U.S. Dist. LEXIS 115923, at *21 (citations omitted).

¹⁵ See, e.g., *Davis & Meyer Law, Ltd. v. ProNational Ins. Co.*, No. 06AP-730, 2007 Ohio App. LEXIS 3240, at *15 (Ohio Ct. App. July 12, 2007) (“innocent insured” clause is an exception to the fraud exclusion); *Cont’l Cas. Co. v. Woodson, Walker, Walker & Dunklin*, No. 4:07cv00298SWW, 2008 U.S. Dist. LEXIS 51819, at *11–*12 (E.D. Ark. July 7, 2008) (policy’s innocent insureds provision was inapplicable where insurer was not invoking any policy exclusion relating to criminal, dishonest, fraudulent or malicious conduct). Cf. *Fremont Indem. Co. v. Gierhart*, 560 So. 2d 1223, 1225–26 (Fla. Dist. Ct. App. 1990) (innocent insureds provision applies only “to certain exclusions and conditions and cannot be construed as a waiver of the basic insuring agreements of the policy”).

¹⁶ Of course, innocent insured provisions differ by policy and the exact policy language is critical in analyzing the applicability of any such provision.

¹⁷ Some policies may also contain other exclusions related to intentional conduct, such as exclusions barring coverage for the misappropriation of client funds, exclusions barring coverage for claims arising under the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961, et seq., etc.

¹⁸ As noted expressly in *Bryan Brothers*, nothing prevents an insured from negotiating for a policy with a narrower prior knowledge provision or a broader innocent insured provision. *Bryan Bros.*, 704 F. Supp. 2d at 542 n.4 (“As [d]efendant noted at oral argument, nothing prevented Bryan Brothers from bargaining for a policy that included a more limited prior knowledge provision or a broader ‘Innocent insureds’ provision”). See also *TIG Ins. Co. v. Robertson, Cecil, King & Pruitt*, 116 F. App’x 423, 427 (4th Cir. 2004) (noting that partnership could have, but did not, bargain for protection in the case of a partner making misrepresentations on the policy application); *Great Am. Ins. Co. v. Geostar Corp.*, No. 09-12488-BC, 2010 U.S. Dist. LEXIS 20258, at *11 (E.D. Mich. Mar. 5, 2010) (noting that “[p]arties are free” to bargain for severability provisions that require proof of each insured’s knowledge or that impute to the company only the knowledge of specific officers); *Stroock & Stroock & Lavan LLP*, 277 F. Supp. 2d at 248 (severability provision stated that “no fact pertaining to or knowledge possessed by any Insured shall be imputed to any other Insured to determine if coverage applies.”).