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NEWSLETTER

Court Rejects Insurer's Attempt to Rescind Lawyers Policy and Holds Prior Knowledge Exclusion Does Not Bar Coverage

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A federal district court has held that a law firm could not have reasonably foreseen that its client would file a malpractice suit against it when it applied for and obtained a renewal of its lawyers professional liability policy, concluding that the attempted real estate transaction giving rise to the suit was thwarted by the client's own actions—not the law firm's—and noting that the client continued to work with the firm in related litigation following the canceled transaction. United Nat'l Ins. Co. v. Granoff, Walker & Forlenza, P.C., 2009 WL 429243 (S.D.N.Y. Feb. 23, 2009). The court therefore rejected the insurer's argument that it was entitled to rescission based on the firm's failure to report the failed transaction on its renewal application or that it was entitled to disclaim coverage based on an exclusion for prior acts that might be expected to give rise to a claim.

The law firm's client was an experienced real estate developer that held a right of first refusal on a Brooklyn property. In 2001, the property owner entered into a contract with a third party to sell the property and, as required, offered the developer the right to purchase it under the same terms and conditions. After the developer, working with the law firm, successfully defeated the property owner's attempt to require the developer to match a higher price subsequently offered by another bidder, the developer and property owner entered into a sales contract in May 2003. The contract contained a mortgage contingency clause requiring the developer to obtain a firm mortgage commitment within thirty days of the contract date and which, if not complied with, enabled the property owner to cancel the contract. Instead of obtaining a mortgage, however, the developer decided to finance the purchase with cash. The developer did not inform the law firm of this plan until shortly before the closing, when a firm partner called him to confirm that he had obtained the mortgage commitment. At that point, the developer informed the firm that he had negotiated the "all cash" deal directly with the property owner's principals. The partner then called the property owner's counsel to inform him about the parties' "all cash" closing agreement and, although the property owner's counsel promised to follow up with the partner, he did not do so before the closing. The mortgage contingency clause expired on the June 2003 closing date, and, on that date, the property owner canceled the contract. When the law firm partner protested, invoking the "all cash" agreement, the property owner's attorney demanded evidence that the developer had the necessary cash. The developer could not produce such evidence. The developer then retained the law firm to bring an action for specific performance. In December 2003, the court

ruled against the developer, holding that the contract had been properly canceled. The developer then asked the firm to represent it on appeal.

In November 2004, the law firm applied to renew its professional liability policy, and indicated on the application that it was not aware of "any legal work or incidents that might reasonably be expected to lead to a claim or suit." In December 2004, just before the renewal policy period began, the firm reaffirmed that it was not aware of any acts, errors or omissions since the application's completion a month earlier. The policy included an exclusion for any claim arising out of a wrongful act occurring prior to the policy period if the policyholder "could have reasonably foreseen that such WRONGFUL ACT might be expected to be the basis of a CLAIM." In April 2005, the developer threatened to file a malpractice suit when he was informed that the appellate court had affirmed the lower court's ruling against him. The firm provided notice of this threat to the insurer.

The insurer subsequently disclaimed coverage and brought a declaratory judgment action. In the coverage action, the insurer asserted that the firm made a material misrepresentation when it submitted its renewal application without reporting the cancellation of the contract in 2003 as an incident that "might be expected to be the basis of a claim." The insurer contended that it was entitled to rescind the policy or, alternatively, to deny coverage based on the prior knowledge exclusion.

The district court rejected the insurer's arguments, holding that on the undisputed record a reasonable jury could not find that, in December 2004, the law firm knew or a reasonable attorney in the law firm's shoes could have reasonably foreseen that the developer would assert a malpractice claim. Notably, the court asserted that insurers seeking to disclaim coverage based on prior knowledge "bear" a heavy burden. "When an attorney is asked by a carrier whether he is aware of any legal work that might reasonably be expected to lead to a claim, he is expected to answer 'yes' only as to matters that involve a clear breach of duty, such as the failure to comply with the statute of limitations, attorney neglect, criticism by the court of disciplinary proceeding or explicit threats of litigation." Here, the court concluded that no such clear breach of duty occurred and that the firm could not have reasonably foreseen when it submitted the renewal application that the client would sue it for malpractice based on the cancellation of a contract some eighteen months earlier.