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NEWSLETTER

Prior Knowledge Exclusion Bars Coverage for Law Firm But Rescission Unwarranted

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The Court of Appeals of New York, applying Pennsylvania law, has held that a prior knowledge exclusion applicable to two excess professional liability policies precluded coverage for lawsuits arising out of a law firm's representation of a student loan company that engaged in securities fraud, where the firm failed to disclose to its insurers that it had learned about the fraudulent activity and might be named in lawsuits pending against the company. *Exec. Risk Indem., Inc. v. Pepper Hamilton LLP*, 2009 WL 3347222 (N.Y. Oct. 20, 2009). The court also held that rescission was not warranted at the summary judgment stage because the one insurer that was issuing a renewal policy had not shown as a matter of law that the law firm's nondisclosure was material to the renewal determination.

The firm had represented a student loan company that serviced the vocational portion of the student loan market. The company financed loans to students, acquired student loans from other lenders, and pooled those loans into certificates and sold them to investors. Prior to October 2002, the firm had two professional liability policies, one primary and one excess. In October 2002, the firm obtained additional excess coverage from two other insurers. The excess policies incorporated all of the terms of the primary policy, including a prior knowledge exclusion for "any act, error, omission, [or] circumstance . . . occurring prior to the effective date of [the policy] if [any insured] at the effective date knew or could have reasonably foreseen that such act, error, omission, [or] circumstance . . . might be the basis of a [claim]."

Meanwhile, in March 2002, the student loan company had informed the law firm that it had been subject to allegations of securities fraud, having inaccurately represented its default rate to make its certificates appear more attractive to investors, underwriters and credit risk insurers. The law firm stopped representing the company in April 2002. In September 2002, the law firm submitted an application to its primary insurer, which did not include information concerning the student loan company, and in October 2002, it wrote to one of its excess insurers warranting that it had no material changes to its application. The firm did not disclose information concerning the allegations against the student loan company to any of its insurers.

The student loan company went into bankruptcy, and in April 2004, the bankruptcy trustee sent the firm a proposed tolling agreement, advising that claims could be brought against the firm. The firm notified its primary and excess insurers. In 2005, the bankruptcy trustee and others brought malpractice claims against the firm based on its work for the student loan company. The excess insurers denied coverage, and a

coverage action ensued.

The state high court held that the prior knowledge exclusion did apply but that rescission was unwarranted. Regarding the exclusion, the court explained that the firm knew of its client's securities fraud months prior to the effective dates of the two new excess insurers' policies. The court noted that the attorney representing the company subjectively believed that its representation could subject the firm to a lawsuit and that the belief was reasonable. According to the court, "[g]iven the law firm['s] role in the securitization of the loans and [the attorney's] close involvement with [the company], a reasonable attorney with the law firm defendant's knowledge should have anticipated the possibility of a lawsuit, particularly when millions of dollars may have been lost from activities of which they were aware." The court rejected the argument that the prior acts exclusion applies only when the act, error, omission or circumstance represents "wrongful conduct on the part of the insured." Instead, the court held, it applies to any act, error, omission, or circumstance that might serve as the basis of a claim.

Regarding rescission, the court held that even if the law firm's omission of the issues surrounding its representation of the student loan company constituted a known false statement, the longstanding excess insurer failed to establish as a matter of law that the false statement was material to the insurer's renewal determination as required under Pennsylvania rescission law. The court explained that an underwriter's affidavit stating that the renewal application would have been treated differently had it disclosed the underlying circumstances of its representation of the company was "insufficient to meet the insurer's heightened burden of proof."