

Insurer's duty to defend excused by 2nd Circuit of appeal due to "prior knowledge" exclusion

Saxe Doernberger & Vita, P.C.

USA | October 12 2023

In *North River Ins. Co. v. Leifer*,¹ the United States Court of Appeals for the Second Circuit determined that a "prior knowledge" exclusion in a professional liability insurance policy excused the insurer from its duty to defend against malpractice claims brought against its insured. In so holding, the Second Circuit concluded that the insured failed to disclose facts and circumstances to its insurer that it knew or should have known could result in a future malpractice claim.

The case involved a dispute over professional liability coverage for legal malpractice claims brought against New York attorney Max D. Leifer and his law firm (together, "Leifer"). In October 2016, Leifer advised one of his clients ("Lee") not to file an answer in a state court action in which Lee was named as a defendant ("Original Action"). Lee followed Leifer's advice and, as a result, the court in the Original Action entered a default judgment against Lee. Leifer unsuccessfully attempted to set aside the default, and in the process failed to comply with New York's Civil Practice Laws and Rules, which required the client to sign an affidavit.

Nearly three years later, in September 2019, Leifer applied for professional liability insurance from North River Insurance Company ("NRIC") and represented that it had "no reasonable basis to believe that there was an act or omission in their rendering of services [that] might become the basis of a claim."² NRIC ultimately issued to Leifer a claims-made³ professional liability policy that was in effect from October 20, 2019, to October 20, 2020.

On October 7, 2020, Leifer reported to NRIC the potential malpractice claim after Lee sent correspondence to Leifer indicating as much. In November 2020, Lee sued Leifer for malpractice based on the allegedly improper advice Leifer had given relative to the Original Action. NRIC initially accepted the tender and defended Leifer, but, in March 2021, NRIC advised Leifer that it did not owe Leifer a defense based on its investigation and conclusion that "Leifer had prior knowledge of facts that Defendants could reasonably have expected to give rise to a claim."⁴

Thereafter, NRIC sued Leifer in the United States District Court for the Southern District of New York, seeking a determination from the court that it did not owe any professional liability coverage to Leifer under the circumstances. The District Court applied a two-prong test that examined (1) whether the insured had actual knowledge of the material facts that could give rise to a claim, and (2) whether a reasonable professional would have anticipated that those facts might be the basis of a claim. It ultimately found that the NRIC's claim satisfied this test, concluding that (1) "Leifer had knowledge of the facts and circumstances giving rise to Lee's malpractice claim" and (2) that "a reasonable attorney would have understood that Leifer's conduct could reasonably have been expected to give rise to a malpractice claim.

On appeal to the Second Circuit Court of Appeals, Leifer argued both that it had no reason to think Lee would bring a malpractice claim against them because Lee thanked Leifer for his services, and that Lee had no meritorious defenses in the Original Action.⁵

In affirming the District Court's decision, the Second Circuit stated that the inquiry is not whether Leifer subjectively believed his client would not sue him for malpractice, but "whether a reasonable attorney, based on the facts known to Leifer at the time, could have expected one."⁶ Notably, the reasonable attorney standard applied in this case differs from the standard held in several other states, which hold that the prior knowledge exclusion applies only if the insured subjectively believed a claim was likely to be brought against him or her.⁷

As for the argument that Lee had no meritorious defenses, the Court concluded it need not resolve the issue because in the Original Action, Leifer filed an opposition to default and asserted that Lee *did* have meritorious defenses. Therefore, the fact that any reasonable lawyer who asserts the existence of a meritorious defense after advising the client not to file an answer would reasonably believe that a malpractice lawsuit is likely.

North River emphasizes the need for insureds to disclose, transparently and carefully during the application process for an insurance policy, any facts or circumstances that could potentially give rise to a claim.

The Second Circuit's decision effectively imposes a burden on those seeking professional liability insurance to check all facts and circumstances that could result in a professional malpractice claim and disclose them to the insurance carrier during the insurance application process. It would also behoove insureds to negotiate an "inadvertent disclosure" exception to the insurer's ability to void coverage because of non-disclosure.

Saxe Doernberger & Vita, P.C. - David G. Jordan and Holly A. Rice

Powered by
LEXOLOGY.