COUGHLIN DUFFY LLP

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New York Appellate Division Denies Rescission Against Law Firm

Adam M. Smith, Esq.
Member

P.O. Box 1917
350 Mount Kemble Avenue
Morristown, New Jersey 07962
Tel (973) 631-6050
Fax (973) 267-6442

asmith@coughlinduffy.com

Danielle M. DeFilippis, Esq.
Associate

P.O. Box 1917
350 Mount Kemble Avenue
Morristown, New Jersey 07962
Tel (973) 631-6054
Fax (973) 267-6442

ddefilippis@coughlinduffy.com

www.coughlinduffy.com

On September 23, 2008, the New York Appellate Division, First Department, held that a law firm's failure to inform its liability insurer of its client's alleged securities fraud cannot form the basis of a rescission action or a denial of coverage based upon "prior knowledge". The Court held that knowledge by the firm of the likelihood that it would be sued based upon its representation of the client at the time of the alleged fraud was insufficient to defeat coverage. Executive Risk Indemnity Inc. v. Pepper Hamilton LLP, et. al., 2008 NY Slip Op 07044 (App. Div. 1st Dept. September 23, 2008).

The underlying claims against the law firm, Pepper Hamilton ("Pepper"), arose out of an alleged securities fraud scheme by its client, the Student Finance Corporation ("SFC"). SFC financed loans to students and then pooled the loans into certificates which were later sold to investors through private placement memoranda prepared by Pepper. To conceal the fact that many of these loans were in default, SFC made forbearance payments from reserve accounts of its own, resulting in SFC's understating default rates, skewing its performance data and making the certificates more attractive to investors. The scheme was uncovered by a lender in March 2002 and, according to Pepper, it was first informed of SCF's practice of making forbearance payments in March 2002. Pepper withdrew from its representation of SFC in April 2002.

SFC filed for bankruptcy and, in April 2004, the bankruptcy trustee contacted Pepper advising that claims against the firm were being considered. Pepper then notified its primary professional liability insurer, Westport Insurance Corporation ("Westport"), and its three excess insurers, Executive Risk Indemnity Inc. ("ERII"), Continental Casualty Company ("Continental") and Twin City Fire Insurance Company ("Twin City"). Both ERII and Twin City's policies were in effect from October 2002 to October 2004. Continental's policies were in effect from April 2001 to October 2004. In November 2004, an action was commenced against Pepper alleging negligence in its failure to discovery SFC's securities fraud as well as complicity in the fraudulent scheme.

Westport did not contest coverage, however, all three excess insurers moved for summary judgment, contending that they had no coverage obligation based upon the "prior knowledge" exclusion. Continental also sought rescission of its excess poli-

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cies for 2002-2003 and 2003-2004.

The prior knowledge exclusion at issue provides that coverage will not be afforded for any claim "arising out of any act, error, or omission committed prior to the inception date of the policy which the insured knew or should have known could result in a claim, but failed to disclose to the Company at inception."

The Court held that there was nothing in the record constituting objective evidence from which a reasonable attorney would conclude that the firm did anything that would subject itself to suit. The Court refused to extend the exclusion to situations in which the insured has knowledge of a client's misconduct, holding that the "known act" must be that of the insured, not the client. The Court found that even the firm's preparation of the inaccurate private placement memoranda does not establish, as a matter of law, the commission of wrongful acts. Notably, the Court went on to state that if it is ultimately established that the firm participated in the misconduct such as knowingly preparing documents with false information, application of the exclusion could be justified.

Finally, the Court held that Continental was not entitled to rescind its policies based on Pepper Hamilton's failure to disclose the potential claims in its renewal applications. The Court stated that the evidence merely shows that Pepper Hamilton knew of SFC's misconduct and believed it might itself be subject to suit. Whether Pepper Hamilton gave false answers in a renewal application and whether such answers were given in bad faith are questions of fact for a jury.

The Court focused on the fact that the "wrongful acts" at issue were those of the client and not the law firm. In such circumstances, New York courts will heavily scrutinize an insurer's efforts to deny coverage for a resultant claim, even when the law firm has failed to provide the insurer with full disclosure.

Should you have any questions about this decision, please feel free to contact us.