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Alerts

Claims-Made E&O Policy's Prior Knowledge Condition Applies Despite Insured's Subjective Belief That Unasserted Claim Could Be Successfully Defended

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Insurance Coverage Alert

From 2004 - 2006, an employee of an insured real estate management firm orchestrated a fraudulent embezzlement scheme. When a tenant who was qualified to have his or her rent subsidized by the U.S. Department of Housing and Urban Development (HUD) moved out of a unit in a certain apartment complex, of which the employee was the on-site manager, the employee would transfer a qualified tenant from a second unit into the vacated unit and place an unqualified tenant in the second unit. The employee then falsified the lease and HUD verification forms for the units to show qualified tenants living in both apartments. She kept the amount paid by the unqualified tenant that exceeded the subsidized rental rate.

The insured discovered the scheme in September 2006, and promptly provided notice under its commercial crime policy. On October 30, 2006, the insured provided notice under its errors and omissions policy with a first insurer, informing that insurer of "circumstances that may give rise to a claim." On November 1, 2006, the errors and omissions policy issued by a second insurer went into effect.

On June 7, 2007, the insured was advised of HUD's claim for reimbursement of its loss due to the negligent retention and supervision of the employee. The second insurer denied coverage for the HUD claim under the claims-made errors and omissions policy based on a "prior knowledge" condition that provided: "as [a] condition[] precedent to coverage hereunder [,] . . . as of the inception date no partner, principal, officer, director, or member of the Insured was aware of any Wrongful Act, fact, circumstance or situation that he or she knew or could reasonably have foreseen might result in a Claim under this Policy."

The trial court granted the second insurer's motion for summary judgment and the insured appealed. Applying a two-prong, subjective-objective test to determine whether the prior knowledge condition had been satisfied, the U.S. Court of Appeals for the Tenth Circuit found that a reasonable real estate management company could reasonably have foreseen that the employee's criminal conduct would result in a claim against the company for negligent retention and supervision. *Cohen-Esrey Real Estate Services, Inc. v. Twin City Fire Ins. Co. and Hartford Fire Ins. Co.,*__ F.3d __, 2011 WL 678383 (10th Cir. 2011). The court rejected the arguments advanced by the insured under the subjective prong of the analysis based on factors mitigating against its liability for the criminal act of an employee.

The insured argued that the HUD claim was unforeseeable because the insured did not subjectively believe it was negligent and did not know how it could have prevented the employee's embezzlement beyond employing the internal and external controls already in place.

In response, the Tenth Circuit noted:

[T]hese observations are most relevant to whether Cohen-Esrey was in fact negligent in retaining Phillips and not monitoring her more closely, not to whether a victim of Phillips's scheme would claim that Cohen-Esrey bore responsibility. Only if a reasonable insured would have concluded that Cohen-Esrey had a sure and obvious defense to a negligent-retention-and-supervision claim—a defense so sure and obvious that a victim would very likely not bother to make the

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claim—would the policy's condition precedent be satisfied. It would not be satisfied simply by a showing that a claimant would likely lose. After all, it bars coverage if Cohen-Esrey was aware of facts or circumstances from which it was reasonably foreseeable that a claim "might result.". . . The threat of a claim, even an unfounded one, is relevant to the insurer's exposure, because defense costs, which can be quite substantial, are covered by the policy even when the claim against the insured proves unsuccessful. The reality of modern American litigation, which is what insurance policies are designed to protect against, is that persons must be prepared to defend against colorable albeit invalid claims.

Practice Note

This decision reaffirms that the insured's belief that a potential claim is frivolous does not change the fact that it has knowledge that such a claim might be brought and does not negate the "prior knowledge" exclusion. Additionally, where issues involving an insured's "prior knowledge" arise, the adjuster will be well advised to request and review the application to determine whether or not the circumstances were disclosed in the application process. Rescission is often an alternative to a coverage defense based on "prior knowledge."

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