

PRIOR KNOWLEDGE EXCLUSIONS: INVERT YOUR RISK

ISSUE

In the retail world, sellers issue warranties backing up their products. In the insurance world, *buyers* of insurance may be required to submit warranties stating that they know of no facts, circumstances or claims that could give rise to a claim under the proposed policy. Warranties are required primarily when new coverage is secured, whether in the form of increased limits of liability or a new type of insurance. The individual signing the warranty executes the statement on behalf of all insureds, after confirming with the other insureds what, if any, knowledge they possess concerning potential claims. The signers often fear they will be held responsible not only for what they knew, but for the knowledge of others. The insureds also worry that the overly broad language in a warranty will result in the loss of protection for matters that they believe are covered.

An alternative to the warranty is the prior knowledge exclusion, often referred to as “inverted warranties.” An inverted warranty eliminates coverage for matters that the insureds were aware of at the time that coverage inception. These exclusions can pose similar problems for insureds.

IMPACT

In a decision recently affirmed by a circuit court, buyers’ worst fears were borne out: proof of prior knowledge voided coverage. Shortly after its 2005 IPO, Refco, a commodities brokerage firm, revealed a \$430 million receivable due from an

entity controlled by its CEO Phillip Bennett. The firm collapsed and Bennett eventually pleaded guilty to criminal charges brought as a result of the fraudulent concealment. In the coverage litigation that followed Refco’s collapse (*XL Specialty Ins. Co. v. Agoglia*), the court granted two excess insurers’ motions for summary judgment based on inverted warranties in their policies. On March 23, 2010, the Second Circuit affirmed the lower court’s decision (*Murphy v. Allied World Assurance Co.*).

Because Bennett admitted in the criminal proceeding that he knew that what he was doing was unlawful, the insurers successfully argued that “an insured” had prior knowledge of facts that could give rise to a claim. The carrier was able to deny coverage under the policy to all insureds based on the inverted warranty.

ACTION

Despite the XL case, inverted warranties offer several advantages over standard warranties – *if they are properly worded*. When properly constructed, the inverted warranty can include qualifying language that the exclusion only addresses facts that the insureds should reasonably have expected to cause a claim. No affirmative declaration is required from an insured and there is no need for individual directors and officers (in the case of a D&O policy) to disclose knowledge of facts. The scope can also be limited to facts or circumstances which an insured “had reason to believe” would result in a claim. The language can include full severability between individuals, ensuring that knowledge on the part of one insured person will not impact coverage for any other insured. This reflects



the difficulties faced by companies with a significant number of directors and officers in polling each potential insured to determine if he or she has knowledge of facts that could give rise to a claim. The carefully worded inverted warranty recognizes the justifiable reluctance of insureds to interpret the facts they know and decide whether or not those facts might give rise to a claim.

Another major advantage of inverted warranties is that they invert the burden of proof. In a situation where a carrier questions the validity of a warranted statement made by an insured, the *insured* will be forced to defend and justify the statement they made. However, when a carrier invokes an exclusion, the burden of proof shifts from insured to insurer. Thus, in the case of an inverted warranty, which operates as an exclusion in the policy, the insurer is required to prove the applicability of the exclusion.

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