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# The Unknown Of 'Known Losses'

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The "known loss" principle, under New York Law, is the recognition of the universal public policy that insurance should only cover fortuitous losses. This article explores this principle as it relates to third party liability and excess liability policies, and discusses its practical implications.

## Known Loss' Principle

The "known loss" principle under New York law is that an insured may not obtain insurance to cover a loss that is known before the policy takes effect. *Stonewall Ins. Co. v. Asbestos Claims Mgmt.*, 73 F.3d 1178, 1214 (2d Cir. 1995), opinion modified on denial of reh'g, 85 F.3d 49 (2d Cir. 1996). The principle extends as much to third-party insurance as it does to first-party insurance. Id. at 1215.

The "known loss" principle requires that, at the time that the policy was purchased or incepted, the loss, as opposed to the risk of loss, was known. If the insured merely knows that there is a *risk of loss*, the principle does not apply, and the insured is entitled to coverage. *City of Johnstown v. Bankers Standard Ins. Co.*, 877 F.2d 1146, 1152-53 (2d Cir. 1989).

The principle might extend to denying coverage to an insured in circumstances where a loss has not yet occurred but the insured knows that a loss will inevitably occur. See *Nat'l Union Fire Ins. Co. of Pittsburgh, PA. v. Stroh Cos.*, 265 F.3d 97, 109 (2d Cir. 2001). Alternatively, where the insured knows that losses are substantially certain to occur. *Wal-Mart Stores v. U.S. Fid. & Guar. Co.*, 816 N.Y.S. 2d 17, 18 (1st Dep't 2006).

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The antithesis to the "known loss" principle is that an insured may insure against the risk of loss even though there might be a likelihood of the risk materializing in the future. A loss that is only likely is not a loss which is known, inevitable, or necessarily a loss that is substantially certain to occur. A known risk of a future loss is thus something which the insured is entitled to insure.

**The Meaning of 'Loss'**

In the case of first-party property insurance: (1) the peril insured against is the risk of accidental damage to property, and (2) the loss insured against is accidental damage to property. If, at the time that an insurance policy was issued or incepted, the insured knows of the damage or the inevitability of damage or the substantial certainty that damage will occur to insured property falling within the scope of cover, then the insured is disentitled from an indemnity in respect of that damage. For example: Where the insured knows that flood damage had occurred to its property before the insurance came into effect or where an insured seeks coverage for a house that has already burned down.

The meaning of a "loss" in relation to third-party liability insurance, in particular an excess of loss liability policy, is less clear. The cases in New York do not specifically examine the nature of the peril or loss that the third-party insurance insured against.

The seminal case of *Stonewall* is instructive. The insured National Gypsum Company (NGC) sought coverage for asbestos claims. Two excess liability policies were issued to NGC by Constitution State Insurance Company (CSIC): the first commenced on Jan. 1, 1983 and the second commenced on January 1, 1984. The 1983 policy provided excess umbrella coverage.

On a motion for summary judgment, CSIC relied upon "the principle that insurance contracts afford coverage only for events that are contingent or uncertain, not for losses that are already known to have taken or to be taking place." *Stonewall Ins. Co. v. Nat'l Gypsum Co.*, No. 86 CIV. 9671 (JSM), 1991 WL 320046, at *1 (S.D.N.Y. Dec. 31, 1991), aff'd sub nom *Stonewall*, 73 F.3d 1178. By the end of 1982, seven property damage cases had been filed against NGC including a class action brought on behalf of all schools in Pennsylvania. Id. at *2. CSIC argued that NGC was disentitled from coverage for losses which had occurred and were known to have occurred, and therefore that NGC could not recover in respect of any liabilities resulting from those cases which had been commenced before the liability policies were taken out. Id.

In his report and recommendation, the magistrate judge noted that NGC agreed that, once a case was filed against it, the loss became known. NGC therefore did not seek coverage for suits that had already been filed against it. The magistrate judge went on to say that even a pre-suit demand letter sent prior to the inception of the policy would be sufficient to bar coverage under the known loss principle. Id. at *4.

The Court of Appeals accepted the insured's argument that, while coverage might not be available to it in respect of claims already made and suits filed against it at the time when its liability policies were incepted, it was covered with respect to potential claims that had not been made against it at inception but only thereafter. It further noted that "[t]hough NGC was aware, prior to the inception of many of the policies, that its products risked asbestosis and cancer diseases and had received a large number of claims, it was highly uncertain … as to the prospective number of injuries, the number of claims, the likelihood of successful claims, and the amount of ultimate losses it would be called upon to pay." NGC was therefore entitled to "replace the uncertainty of its exposure with the precision of insurance premiums." *Stonewall*, 73 F.3d at 1215.

With this exegesis in mind, it might be postulated that what triggers

the application of the known loss principle under a third-party liability policy includes the commencement of suit or the intimation of future suit against the insured before the policy was issued or incepted. It seems to be irrelevant whether the policy is primary or excess.

The problem with the decisions in *Stonewall* and extrapolating any legal principle from that case relating to known loss arises for two reasons. First, there was apparently no adversarial argument as to whether the bringing of suit against the insured before policy inception was a known loss in the context of a liability insurance. Secondly, the conclusion apparently reached that it was—and that the mere intimation of suit might also be—is contrary to principle and logic.

A known loss means what it says, and says what it means, even in the context of liability insurance. In the context of a third-party liability policy: (1) the peril insured against is the risk of incurring a covered liability, and (2) the loss insured against is the incurring of a covered liability. The loss is not the happening of an event or occurrence or a disputed claim which only gives rise to the risk of a covered liability. For the liability to be known, and thus the known loss principle in the context of a third-party liability insurance to apply, there must be an established liability, or, at least, the inevitability of a liability or the substantial certainty of a liability—not just the risk or apprehension or suspicion of a possible liability even if it might be said to be likely.

Applying this logic, a known loss would cover those cases where there had either been a determination of liability by a tribunal or court of competent jurisdiction or where it could be said that liability was substantially certain or inevitable to occur.

This logic and reasoning have been endorsed by the U.S. District Court for the District of New Jersey, in *UTI v. Fireman's Fund Insurance*, 896 F. Supp. 362, 376-77 (D.N.J. 1995):

> "[P]laintiff did not purchase liability insurance to compensate it for all property damage, but rather to compensate it for all sums for which it is held liable as a result of claims in which damage to property of third parties is alleged. The relevant "loss" to plaintiff is not the property damage itself, but rather the company's legal liability arising therefrom. This point is especially salient here, where it is an excess liability policy at issue; even if it were a certainty that legal liability would follow from the known leakage of TCE's by the date the policy was issued, defendants have supplied no proof that, at the time of contracting, there existed certain knowledge of a particular legal liability which would reach the excess layer".

New York case law does not suggest that the above would not be regarded by the New York Court of Appeals as consistent with, and reflective of, New York's "known loss" principle.

### Conclusion

For the reasons above, the "known loss" principle under New York law is unlikely to have much impact in cases of third-party liability insurance. The correct principled conclusion is that, in the context of a third-party liability policy, the loss that must be known by the insured at the time of the policy's issuance in order to attract the "known loss" principle must be the ascertainment of a legal liability or a legal liability which is known to be inevitable or substantially certain to exist. In the case of an excess liability policy, this can only occur when the amount of such a liability has reached or will inevitably reach the attachment point, and thus be a genuine loss to the policy. The "known loss" principle is not triggered by the bringing of suit or the mere intimation of a future suit.