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THE KNOWN-LOSS DOCTRINE: A CRITICAL BUT CONVOLUTED COVERAGE DEFENSE

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The “known loss” doctrine is a critical yet frequently misunderstood and misapplied common law defense to liability insurance claims. Although the doctrine is described differently in different jurisdictions—and not uncommonly described differently within the same jurisdiction—as a very general rule it precludes coverage for losses which the insured knew before the inception of a policy either had already occurred or were very likely to occur.¹ The doctrine encapsulates the principle that “losses which exist at the time of the insuring agreement, or which are so probable or imminent that there is insufficient ‘risk’ being transferred between the insureds and insurer, are not proper subjects of insurance.”² It has been broadly applied as a coverage defense in many types of insurance, including professional liability.³

A number of different rationales have been offered for the doctrine. As a matter of legal theory, the doctrine is frequently described as an offshoot of the fortuity principle. In other words, it is based on the premise that an “essential characteristic” of insurance is “the transfer from the policyholder to the insurer the risk of fortuitous losses, not losses that are reasonably certain or expected to occur within the policy period.”⁴

On a more practical level, the doctrine is often described as a tool to prevent fraud. In particular, the doctrine provides carriers with an additional defense in circumstances where an insured has purchased a policy intending that it cover losses that have already occurred or that are virtually certain to occur.⁵ Courts relying on this rationale tend to apply the doctrine in circumstances where the evidence establishes that the insured knew of a certain existing or pending loss or damage at the time the insurance was purchased but failed to reveal that fact to the carrier in the application process.⁶

The known-loss doctrine is frequently confused with other similar and overlapping doctrines, including the known-risk or loss-in-progress doctrines. As noted below, there are many variations in these doctrines, and courts oftentimes use these terms interchangeably to describe the same basic concepts.⁷ As a practical matter, because there is little consistency in the application of the doctrines, or in the nomenclature used to describe them, when addressing coverage disputes it is important to determine from the outset how the doctrine has been applied and described in the particular jurisdiction at issue.

The doctrine is usually described as a common law affirmative defense to coverage.⁸ There is not universal agreement on this point, however, as the doctrine has also been described—somewhat ambiguously—as a “condition precedent to coverage.”⁹

In addition, the courts also differ on whether the carrier or the insured has the initial burden of proof on known-loss issues. Consistent with the principle that the doctrine is an affirmative defense, most courts place the burden on the insurer to demonstrate that the insured had the requisite level of knowledge.¹⁰ Some states, however, expressly place upon the insured the initial burden of showing that the loss in question was fortuitous, “meaning that the inevitability of such loss was not known to the insured before coverage took effect...”¹¹ In those jurisdictions, once that burden is met, the insurer then must come forward with evidence showing that the known loss “exception to coverage” applies.

The principal importance of the doctrine is that it provides insurance carriers with an alternative to

rescission as a remedy in circumstances where an insured has purchased a policy without advising the carrier of losses that have already occurred or that are substantially certain to occur. The rescission remedy also has very different requirements and consequences, and it places different burdens on the carrier.

Rescission generally requires a return of premium, whereas the known-loss defense does not. Rescission also effectively serves as a *de facto* defense to all claims under the policy, whereas the known doctrine is claim-specific; the doctrine precludes coverage only for those existing or impending losses of which the insured was aware when the policy was purchased.

In addition, in order to rescind a policy, an insurer oftentimes must demonstrate that the insured made a fraudulent misrepresentation in the application process.¹² To demonstrate fraud, of course, the carrier must introduce evidence proving the insured's intent. It must also demonstrate the materiality of the misrepresented facts as well as its own justifiable reliance.

The carrier's evidentiary burden under the known-loss doctrine is significantly less onerous. As a general rule, and with variations depending on the jurisdiction, in order to invoke the defense the carrier need only establish that the insured knew or should have known that a loss had already occurred or was imminent. The carrier need not introduce evidence on the insured's intent, and it need not prove that a misrepresentation was made. For all these reasons, insurance carriers may prefer to rely on the known-loss defense rather than the rescission remedy.¹³

Modern professional liability policies oftentimes contain exclusions designed to preclude coverage for expected or intended losses and/or for losses known to the insured at the time the policy is purchased.¹⁴ A question sometimes arises concerning whether the known-loss doctrine still has any relevance in circumstances where such exclusions are present in a policy. Most courts that have addressed this issue have concluded that the doctrine provides an independent common law defense that applies notwithstanding the presence of such exclusions.¹⁵ Courts that have adopted this approach have explained that, because the doctrine is “integral to the nature of insurance,” it applies “irrespective of specific policy terms.”¹⁶

As a practical matter, the doctrine may also be a valuable tool notwithstanding the presence of potentially relevant exclusions in a policy. For example, a given exclusion may place a high burden

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on the carrier to demonstrate an insured's knowledge or intent concerning misrepresentations or omissions in the application process. In addition, the doctrine may provide a backup defense in circumstances where, through errors in policy underwriting or drafting, an exclusion intended to cover certain circumstances may not apply.

This latter situation may arise, for example, where a policy excludes coverage for claims arising out of circumstances known to the insured before inception of the policy and which the insured knew or reasonably should have known would lead to claims. The prior-knowledge date oftentimes used in such exclusions is the date of the initial issuance of the policy. If the policy term is later extended by means of an endorsement, but the endorsement does not also address or change the prior knowledge date contained in the exclusion, the exclusion may not protect the carrier against claims arising out of circumstances known to the insured on the date of the renewal. In such circumstances, the known-loss doctrine may give the carrier an additional defense.

Similar issues may arise when new insureds are added to an existing policy and those insureds are

aware of existing or pending losses. In such cases, the known-loss doctrine may provide the carrier with a valuable defense if existing exclusions fail to capture claims arising out of circumstances known to additional insureds at the time of their addition to the policy.¹⁷

As noted above, the value of the doctrine as a coverage defense is highly dependent upon which state's law applies, because courts describe the doctrine in vastly different terms in different jurisdictions. Some states have not addressed whether the doctrine applies. Other courts "wrestle with whether the... doctrine should be recognized as part of the common law in their... jurisdiction."¹⁸ The fact that state laws vary on this point may be an important consideration when negotiating choice-of-law provisions in professional liability policies.


The point on which the courts most often diverge is the level of knowledge that must be established before the doctrine can be applied to preclude coverage for a claim. There are also disagreements on what constitutes a "loss,"¹⁹ and whether the insured's knowledge is to be judged by an objective standard (i.e., one which asks whether a reasonable insured should have known of existing or pending losses) or a subjective standard (i.e., one focused on what the insured actually knew).²⁰ While a detailed

review of the decisions is beyond the scope of this paper, the following is a short overview of the most commonly applied standards.

The most restrictive interpretation of the doctrine permits its application only where a legal obligation to pay has already been imposed on the insured prior to issuance of the policy.²¹ In other words, unless the insured's liability has been conclusively established before the policy was issued, the doctrine does not apply to preclude coverage.


Other courts with a slightly more liberal test require that the insurer demonstrate that the insured knew that such liability was "substantially certain" to occur.²² Courts applying this standard may decline to apply the doctrine in circumstances where the insured knew before the policy was issued that claims would likely be asserted against it, so long as the insured had "sufficiently viable" defenses to liability.²³ Another variation applies the doctrine to preclude coverage where an insured is aware of a "substantial probability" that it has suffered or will suffer a loss.²⁴

The doctrine has, however, also been applied far more broadly. For example, some courts apply it to preclude coverage where the insured was merely aware of a substantial probability of a "claim," as opposed to a "loss."²⁵ Other courts apply a standard that requires merely that the policyholder have a "reason to know" of a potential loss.²⁶ Finally, perhaps the most liberal standard applies the doctrine to preclude coverage in circumstances where the insured "knew at the time they entered the insurance policy that they were engaging in activities for which they could *possibly* be found liable."²⁷

In short, the known-loss doctrine is a potentially critical coverage defense for issuers of professional liability policies. It offers an alternative to rescission in circumstances where a policy has been purchased without the insured revealing important facts about existing or potential claims or losses, and it may apply to provide a defense even if the policy contains exclusions that are designed to address, but fail to capture, such conduct. The case law applying the doctrine is, however, inconsistent. It is critical to determine from the outset which state's law controls; what level of knowledge is required, and whether the state applies an objective or subjective standard; and which party will bear the burden of proof. 

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