

# Prior Knowledge Exclusion Requires Subjective Belief that Claim Will Be Made

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In an unpublished decision, the United States District Court for the Northern District of New Jersey has held that an insurer could not deny coverage under a prior knowledge exclusion in an E&O policy unless it could show that the insured had "subjective" knowledge that a claim would be made. *Colliers Lanard & Axilbund v. Lloyds of London*, 2005 WL 1378882 (D.N.J. June 8, 2005).

The insurer issued an E&O policy to a real estate lending broker. The policy at issue stated that the insurer would provide coverage "provided that the insured had no knowledge of any claim or suit, or any act or error or omission, which might reasonably be expected to result in a claim or suit as of the date of signing the application for this insurance." The policy defined "claim" as "(a) a demand received by an Insured for money or services; or (b) a notice received by an Insured alleging a breach of duty by an Insured; or (c) service of suit, or notice received of the initiation of arbitration or other proceedings against the Insured." In applying for coverage, the insured stated that he did not have "knowledge of any claim or suit, or any act or error or omission, which might reasonably be expected to result in a claim or suit."

During the policy period, the insured was served with a complaint by a client relating to a landlord/tenant matter and informed its insurer of the lawsuit. The insurer denied coverage because, prior to the inception of the policy, the real estate broker was aware that its clients believed that the broker had made a mistake in drafting the terms of a lease. However, the vice president and general counsel of the real estate broker, who completed the insurance application, testified that he did not believe the matter would result in litigation because "litigation was a rare occurrence" and because "[m]ost landlords and tenants most always settle their disputes." He also testified that he expected that any litigation would be against the tenants to reform the lease, not against the broker.

The court first noted that exclusions are to be narrowly construed, and that the burden is on the insurer to show that a case falls within the exclusion. The court next stated that whether the insured reasonably expected to be sued "is a subjective question" that depended upon whether the insured "in fact" believes he will be sued. Because the insured did not honestly believe that a legal claim would be brought against him, it held that the insured's response in its application was not a misrepresentation. The court therefore held that the insurer had wrongfully refused to defend the insured.

The court also held that the amount of the underlying settlement was reasonable in "consideration of the risk, exposure of liability, the amount in controversy, the extent and duration of the negotiations, and the lack of collusion."

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