

Applying Mixed Subjective/Objective Test, Third Circuit Holds that Prior Knowledge Exclusion Bars Coverage

August 2009

The United States Court of Appeals for the Third Circuit, applying New Jersey law, has held that there is no coverage under a real estate brokerage professional liability policy where the insureds had knowledge of drafting errors in two commercial leases prior to completing the application for insurance. *Colliers Lanard & Axilbund v. Lloyds of London*, 2009 WL 1942004 (3d Cir. July 8, 2009).

The insurer issued a professional liability insurance policy to a real estate brokerage firm. The policy provided specified coverage for claims made against the insured during the one-year policy period, "provided that . . . the [i]nsured had no knowledge of . . . 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." At the time the brokerage firm completed the insurance application, the firm had knowledge of drafting errors that it had made in two commercial leases, which resulted in the firm's client losing substantial revenue because it was unable to collect certain operating costs from its tenants. The client later filed suit against the brokerage firm based on these drafting errors and the resulting loss in revenue. The firm tendered the claim for coverage under the policy.

The insurer denied coverage pursuant to the policy's prior knowledge exclusion based on the insured's knowledge of the drafting errors at the time it completed the application for insurance. In the coverage litigation that followed, the brokerage firm asserted that a recent New Jersey Supreme Court decision mandated the application of a purely "subjective" test to the prior knowledge inquiry—that is, the insured must actually know or believe that a claim is forthcoming in order for the prior knowledge exclusion to preclude coverage. The firm argued that, although it was aware of the lease drafting errors at the time that it completed the insurance application, it did not subjectively believe that the firm's client would sue based on those errors. Accordingly, the firm contended that the policy's prior knowledge exclusion was inapplicable.

The court disagreed, concluding that the policy exclusion was unambiguous and required the application of a two-part mixed subjective/objective test: (1) the insured must have subjective awareness of the relevant act, error or omission and (2) the act, error or omission must be such that a reasonable professional in the insured's position might expect it to result in a claim. The court rejected the insured's argument that the recent

New Jersey Supreme Court decision required application of a purely subjective standard. The court distinguished the New Jersey case, noting that in that case the parties had agreed that a subjective standard should apply, and the court did not address the applicable standard, except to note, *in dicta*, that the policy exclusion appeared to require an objective inquiry. Indeed, the court stated that the New Jersey case "expressly does not hold that the policy exclusion bars coverage only if the insured subjectively believed that a claim against it was forthcoming."

Based on the undisputed evidence showing that the brokerage firm knew of its drafting errors and knew that those errors had caused a client to lose substantial expected revenue, the court determined that the jury's finding that a reasonable professional would have expected those errors to result in a claim was "amply supported by the evidence."