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NEWSLETTER

Prior Knowledge Exclusion Bars Coverage Where Insured Knew Litigious Plaintiff Might Bring Claim

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Applying New Jersey law, a federal district court has held that a prior knowledge exclusion barred coverage for a lawsuit against the insured law firm where the underlying claimants had, prior to the inception of the policy, accused the law firm of contributing to the law firm clients' alleged fraud and of improperly withholding certain documents during the course of discovery. *Navigators Specialty Ins. Co. v. Scarinci & Hollenbeck, LLC*, 2010 WL 1931239 (D.N.J. May 12, 2010). The court also held that a coverage action regarding the duty to defend is ripe while the underlying action is ongoing and that, although coverage was excluded, the allegations against the law firm constituted professional services.

The insured law firm represented certain other companies in bringing a foreclosure action against the underlying claimants. During the course of that litigation, and prior to the inception of the relevant policy, the law firm allegedly falsified certain accounting documents filed with the court and withheld other documents from the court and from the underlying claimants. Also prior to inception, the underlying claimants complained of these alleged actions and threatened to sue the law firm.

The policy in question was a legal malpractice policy that provided specified coverage for claims regarding the "rendering or failing to render Professional Services." "Professional Services" was defined as services "provided as a lawyer." The policy excluded coverage for "any Claim arising out of any acts, errors, or omissions which took place prior to the inception date of the first policy issued and continuously renewed, if any Insured on the effective date knew or could have reasonably foreseen that such acts, errors, or omissions might be expected to be the basis of a Claim."

After the policy had been issued, the underlying claimants followed through on its threats to sue the law firm in connection with its representations during the earlier foreclosure suit. The insurer provided a defense under a reservation of rights and brought this declaratory judgment action for a determination as to whether the underlying suit alleged "professional services" and, if it did, whether the prior knowledge exclusion barred coverage. The law firm asserted that the coverage action was not ripe and, then, after the underlying suit was settled during the pendency of the coverage suit, took the position that the coverage suit was moot.

The court first held that the coverage suit had always been ripe and was not rendered moot by the settlement of the underlying action. As to ripeness, the court explained that the parties genuinely disputed the existence of the insurer's duty to defend and that a ruling on the duty to defend would be helpful to the parties in determining whether the law firm would be obligated to reimburse the insurer for the previously paid defense costs. The court further rejected the mootness argument, explaining that the ruling on coverage will determine whether the law firm will be obligated to reimburse past defense costs and settlement payments.

The court then addressed whether the alleged abuses during the prior litigation constituted "professional services." The court rejected the insurer's argument that the underlying suit could not allege professional services because it was not brought by a former client. According to the court, the policy language did not restrict the type of claimant that could bring a claim alleging professional services. Addressing whether the alleged abuses, falsifying information and withholding other information, constituted professional services, the court held that they did because they "are acts that allegedly occurred in the context of [the law firm's] representation of [its clients] in a foreclosure action, and there is clearly a substantial nexus between such representation and the professional services that [the clients] sought from" the law firm.

The court then considered the prior knowledge exclusion. The court held the exclusion must be applied according to a mixed subjective and objective test, under which the question is whether the insured was subjectively aware of facts that would cause a reasonable person to expect a claim. The court noted that a New Jersey intermediate appellate court had refused to apply this test in *Liebling v. Garden State*, 337 N.J. Super. 447 (App. Div. 2001), but explained that this case was irrelevant because a later Third Circuit decision had predicted that the ruling in *Liebling*, if presented to the New Jersey Supreme Court, would not be adopted by the New Jersey Supreme Court. Applying this test, the court held that the exclusion barred coverage because the law firm was subjectively aware of the allegations of its misconduct prior to the inception of the policy and, according to the court, a reasonable person in the insured's position, unaffected by any subjective view of the merits of any possible claim, would have expected the underlying claimants to bring a claim.