NEWSLETTER

No Coverage Based on Prior Knowledge Condition and Business Enterprise Exclusion

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The United States District Court for the Northern District of Illinois has held that there is no coverage under a lawyers professional liability insurance policy where the policy's prior knowledge condition to coverage was not met and where the business enterprise exclusion precluded coverage. *DarwinNat'l Assur. Co. v. Hellyer,* No. 10 C 50224, (N.D. Ill. June 7, 2011). Wiley Rein represented the insurer in the litigation.

The insurer issued a lawyers professional liability insurance policy to the insured for the policy period March 18, 2010 to March 18, 2011. The policy included a prior knowledge provision, which conditioned coverage on no insured having a basis "(1) to believe that any Insured had breached a professional duty; or (2) to foresee that any such Wrongful Act or Related Act or Omission might reasonably be expected to be the basis of a Claim against any Insured . . . ." The policy also included a business enterprise exclusion, which provided that the policy shall not apply to any claim "based on, arising out of, directly or indirectly resulting from, in consequence of, or in any way involving, in whole or in part . . . the Insured's capacity or status as an officer, director, partner, trustee, shareholder, manager or employee of a business enterprise . . . ."

The insured lawyer provided legal services to the beneficiaries of a trust, which owned a large tract of real estate. The insured, through a limited liability corporation, entered into a contract with the beneficiaries to purchase the real estate held by the trust. The contract provided that the limited liability corporation would execute a promissory note payable to the beneficiaries and secured by a mortgage on the real estate. After the corporation was unable to make a mandatory principal payment on the note, the insured obtained additional financing from a bank. The bank required the corporation to obtain a subordination of mortgage agreement from the beneficiaries. The insured represented the beneficiaries in connection with the execution of the mortgage subordination agreement, and the transaction closed on May 9, 2008.

The corporation subsequently defaulted on the loan. The beneficiaries sued the insured alleging that the insured failed to advise them properly regarding the terms of the subordination agreement and that they should seek the advice of independent counsel regarding the agreement. The beneficiaries also asserted that the insured violated professional standards of care by engaging in a business transaction with clients in which the insured knew or reasonably should have known that he had conflicting interests with the clients.

The insured sought coverage under the policy and, in the coverage litigation that followed, the insurer asserted that it had no duty to defend the insured in the underlying action because the policy's prior knowledge condition had not been met and because the policy's business enterprise exclusion precluded coverage.

The court granted the insurer's motion for judgment on the pleadings. The court first held that the policy's prior knowledge condition had not been met. The court stated that, by advising the beneficiaries to sign a mortgage subordination agreement that would allow the insured's corporation to borrow more money while simultaneously reducing the extent of the beneficiaries' security interest, the insured acted to advance his own interests and not the best interests of his clients. The court concluded that, based on this conduct, the insured "certainly had an objective basis to believe that he had breached a professional duty and that his conduct might form the basis for a malpractice claim." The court rejected the beneficiaries' argument that there was a factual issue as to whether the insured intended for there to be a default on the loan and noted that, although it may be true that the insured did not intend for a default, it was irrelevant because a "reasonable attorney" in the insured's position "would have had a basis to believe, at the time of the closing on the mortgage subordination agreement, that a professional duty had been breached and that this breach could form the basis for a claim."

The court also concluded that the policy's business enterprise exclusion precluded coverage because the underlying claim is based on, arises out of, and is a direct result of the insured's business interest in the limited liability corporation. The court rejected the beneficiaries' argument that the business enterprise exclusion was not applicable because certain allegations could constitute professional negligence regardless of the insured's business interests. In reaching this conclusion, the court stated it would not read any particular allegation in isolation and that, when the underlying claim was read as a whole, "it is clear that the thrust of the allegations of negligence stem from the conflict of interest" that the insured had as a result of his interest in the limited liability corporation. The court went on to state that the underlying claim was based on the fact that the insured had a personal financial stake in his business venture, "and this is precisely the increased risk that [the insurer] has excluded from its coverage with the Business Enterprise Exclusion."