

Factual Issues Preclude Application of Prior Knowledge Provision and Exclusions as a Matter of Law

April 2013

The United States District Court for the District of South Carolina, applying South Carolina law, has held that factual issues precluded the application of a prior knowledge provision and a property syndication exclusion as a matter of law. *Greenwich Ins. Co. v. Garrell*, 2013 WL 869602 (D.S.C. Mar. 7, 2013). The court denied an insurer's motion for judgment on the pleadings based on these and additional coverage issues and also denied the insured's motion for summary judgment seeking a declaration that the insurer had a duty to defend it in an underlying action.

An insurer issued a professional liability policy to a real estate agency that provided coverage for claims arising out of services performed for others in the insured's capacity as a real estate agent or broker. The agency and related insured entities and individuals assisted investors with the purchase of commercial real estate, which led to the formation of a single-purpose entity (SPE) for each real estate transaction. These SPEs were identified together as an investment fund (the Fund) that was managed by a board comprised of members elected from the investor-members involved with the SPEs (the Board).

In August 2011, certain member-investors in the Fund filed a lawsuit against, among others, the Board, other Fund member-investors and the real estate agency and agent (the Underlying Lawsuit). The complaint made "wide-ranging" allegations, including that the insured defendants omitted material information with respect to certain real estate transactions, falsely represented information regarding cable agreements and made negligent misrepresentations regarding certain real estate transactions, including a transaction that was the subject of a lawsuit in 2007 (the Prior Lawsuit). The Prior Lawsuit had been filed by the Board against a counterparty to a failed real estate transaction. The insureds were aware of the Prior Lawsuit but were not named as defendants in that action. The Prior Lawsuit was settled in early 2011.

The insureds tendered the Underlying Lawsuit for coverage under the policy. The policy provided coverage for claims first made after the policy's inception in February 2011 unless, prior to the policy's inception, the insured had "a basis to believe that [the act or omission at issue], or any related act or omission, might reasonably be expected to be the basis of a claim" (alteration in original). The insurer agreed to provide a defense for the Underlying Lawsuit subject to a reservation of rights and filed this action for a declaration that

it had no duty to defend or indemnify the insureds. The insureds counterclaimed for a declaration that the insurer had a duty to defend and for bad faith. The insurer and insureds filed cross-dispositive motions on whether the Underlying Lawsuit was covered under the policy.

First, the insurer argued that the plaintiffs in the Underlying Lawsuit first made a claim against the insureds prior to the inception of the policy. The policy defined "claim" to include "a demand for money or services." In the Underlying Lawsuit, plaintiffs alleged that they demanded that parties in the Prior Lawsuit add the insureds to the Prior Lawsuit, and the insurer argued that plaintiffs thus made a monetary demand against the insureds in the Prior Lawsuit. However, the insureds were not parties in the Prior Lawsuit, and the court stated that the record before it did not show a demand for money or services was made against the insureds in connection with the Prior Lawsuit. As such, the insurer failed to show as a matter of law that a claim was first made against the insureds prior to the inception of the policy.

Second, the insurer argued that the Prior Lawsuit gave the insureds a basis to believe that a claim against the insureds could reasonably be expected. The court concluded that the prior knowledge provision was a "condition precedent" to coverage and applied a two-part subjective/objective analysis to determine the applicability of the prior knowledge provision. The court noted that the insureds were not parties in the Prior Lawsuit and were informed by counsel that there was no basis for a claim against them in connection with the Prior Lawsuit. The court therefore concluded that the pleadings failed to show as a matter of law that a reasonable insured in possession of those facts would believe that the allegations in the Prior Lawsuit could be the basis of a future claim against them. However, the court also concluded that there were genuinely disputed facts regarding whether the Prior Lawsuit could put "a reasonable insured on notice of an act or omission that could be the basis of a claim" and the extent to which the Prior Lawsuit and the Underlying Lawsuit were related. The court therefore denied the insurer's motion for judgment on the pleadings. In addition, the court stated that the issue of the duty to defend required it to evaluate "facts outside the complaint that are known by the insurer," such as the insurer's knowledge of the Prior Lawsuit at the time it issued the policy, which the court described as "highly relevant" to the insurer's duty to defend. The court therefore determined that summary judgment on the issue of the insurer's duty to defend was inappropriate.

Finally, the court addressed an exclusion described as precluding coverage for "property syndication or real estate investment trusts . . ." The insurer argued that the Underlying Action alleged that one or more of the insureds were members of the Board, which managed the SPEs, and the SPEs' actions constituted property syndication. The insurer asserted that, because the insureds participated in property syndication, the exclusion therefore barred coverage for the Underlying Lawsuit. The court noted that the insurer's argument relied on very few paragraphs in the complaint and that the Underlying Action alleged that the insureds either acted as or held themselves out as real estate agents. The court concluded that it could not decide "as a matter of law that *all claims* were caused by purported property syndication." The court denied the insurer's motion for judgment on the pleadings on this issue. With respect to the insureds' motion for summary judgment, the court stated that the insureds "appear to merely argue that [the insurer] fails to establish the applicability of the property syndication exclusion, as opposed to showing that the exclusion is inapplicable a matter of law" and thus the insureds "failed to carry their burden of demonstrating that summary judgment is appropriate." The

court reserved ruling on the insureds' argument that the property syndication exclusion was ambiguous.

The court declined to address the remaining exclusions raised by the insurer. Finally, the court determined that the issue of bad faith could not be determined as a matter of law where there were genuine disputes of fact related to the issue of coverage under the policy.