

Third Circuit Holds That Prior Knowledge Exclusion Requires Mixed Subjective/Objective Test

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The U.S. Court of Appeals for the Third Circuit, predicting New Jersey law, has expressly disagreed with a New Jersey Superior Court and held that a prior knowledge exclusion requires an inquiry into whether the policyholder was subjectively aware of circumstances that the policyholder objectively should have expected to result in a claim. *Colliers Lanard & Axilbund v. Lloyds of London*, 2006 WL 2327039 (3d Cir. Aug. 11, 2006).

A real estate brokerage firm purchased E&O coverage subject to the condition "that the insured had no knowledge of any 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." Evidence established that, prior to signing the application, the brokerage firm was aware that it had failed to input an operating expense term into a lease. This failure had resulted in correspondence, prior to signing the application, in which the brokerage firm attempted to input the term after the fact. The lessee informed the brokerage firm that it would not agree to such a modification and that all future correspondence "should be directed to [the lessee's] attorney." After submitting the insurance application, the brokerage firm was given notice of a claim by the lessee, and eventually the lessee filed suit. The insurer denied coverage based upon the prior knowledge exclusion.

The Third Circuit first considered the language of the exclusion. According to the court, the first condition of the exclusion, whether "the insured had knowledge," required a subjective, rather than objective, analysis. The second condition of the exclusion, whether there was a circumstance that "might reasonably be expected" to result in a claim, required an objective, rather than subjective, standard. The court noted that this analysis was in accord with its decision in *Selko v. Home Insurance Co.*, 139 F.3d 146 (3d Cir. 1998), in which the court, applying Pennsylvania law, held that a prior knowledge exclusion requires an inquiry into whether a policyholder was subjectively aware of the circumstances that the policyholder objectively should have expected to result in a claim.

In reaching the opposite conclusion, the district court had relied upon *Liebling v. Garden State Indemnity*, 767 A.2d 515 (N.J. Super. 2001). The *Liebling* court in turn relied upon the Supreme Court of Wisconsin's decision in *Estate of Logan v. Northwestern National Casualty Co.*, 424 N.W.2d 179 (1988). The Logan court had held that

a prior knowledge exclusion must be applied according to a subjective standard because an objective standard would prevent all retroactive coverage, in that an objectively reasonable professional would necessarily be aware of his prior errors and expect claims thereon.

The Third Circuit disagreed. The court, referring to *Selko*, noted that applying a subjective approach to determine whether the policyholder expected a claim would reward ignorance on the part of professionals and promote a lack of candor toward the courts by providing an incentive for the policyholder to present post hoc justifications for his wrongful withholding of information.

Further, the court also found the *Logan* court's reasoning unpersuasive in that the concerns regarding illusory coverage for objective awareness of claims could be solved by determining whether the policyholder subjectively had knowledge of the relevant facts. The Third Circuit therefore predicted that the New Jersey Supreme Court would adopt the "mixed subjective-objective" test of *Selko*. The court then remanded the case for further proceedings.