

Attorney's Prior Knowledge of Contract Negotiation Error Bars Coverage for Malpractice Claim

Applying Florida law, the federal district court for the Southern District of Florida recently held that a prior knowledge exclusion barred any duty to defend or indemnify against an underlying malpractice lawsuit, given the insured attorney's prior knowledge of an alleged error in negotiating a client's contract. *David R. Farbstein, P.A. v. Westport Ins. Co.*, 2017 WL 3425327 (S.D. Fla. Aug. 9, 2017).

A former client sued the insured attorney for failing to include terms in a real estate sales contract that would relieve the client of responsibility for a pre-payment penalty under the existing mortgage on the property. The insured attorney tendered the complaint to Westport for coverage under the insured's lawyer's professional liability policy. Westport denied any obligation to defend or indemnify based on the policy's prior knowledge exclusion. The exclusion applied to any claim arising out of a wrongful act if, on the effective date of the policy, the insured knew or could have reasonably foreseen that the wrongful act might be expected to be the basis of a claim.

In a subsequent declaratory judgment action, the insured and Westport filed cross-motions for summary judgment. The insured asked the court to declare that Westport had a duty to defend but to defer any ruling regarding indemnification until conclusion of proceedings in the underlying lawsuit. Westport requested summary judgment on both the duty to defend and the duty to indemnify.

In considering the duty to defend, the court observed that under Florida law, the duty to defend is determined solely from the allegations of the complaint, with resort to extrinsic evidence only in rare circumstances. Because the court determined that the underlying complaint alleged sufficient facts to decide when the insured had notice of a potential malpractice issue, it refused to consider the deposition transcripts and discovery responses submitted by both the insured and Westport in connection with their cross-motions for summary judgment.

The court held that the prior knowledge exclusion was unambiguous and that the exclusion is applicable where the underlying complaint alleges that the insured either (1) knew that a wrongful act might be expected to be the basis of a claim, or (2) could have reasonably foreseen that a wrongful act might be expected to be the basis of a claim. The court explained that the first circumstance requires use of a subjective standard requiring actual knowledge. And the second circumstance involves both a subjective and objective standard; whether the insured could have reasonably foreseen that a wrongful act might be expected to be the basis of a claim is the objective question, but it must be based on the facts subjectively known to the insured.

Applying these standards, the court found that the allegations in the underlying complaint established that at the time of the policy's inception, the insured attorney subjectively knew

that he failed to incorporate specified terms into the sale contract, causing injury to his client, and that the insured could have reasonably foreseen that the alleged error might be expected to be the basis of a claim. The court identified the following determinative allegations from the underlying complaint:

- the insured was retained to ensure that the client would not be required to pay the pre-payment penalty under the existing mortgage;
- the insured agreed that he would negotiate a sales contract in which the buyer would be required to either assume the existing mortgage or pay the pre-payment penalty;
- the insured failed to negotiate a contract containing the required terms;
- upon discovery of the error, the insured and client discussed the buyer's lack of obligation to pay the pre-payment penalty or to assume the mortgage, and the insured advised the client to proceed with the closing anyway;
- during this discussion with the client, the insured referenced his errors and omissions insurance policy; and
- based on the insured's advice, the client went forward with the closing and incurred the \$482,604.94 penalty – the very event that the insured was retained to prevent.

Because the only claim alleged in the underlying complaint fell within the prior knowledge

exclusion, the court held that Westport did not owe a duty to defend. The court then considered whether it could determine the duty to indemnify prior to resolution of the underlying lawsuit. The court acknowledged cases stating the general rule that determination of the duty to indemnify is premature prior to resolution of the underlying claim. However, the court noted the exception to this rule where the allegations of the complaint could never trigger a duty to indemnify, and cited corollary cases holding that where there is no duty to defend, there can be no duty to indemnify. In light of its finding that Westport had no duty to defend, and citing to what it characterized as Florida's well-established principle that there cannot be a duty to indemnify without a duty to defend, the court concluded that Westport had no duty to indemnify.

Comment

The ruling reaffirms the enforceability and application of prior knowledge exclusions and is notable in that the court found no duty to defend or indemnify based solely on the allegations of the underlying complaint.

If you have any questions about this Update, please contact the author listed below or the Aronberg Goldgehn attorney with whom you normally consult:

Lisa J. Brodsky
lbrodsky@agdglaw.com
312.755.3177