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District of Maryland: Prior Knowledge Exclusion in Policy Application Bars Coverage

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Professional liability insurance policies often contain prior knowledge exclusions, which typically bar coverage when an insured has "knowledge or information of any act, error or omission which may give rise to a Claim." These exclusions are important because they can provide insurers with some level of protection with respect to potential issues that may be known to the policyholder, but not the insurer. Given the fact-intensive nature of the prior knowledge exclusion, it is a recurring issue in coverage litigation between insurers and policyholders.

On March 30, 2018, the United States District Court for the District of Maryland, applying Maryland law, held that a prior knowledge exclusion in a policy application barred coverage for a lawsuit because it arose from a prior demand letter which placed the insured on notice of "acts that could give rise to a claim." *See*, *Madison Mechanical, Inc. v. Twin City Insurance Company*, 2018 US Dist. LEXIS 55898 (D. Md. Mar. 30, 2018).

BACKGROUND

The underlying action arose out of the formation of Madison Mechanical Contracting, LLC (MM LLC) by certain members of Madison Mechanical, Inc. (MM Inc.). According to the court, the formation of MM LLC was done "in an alleged effort to take business from MM Inc." and excluded one of MM Inc.'s former owners. *Id*. at 2-3.

On November 11, 2015, the former owner sent a demand letter to the members regarding the formation of the new company. In that letter, the former owner "asserted that the purpose of [the new company's] formation was to divert the business and client base of [the old company] for the benefit of [the new company] and to the detriment of [the old company]." *Id*. at 4 (internal citations omitted). The letter further stated that these actions "could lead to a cause of action for breach of fiduciary duty, interference with a contractual relationship, interference with an economic relationship, civil conspiracy and other potential causes of action." In the letter, the former owner put the members "on notice of the potential litigation liability of such actions both on a corporate and personal level." *Id*.

MM Inc. had purchased two insurance policies from Twin City Insurance Company (Twin City): (1) a policy providing coverage for the May 1, 2015 to May 1, 2016 policy period (2015-2016); and (2) a policy providing coverage for the May 1, 2016 to May 1, 2017 policy period (2016-2017).

On December 29, 2015, the insured submitted an application to add MM LLC to the 2015-2016 Policy, effective January 1, 2016. The application contained a "Prior Knowledge Question" which provided that:

> With respect to each coverage currently purchased, did any Applicant or any natural person for whom insurance is intended have any knowledge or information, as of the "date of coverage first purchased," of any error,

> misstatement, misleading statement, act, omission, neglect, breach of duty or other matter that may give rise or could have given rise to a claim.

The insured answered "no" to this question. Directly underneath the "Prior Knowledge Question," the application contained a "Prior Knowledge Exclusion," which provided that:

> It is agreed that if any such knowledge or information existed, any claim based on, arising from, or in any way relating to such error, misstatement, misleading statement, act, omission, neglect, breach of duty, or other matter of which there was knowledge or information shall be excluded from coverage requested.

On May 27, 2016, the former owner filed a lawsuit alleging that "MM LLC took over ongoing projects that were previously being performed by [MM Inc.] as well as several contracts that had been negotiated under [MM Inc.'s] name and began performing the projects for the benefit of [MM LLC]." *Id*. at 7 (internal citations omitted). The former owner further alleged that "the purpose of MM LLC was to take business and corporate opportunities from [MM Inc.] and [MM Corp.] for the benefit of [MM LLC] and its members." *Id*. The complaint contained various causes of action, including breach of fiduciary duty and tortious interference with economic relations.

Twin City denied coverage for the underlying action on various grounds, including the prior knowledge exclusion. The insureds filed a complaint for declaratory relief against Twin City, and the parties filed cross-motions for summary judgment.

THE COURT'S HOLDING

First, the insureds argued that because the prior knowledge exclusion appeared in the policy application only, the prior knowledge exclusion was not part of the policy. The court rejected this argument, and specifically noted that the policy defined "Application" as:

> [T]he application for this Policy, including any material or information submitted therewith or made available to the Insurer during the underwriting process, which application shall be on file with the Insurer . . . ***shall be deemed a part of this Policy [and attached hereto]***.

Therefore, the court held that the application was "unambiguously deemed part of" the policy.

Next, the court considered whether the prior knowledge exclusion barred coverage for the underlying action. In concluding that the prior knowledge exclusion barred coverage, the court noted that:

> [The demand] letter certainly falls under the scope of an "other matter that may give rise or could have given rise to a claim." And the Member Plaintiffs certainly had "knowledge or information" regarding its contents as the letter was addressed to all of them and none of them disputes that he received it. Nevertheless, [the insured] answered "no" to the Prior Knowledge question on the 2015 Application when he submitted it in December 2015. *Id*. at 20.

The court also noted that the underlying action was brought "about six months after sending the [demand] letter" and sought "a declaration that [the former owner] remains a 13% shareholder in MM Corp. and br[ought] several counts . . .

including breach of fiduciary duty and tortious interference with economic relations – assertions [the former owner] made in his [demand] letter." *Id*. at 21. The court therefore held that "there is no dispute of material fact that [the demand] letter put Plaintiffs on notice of acts that could give rise to a claim" and that "the Underlying Action arises from or relates to [the demand] letter." *Id*. at 19-20.

The court's decision underscores the fact that a prior knowledge exclusion in a policy application can operate to bar coverage, regardless of whether the exclusion itself appears in the actual policy. However, in order to get the benefit of the exclusion, insurers should include language in the policy specifically providing that the "application" (including all materials submitted with the application) is incorporated and "deemed a part of" the policy. The decision is also significant because the court broadly construed the "arising out of" language in the prior knowledge exclusion. Although the demand letter and the subsequent litigation were not identical, the prior knowledge exclusion nevertheless applied to bar coverage because the subsequent litigation "arose from or related to" the demand letter. Finally, the decision reinforces the importance of timing when considering these types of exclusions – the application in this case was submitted less than two months after the date of the demand letter, and the lawsuit was filed approximately five months later.

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