COMMON FEATURES OF PROFESSIONAL AND MANAGEMENT LIABILITY POLICY FORMS

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Common Features of Professional and Management Liability Policy Forms
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Chapter 1
Course Overview and Introduction

IRMI has teamed up with WebCE to bring you this quality continuing education course.

This WebCE course is designed to provide a moderately experienced insurance person with an in-depth look at the important provisions common to nearly all types of professional liability (PL) and management liability (ML) insurance policy forms. The four major types of provisions this course analyzes are: (1) insuring agreements; (2) limits, deductibles/retentions, and coinsurance; (3) conditions, and (4) exclusions. The course concludes with a section addressing coverage coordination issues, whereby professional and management liability policies must be coordinated with each other *and* with other types of insurance coverage.

Insurance textbooks and reference manuals frequently contain separate discussions of a policy's "definitions" section. Although virtually all PL and ML policy forms contain a "definitions" section, please note that this course will *not* have a separate section addressing them. This is because the insuring agreements, limits, deductibles/retentions, coinsurance, conditions, and exclusions sections of PL and ML policies contain numerous defined terms. Such terms will be analyzed in these sections of this course.

Following a course introduction and overview in Chapter 1, the course is arranged as follows:

- **Chapter 2: Insuring Agreements.** This chapter examines in detail the sections of an insurance policy that explain the circumstances under which the insurer promises to make payment to or on behalf of the insured. More specifically, it analyzes provisions covering professional services/acts, persons and organizations, the territory in which the policy applies, and the provisions enumerating the kinds of damages policies cover. This chapter concludes with a discussion of how defense costs and defense procedures are addressed by the forms.
- **Chapter 3: Limits, Deductibles/Retentions, Coinsurance.** This chapter analyzes the key elements of the limits, deductibles/retentions, and coinsurance provisions found within professional and management liability policies. The chapter explains how they work in conjunction with other types of policy provisions to both restrict and, in a few instances, expand the scope of coverage provided by the forms.
- **Chapter 4: Conditions.** The conditions sections in professional and management liability policy forms state the respective rights and the requirements applicable to both the insured and insurer under the policy. The major policy conditions discussed in this chapter include (1) notice of cancellation, nonrenewal, and premium/coverage change; (2) subrogation; (3) other insurance; (4) notice of claim; and (5) miscellaneous conditions.

- **Chapter 5: Exclusions.** Policy exclusions—both those included in the form itself and those added by endorsement—have a profound effect on the scope of coverage provided by professional and management liability insurance policies. This chapter discusses the four major types of exclusions: (1) exclusions for uninsurable exposures; (2) exclusions removable or modifiable by negotiation, with or without additional premium; (3) exclusions for exposures better suited to other types of coverage; and (4) exclusions for exposures pertaining to a specialized type of work within a given profession.
- **Chapter 6: Coverage Coordination.** This section addresses the issue of professional and management liability coverage coordination. More specifically, it explains how to (1) coordinate professional and management liability policies with commercial general liability (CGL) policies and (2) coordinate professional and management liability policies with each other, to eliminate coverage gaps and overlaps between the policies.

Upon successful completion of this course, you will be able to:

1. List and describe the insuring agreements found in professional and management liability insurance policies.
2. Explain how these insuring agreements apply to actual claim situations and offer examples of how they can be modified to expand the scope of coverage the policies can provide for an insured.
3. State the types of losses that are covered or excluded by professional and management liability policy forms and state the rationales for coverage or exclusion, especially as respects punitive damages.
4. Apply the defense cost coverage and defense procedure provisions to real-world claim scenarios.
5. Analyze the ways in which the different types of limits, deductibles/retentions, and coinsurance provisions apply to various professional and management liability policies and understand how they restrict, but in some cases, expand the scope of coverage under a given policy.
6. Identify the important policy conditions found within professional and management liability policy forms and discuss the ways in which they affect the respective rights and responsibilities of both the insurer and the insured.
7. List and classify the major exclusions found within professional and management liability policies into one the four major groups of exclusions.
8. Describe the major exclusions, analyze the rationale underlying each, and state the ways in which they can be modified to expand the scope of coverage available for an insured under professional and management liability policies.
9. Explain the importance of coordinating professional/management liability coverage in preventing coverage gaps and overlaps and provide examples of how PL/EL policies can be coordinated with (1) each other and (2) with other types of insurance policies such as commercial general liability (CGL) insurance.

Chapter 2
Insuring Agreements

The insuring agreements common to PL and ML policies include: covered services/covered acts, covered persons, covered organizations, covered territory, covered damages, defense procedures, and defense cost provisions. Insuring agreements are those sections of an insurance policy in which the insurer explains the circumstances under which, as well as the terms and conditions under which, it promises to make payment to or on behalf of the insured.

Covered Services/Covered Acts

Professional liability insurance policies specify the scope of "covered services" (or "covered acts"), in one of three places:

1. the policy's "covered services" definition,
2. the policy's declarations page, or
3. the application form.

Since the information contained in application forms is automatically incorporated within PL and ML policies, the scope of covered services indicated by applications also delineates the kinds of services and activities the policy will cover.

Check the Scope of "Covered Services" To Assure Coverage

It does not matter which of the three approaches noted above is used to indicate the scope of the insured's services that will be covered by a policy. However, it is important to verify that the description provided by any of these methods matches the correct and complete scope of work actually engaged in by the insured and is consistent with acts that are a generally accepted part of a given profession.

The Policy's Definition of "Covered Services" Should Match the Insured's Services

Where the definitions section of the policy is used to specify the services offered by an insured, this definition should be checked to verify that it does, in fact, match the types of professional services actually provided by the insured. If this is not the case, appropriately worded manuscript endorsements should be attached to the policy to expand the definition of covered professional services. (Manuscript endorsements are customized endorsements, applying to individual insurance policies, as opposed to standard, preprinted endorsements that can be attached to many policies. In effect, a manuscript endorsement is a "one-of-a-kind" modification to a single policy.)

A few additional points regarding policy definitions of "covered services" should be considered, as follows.

- **Services not enumerated but covered because they are common to the profession.** Insurance agents routinely handle small (i.e., less than $1,000) homeowners claims, rather than having an insurance company adjuster settle them. Accordingly, these agents have the authority to issue claim payments to an insured. As a result, "claims handling services" need not be specifically enumerated as a covered professional service by an insurance agent's E&O policy's definition of "covered services," other than having the policy cover "insurance brokerage services."
- **Services not enumerated and uncommon to the profession; covered only by endorsement.** Conversely, few insurance agents also provide actuarial consulting services on a fee basis. Thus, an insurance agent who desires professional liability coverage for such activities should be certain that "actuarial consulting" is specifically included within the policy's definition of covered services. (Normally, coverage for actuarial work is not within the definition of covered professional services under agents E&O policies. Accordingly, a manuscript endorsement that adds "actuarial services" to the "professional services" definition must usually be added by endorsement.)

Declarations Pages Should Contain Broad "Covered Services" Descriptions

Particular care should be taken with policies requiring a simple definition of the insured's profession to be entered on the declarations page. While such descriptions are usually very brief (e.g., "mechanical engineering"), they are nevertheless significant. For example, suppose the phrase "mechanical engineering" is entered on the declarations page of an engineer's professional liability policy. If the insured firm were to sublet to another engineering firm a portion of a project involving electrical engineering work, an insurer could assert that coverage under the policy does not extend to a claim involving such work because "electrical engineering" was not noted in the declarations page description as an insured professional service. Thus, in this case, the declarations page professional services description should state "engineering services, including, but not limited to mechanical and electrical engineering."

As another example, assume that an ophthalmologist specializes in retinal surgery. If the "covered services" description in the declarations page of the ophthalmologist's PL policy reads "ophthalmology," an insurer could possibly deny coverage for a claim on the basis that retinal surgery is a more risky sub-specialty of ophthalmology. In this situation, the covered services line on the declarations page should read "ophthalmology, including but not limited to retinal surgery."

As indicated in these examples, the professional services description on the declarations page should be as broad as reasonably possible.

Application Forms Should Contain Details of All Professional Services Offered

The application for professional liability coverage typically describes in detail the scope of the insured's professional activities. To assure that all types of work engaged in by the insured will be covered by the policy, portions of the application that require a description of services provided should be reviewed carefully. On most applications, insureds are asked to list the subcategories of services they provide. After each such category, either the total annual revenue generated from those services or the percentage of the insured's annual revenue derived from such services must also be indicated.

Under the provisions of virtually all professional liability insurance policies, applications automatically become part of, or are incorporated into, that policy. By incorporation, statements made in the application become warranties and, thus, conditions of the insurer's obligations under the policy. For this reason, if the complete scope of an insured's activities is listed on the application in the manner described above, it will be difficult for an insurer to deny coverage for a claim associated with any type of work that is enumerated in the application.

Advise the Underwriter of Changes in Professional Services Provided

It should also be mentioned that if, during the term of coverage, an insured begins to offer professional services that are somewhat different from those described within the policy's "covered services" definition, the policy's declarations page, or the application, it is prudent to advise the underwriter. This action provides yet another safeguard against a potential coverage denial in the event that the insurer did not intend to cover such activities, even if it means that the underwriter requests additional premium. To illustrate: an accounting firm that previously provided only tax preparation services decides to begin performing audits. Under these circumstances, the firm should notify its PL insurer because audit work generates higher claim frequency and severity than tax preparation services and for this reason, the insurer will appropriately require additional premium.

Coverage for High-Hazard Activities

Within many professions there are a number of specialty areas that generate higher-than-average claim frequency. For example, accountants involved in Securities and Exchange Commission (SEC) work, physicians who perform bariatric surgery, and engineers who do soil testing have a tendency to produce a much higher frequency and severity of claims than do comparable professionals who do not engage in these specialty areas. Accordingly, a number of professional liability policies routinely exclude coverage (either within the policy form or by standard exclusionary endorsements) for claims arising from certain specified high-risk professional activities. If an insured's practice involves such work, either the underwriter should be requested to remove the applicable exclusion (for which additional premium will be charged), or the insured should secure coverage under a special policy (normally written in the excess and surplus lines insurance market), that is designed to cover professionals who practice in these high-hazard specialty areas which are frequently excluded by standard forms.

Covered Persons

Under most PL policies, both the professional firm and the individuals affiliated with the firm, while acting within the scope of their employment, are also insureds. Depending upon the individual policy, the following are normally designated as "covered persons" under the policy.

- Directors
- Officers
- Managers
- Supervisors
- Employees
- Partners
- Principals

- Stockholders
- Owners
- Volunteers
- Interns

Note that the exact scope of such "covered persons" varies slightly from policy-to-policy.

Coverage of Past Personnel

Nearly all PL policies also include provisions affording coverage to persons no longer affiliated with the insured firm, provided the act which is the subject of the claim against them was committed while they were associated with the insured organization.

For example, assume that during 2006, an accountant employed by ABC Accounting performed an audit of the XYZ Company. On January 1, 2007, the accountant left ABC. On January 1, 2008, XYZ Company brings a claim against the accountant. Under these circumstances, ABC's professional liability policy will cover the accountant despite the fact that she is no longer an employee of ABC at the time the claim was made. This is because the alleged wrongful act giving rise to the claim was committed during 2006 while she was an employee of ABC. As this scenario illustrates, coverage applies to past personnel under professional liability forms—even if the individual against whom the claim is brought is no longer associated with the insured firm—as long as that person committed the alleged wrongful act while working on behalf of the insured organization.

Why Cover Past Personnel?

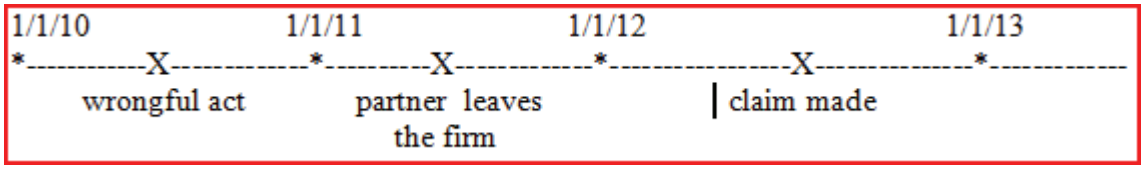
It is usually favorable to provide coverage for claims that may arise involving individuals, even after they are no longer working for the insured professional firm. This helps to assure that they will cooperate in a claim made jointly against them and the insured firm. Assume, for example, a claim is made against a law firm and that a former partner ("FP") is also named in the lawsuit. FP's incentive to cooperate with the firm is greatly reduced if no coverage is afforded for FP. This, in fact, could lead FP to cooperate with the plaintiff in return for dropping the claim against FP. Bottom line: coverage of persons who are no longer with a professional firm at the time a claim is made encourages such individuals to cooperate with the insured firm in the event a claim is brought against both the insured firm and the former employee.

The Professional Liability Exposure of Former Personnel

One significant implication of a policy that provides coverage for past personnel is that once a person leaves a professional firm, there is little need for that person to buy separate coverage for acts committed while associated with that organization.

There could, however, be potential problems for the former employee/partner if the organization fails to continuously purchase professional liability insurance or carries an inadequate limit. Consider this scenario: 3 years after a lawyer leaves a law firm, a claim is made against him for acts that took place while he was employed by a law firm. The lawyer would have coverage for the claim under the firm's current policy, but only if it has continued to renew coverage and actually does have a policy in effect at the time the claim is made. This situation is illustrated in Exhibit 2.1.

Exhibit 2.1
Coverage of Former Personnel



In this example, coverage for the former partner's wrongful act will be available under the firm's 1/1/12–13 policy. This is true even if the insurer during the 1/1/12–13 term is not the same as the one that wrote the policy when the wrongful act was committed (i.e., during the 1/1/10–11term), provided the retroactive date under the 1/1/12–13 policy is earlier in time than the date on which the wrongful act was committed.

However, even assuming the firm did renew coverage and had a policy in place at the time a claim is made against the former employee, there are three additional, potential coverage gaps facing the attorney in this situation:

- The policy limit available may be inadequate to cover the claim;
- The limit may already have been exhausted by other claims against the firm, or
- Coverage for the particular type of claim made against the attorney may be excluded by the policy.

For these reasons, professionals should keep abreast of the coverage purchased by professional organizations with which they were previously affiliated. If they feel they may be exposed to claims as a result of such service, they should consider arranging coverage of their own. This is especially true if they have doubts about whether their prior firm is continuing to buy PL coverage. Nevertheless, it should be recognized that it is difficult and costly to buy coverage under such circumstances.

Coverage for Prior Acts

Another coverage issue that individual insureds must consider under professional liability policy forms is the extent of coverage they are afforded for acts committed before joining the insured professional organization. Such persons have no coverage under the policy written for their current firm for acts committed while working for a previous firm, even if claims are made against them during the current policy period of their present employer. This is because, as a general rule, professional liability coverage follows the organization rather than the individual. However, such persons will be provided coverage by the previous firm for actions taken on the firm's behalf, based on the principles discussed above in "The Professional Liability Exposure of Former Personnel."

Under special circumstances, an underwriter may be willing to afford prior acts coverage for an individual who joins a professional firm. However, this would typically require the person to submit a separate application so the insurer could properly evaluate the exposure to claims prior to joining the firm. Such coverage should only be requested in very special situations, especially since claims from prior acts potentially dilute the limits available to the firm that the professional has just joined.

The Lack of Coverage for Outside Activities

It should also be noted that under nearly all types of professional liability policies, insured status only applies while acting within the scope of employment for the named insured. Because professionals of all kinds sometimes undertake work in their spare time or moonlight with other organizations, it should be made clear to them that no coverage will be provided for outside activities under the named insured's professional liability policy.

Therefore, if an employee or a partner of a professional firm begins doing work that is not associated with the firm, such persons must either: (1) make sure they are covered under the other organization's policy (i.e., the organization for which he or she is "moonlighting" or (2) arrange separate PL coverage of their own. Note: some PL policy forms preclude coverage for work done while not on behalf of the named insured employer, by means of an exclusion, rather than via the policy's "covered acts" provision. This exclusion will be addressed later in this course.

Liability Coverage for Independent Contractor Acts

The majority of professional liability policy forms cover the named insured's liability for services performed by independent contractors working "on behalf of the named insured" or for the errors and omissions of others "for which the named insured is legally responsible." For instance, law firms sometimes consult with other law firms or lawyers (in what are known as "of counsel" relationships) when specialized expertise is required on a given case. Such coverage extensions could become important if, for example, the outside firm commits an error or omission and the insured is also named in a lawsuit.

If a claim is made against a professional or professional firm in conjunction with the independent contractors' work, the contractor's own coverage will normally respond to such a claim. A possible scenario: law firm A contracts with law firm B to do specialized research on a particular case. If law firm A is sued based upon law firm B's negligent work, B's professional liability policy should respond to the claim and defend or indemnify law firm A. However, there may be times when independent contractors such as law firm B are uninsured or underinsured. Therefore, as a "back-up," nearly all professional liability policies also cover an insured's liability for the acts of independent contractors, such as law firm B in this example.

Spousal Coverage

Insured professionals sometimes attempt to shield their assets from potential claim judgments by transferring those assets to their spouses. To counter this tactic, plaintiffs' attorneys also name the insured professionals' spouses in suit papers. Therefore, spouses require protection under professional liability forms, and many insurers have responded to this need by extending insured status to the spouses of insured professionals.

At one time, such coverage was available only by endorsement, although currently many professional liability insurers automatically afford spousal coverage within their regular policy form.

Spousal Coverage Definition That Includes Domestic Partners

A few insurers' forms contain a spousal coverage definition that covers "spouses, including 'domestic partners'..." Given the increasing incidence of such living arrangements, the need to provide this coverage extension will grow. Preferred wording, which provides the broadest possible scope of coverage, defines a domestic partner as a person qualifying as such "under the applicable federal,

state, or local law or under the provisions of any benefit program established by the corporate organization."

No Coverage for a Spouse's Wrongful Act

It should be recognized, however, that spousal coverage does not extend protection to a spouse of an insured if the spouse commits an alleged wrongful act. Rather, such provisions only cover a spouse's liability because the spouse shares interest in the property of an insured professional. In effect, coverage of a spouse applies only as a consequence of the spouse's status, rather than for the spouse's acts. Case-in-point: under employment practices liability policies, all employees are insureds. If a claim were made against an employee, coverage would also extend to the employee's spouse, but only as to the spouse's interest in assets held jointly (to which, as noted above, claimants' attorneys frequently seek access). In contrast, the employee's spouse would not have coverage if, for example, the spouse was accused of committing sexual harassment at the insured company's Christmas party.

Coverage of Personal Representatives: Heirs, Executors, Trustees, and Legal Representatives

Nearly all professional liability policies also include heirs, executors, trustees in bankruptcy, and legal representatives (of insureds) as insureds. The necessity of this feature can be appreciated when one considers that the liability of professionals is a form of personal liability. The coverage afforded under such policy provisions is protection against claims on their personal assets. If persons insured under the policy die, are declared incompetent, or file for bankruptcy, such protection is transferred to their heirs, estates, or trustees.

Covered Organizations

The covered professional firm or individual (if a sole practitioner), is designated as the "insured organization" under most professional liability policies.

Coverage for Predecessor Organizations

Many, but not all professional liability insurance policies provide coverage for what are known as "predecessor organizations." Such coverage would be important under circumstances similar to those in the following example. Assume that two accountants—"A" and "B"—form a partnership. After 5 years, they merge their practice with an existing partnership consisting of accountants "C," "D," and "E." Also assume this new combination purchases a professional liability policy. Under many policy forms, coverage would be available for errors and omissions committed during the "A and B" partnership—even if claims arising from those acts are not made against the new firm until after the aforementioned merger of the two firms.

PL policies use one of two approaches to provide predecessor organization coverage: (1) defining the term "predecessor firm" and including predecessor firms within the policy's definition of "insured organization" or (2) listing specific predecessor firms as insureds on the policy's declarations page.

Defining Predecessor Firms as "Insured Organizations"

Under this approach, "predecessor firm" is defined as "a corporation or partnership to whose assets and liabilities the named insured is the majority successor in interest." The key word in this definition is "majority." More specifically, unless the currently insured firm took over more than 50 percent of the former firm's assets and liabilities, there would be no coverage for the acts of the acquiree that took place prior to the acquisition.

In more concrete terms, assets and liabilities generally refer to active client files or to current projects. For example, in the merger of A and B with C, D, and E in the previous example, C, D, and E would be a majority successor in interest if it took over 50.1 percent of A and B's active files as part of the merger agreement. Thus, for a predecessor firm to be an insured under a PL policy, the professional firm that acquired it must have acquired a majority of its assets.

Listing Predecessor Firms as Insureds on the Declarations Page

This approach simply lists the predecessor firm(s) for which coverage is sought on the declarations page of the policy, without actually having to define the term "predecessor firm," and would be useful in a situation where the insured organization did not take over a majority of the predecessor firm's assets and would therefore not be considered a predecessor firm under most PL policies' definition of the term. For example, assume in the merger of A and B with C, D, and E, that the latter firm did not take over a majority or A&B's client files. Yet the partners and employees of A and B will still need coverage for acts committed prior to the merger, and this approach will provide it.

Predecessor Firm Coverage is Not Automatic

As already mentioned, not all PL policy forms automatically cover predecessor organizations. However, underwriters will usually agree to provide such coverage by naming the predecessor firm as an insured on the current policy. Typically, this requires payment of additional premium. Most insurers are not averse to covering exposures of this kind, provided they are given sufficient underwriting data with which to evaluate and price such risks.

Coverage for Joint Ventures

Most of the policies also include "joint ventures" within their definitions of "insured organizations." However, there is one key caveat associated with joint venture coverage: only named joint ventures are covered. In effect, unless the underwriter is on notice as to the existence of a joint venture (normally by means of the application form or by being notified by the insured during the policy period), no coverage applies. This is logical from an underwriting standpoint because the insurer should be in a position to evaluate a joint venture for which coverage is sought and either (a) provide such coverage (usually subject to additional premium reflecting the additional exposure) or to (b) determine that it does not wish to cover the joint venture at any premium.

Coverage for Newly Acquired/Formed Entities

Most, but not all, professional liability policies provide "automatic" coverage for newly acquired and newly formed entities in which the insured owns a majority interest (i.e., more than 50 percent).

Automatic Coverage

Automatic coverage means that coverage is immediately applicable for the newly created or newly acquired entity, with no other restrictions—even before the insurer's underwriter receives information about the new entity. The period of time during which automatic coverage applies, before the underwriter must receive notification, varies from 30 to 90 days, with 60 days being most common. (For the insured, the longer the period during which automatic coverage applies, the better.) After this period of automatic coverage, the insurer requires submission of information about the new company, as well as additional premium, if coverage is to continue.

Automatic Coverage Subject to Limits on the Size of the New Entity

In contrast to the policies that grant automatic coverage of newly acquired/created entities without qualification, some policies grant such coverage only if the new entity does not exceed a certain size relative to the existing entity. For example, if a newly acquired entity's assets do not exceed 15 percent of the acquiree's assets, an insurer would provide automatic coverage. Generally, this threshold of assets for which automatic coverage applies ranges from 10 percent to 25 percent; the higher the percentage, the more favorable for the insured.

Nonautomatic Coverage

In contrast, a few PL and ML insurers' policies do not grant automatic coverage. Instead, they indicate that in the event of a merger or acquisition, the insurer reserves the right to renegotiate the policy's premium, or even refuse to cover the new entity. Nor do such policies provide any temporary coverage, prior to requiring additional premium for the continuation of coverage.

Covered Territory

There are two types of territorial provisions used in professional liability policies. The first type provides (1) unrestricted worldwide coverage. The second, and most common type affords coverage for (2) wrongful acts taking place anywhere in the world, but only if the claim or suit is brought in the United States, its territories, possessions, or Canada.

Rationale for Territorial Restrictions

One rationale for territorial restrictions in professional liability policies is that insurers are sometimes reluctant to provide coverage for claims based upon laws of countries outside the United States. Another rationale for not covering claims brought outside of the United States is that such claims are more difficult for the insurer to control and manage. Given the problems of location and distance, it is often harder to provide the personnel to oversee and adequately defend such claims, especially for small, regional insurers. Yet another rationale for territorial restrictions is that some insurers may not be legally permitted to operate in certain foreign countries due to licensing restrictions.

Despite such restrictions, insurers are usually willing to amend policies to provide broader coverage, e.g., coverage for claims brought in additional, specific locations or coverage for claims brought anywhere in the world. Such extensions are especially important for professional organizations having operations or exposures in non-U.S. locations as well as when they have any kind of electronic exposures to professional liability (e.g., a hospital that subcontracts the reading of radiological scans to firms in India; an insurer that subcontracts data entry operations to a company in Ireland).

Covered Damages/Covered Losses

PL and ML policies cover damages/losses for which the insured is legally liable when such damages result from the delivery of professional services. Covered damages/losses are generally of two kinds: (1) the costs to investigate and defend a claim made against insureds, and (2) amounts that result from either a judgment in a court of law or a settlement between the insurer and the claimant. (The damages paid in a judgment or settlement are known as "indemnity payments.")

Key areas pertaining to covered damages/covered losses under PL and ML policies include coverage of punitive damages, coverage for return of professional fees, and coverage for "other" items.

Coverage of Punitive Damages

Punitive damages, which are frequently awarded against professionals, are intended to punish a defendant (rather than compensate a plaintiff/claimant for a specific loss) and are awarded to "send a message" that the defendant's conduct in causing the claim was unusually objectionable, with the intention of deterring such actions by this particular professional (and others) in the future.

Coverage of Punitive Damages Varies by Line of Coverage

Although it is difficult to generalize, currently, about two-thirds of all professional liability policies either affirmatively cover punitive damages (by stating that coverage is available where payment of punitive damages under an insurance policy are not barred by applicable statute or by common law) or contain no exclusion for punitive damages.

Whether or not a policy covers/excludes punitive damages is most often a function of the type of professional liability policy in question. For example, while nearly all employment practices liability insurance policies cover punitive damages, the majority of miscellaneous professional liability policy forms exclude punitive damages.

Exclusion of coverage for punitive damages is accomplished in one of two ways (1) by means of "covered damages" or "covered loss" definitions stating that punitive damages do not fall within these definitions, or (2) by means of a punitive damages exclusion.

Coverage of Punitive Damages Varies by Jurisdiction

Despite the fact that the majority of PL and ML policies either affirmatively cover punitive damages or do not specifically exclude them, it is important to understand that a significant minority of states, including California, New York, Pennsylvania, Florida, and Illinois, bar or restrict the extent to which punitive damages may be paid by an insurance policy. As a result, even though a PL or ML policy covers them, state law in a number of jurisdictions prevents an insurer from paying punitive damages under a policy.

Most Favorable Jurisdiction Provisions

In recent years, professional liability insurers (most often, those writing directors and officers liability and employment practices liability policies), have attempted to circumvent state-specific prohibitions against insurer payment of punitive damages, by means of what are known as "most favorable jurisdiction" provisions. Such wording states that, with respect to determining the insurability of punitive damages, the law of the jurisdiction most favorable to the insurability of punitive damages will apply, provided the jurisdiction meets one of the following 4 criteria; the jurisdiction where: (1) the act giving rise to the punitive damages award occurred, (2) the claim giving rise to the punitive damages is made, (3) the insured is incorporated or maintains its principal place of business, or (4) the insurer is incorporated or maintains its principal place of business. A most favorable jurisdiction provision would be important in the following scenario. Assume that an insured is incorporated in a jurisdiction that bars insurance payment of punitive damages and that a punitive damages award is made against the insured in this jurisdiction. However, the insured has a PL policy written with a most favorable jurisdiction provision and the insurer is incorporated in a state where punitive damages coverage is permitted. As a result, the insurer will indemnify the insured for payment of the punitive damages award, regardless of the fact that the insured is incorporated in and punitive damages were awarded in a jurisdiction that bars such payment.

When Most Favorable Jurisdiction Provisions are Critical

Most favorable jurisdiction wording is important if a claim is brought in a state where payment of punitive damages is prohibited by law despite the fact that the applicable professional liability policy provides such coverage. Under these circumstances, in the absence of most favorable jurisdiction wording, punitive damages coverage may not be available, even if the claim were made under a policy that affirmatively covered punitive damages. Most favorable venue wording is therefore imperative (a) when purchasing a PL or ML policy in a state where punitive damages are not insurable and (b) for insured professionals who have multistate operations and who therefore cannot predict where the claims seeking punitive damages will arise.

Two Limitations of Most Favorable Jurisdiction Provisions

Despite the additional coverage provided by most favorable jurisdiction provisions, they contain two key limitations. First, most favorable jurisdiction wording merely modifies the existing level of coverage for punitive damages already provided by a professional liability policy; it does not provide coverage if punitive damages are excluded by the policy. (Although, if a professional liability policy is written with punitive damages coverage, an endorsement providing most favorable jurisdiction wording should, of course, be requested.) Second, the enforceability of most favorable jurisdiction wording has never been tested in court. As a result, insureds are advised to request such wording, but should not be required to pay additional premium for it, because its legal enforceability has not yet been proven and therefore an insurer's liability for payment as a result of this endorsement remains uncertain.

Return of Professional Fees Are Not "Covered Damages"

PL policies do not cover claims involving the return of fees or recoupment of charges that have been paid to a professional. For example, assume an architect designs a defective building that collapses and injures several pedestrians. Also assume that the owner of the building who hired the architect sues the architect, demanding a return of the $100,000 fee that the owner paid the architect. An architects and engineers PL policy would not provide coverage to the insured architect for returning the fee, despite the fact that the architect may still be legally liable to the owner for doing so.

Rationale for Not Covering the Return of Professional Fees

The rationale for not covering the return of professional fees is that this exposure is a business risk which should not be the subject of professional liability insurance coverage. In effect, the policy intends to cover unforeseeable damages resulting from a professional's negligent acts (e.g., bodily injury, property damage, financial loss, personal injury), but not the cost of the services charged by a professional who performs negligently. Accordingly, in the above example, the architect's professional liability policy would cover the cost of paying another architect to perform "remedial" services to correct the insured architect's error, when the defective building is repaired, but would not indemnify the architect if he were required to return his original $100,000 paid to the owner.

Other Items That Are Not "Covered Damages"

In addition, the following items generally do not fall within the typical PL policy's definition of "covered damages" or "loss": (1) professional sanctions (e.g., suspending a professional's license for a period of time), (2) fines, (3) penalties, and (4) taxes.

The first three items are not covered since they are generally imposed upon a professional whose conduct is not merely negligent. Rather, they are assessed when the professional's conduct has been

either grossly negligent (e.g., a doctor performs an operation while intoxicated) or willful (e.g., a dentist actually tries to injure a patient). To cover such items would be contrary to public policy. "Public policy" refers to rules or laws that either guide or encourage certain actions, rather than compel such actions. Taxes owed are not covered since they are considered a cost of doing business and therefore are not the subject of professional liability insurance coverage.

Covered Defense Costs

As noted previously, all professional liability insurance policies afford coverage for the costs involved in investigating, defending, and settling claims. These covered items encompass attorneys' fees, court costs, bonds, and related expenses involved in the loss settlement process. The key areas pertaining to defense cost coverage include:

- the fact that defense costs are covered within (and not in addition to) policy limits,
- the fact that the insurer's internal claim handling costs are not charged against policy limits,
- the rationale for and implications of PL and ML policy defense cost provisions,
- the application of deductibles\retentions to defense costs, and
- the manner in which supplementary payments coverage applies to PL policies.

Defense Costs are Covered Within—Not In Addition to Policy Limits

Under the vast majority of PL policies, defense costs are covered within, rather than in addition to, policy limits. This means that if monies are expended to defend an insured, this reduces available policy limits. In other words, under PL policies, not only indemnity payments (i.e., settlements and judgments), but also the expenditure of defense costs, reduce policy limits. This is significant since under some types of coverage, notably D&O insurance, defense costs routinely exceed the indemnity payments for an individual claim.

The approach to covering defense costs under PL/EL policy forms is in direct contrast to that used in commercial general liability (CGL) policies, whereby defense costs are covered in addition to policy limits. When coverage is written in addition to policy limits, the expenditure of defense costs does not reduce the policy's limit of coverage, so that in theory, an unlimited amount of money could be spent under a CGL policy to defend an insured, without reducing the amount of money available to pay indemnity costs.

Exhibit 2.2
Defense Cost Coverage Case Study

A PL Policy in Which Defense is Covered "Within" Policy Limits

Policy Limit: $1 million

Once defense costs and indemnity payments (in any combination) have reached $1 million, no additional monies are available under the policy for *either* indemnity payments or defense costs. In fact, defense costs *alone* could exhaust the policy limit.

A CGL Policy in Which Defense is Covered "In Addition To" Policy Limits

Policy Limit: $1 million

Regardless of how much money has been expended to defend a claim (or claims) against an insured, the full $1 million policy limit remains available to cover (1) $1 million of indemnity payments, *plus* (2) an unlimited amount of additional defense costs until the policy's limit is exhausted by indemnity payments.

Insurers' Internal Claim Handling Costs Are Not Subject to Policy Limits

Insurers' internal costs of defending claims, such as the salaries of attorneys and adjusters employed by the insurer, do not constitute defense costs according to PL policy definitions of "defense costs." These items are not charged against an insured's policy limits—as are the cost of services rendered by an independent attorney or by an independent adjusting firm—and therefore do not reduce the limit of coverage available (under a policy where defense is "within limits").

Rationale for Defense Cost Provisions

Until the early 1980s, it was actually more common for professional liability insurance policies to cover defense in addition to, rather than within, policy limits. However, since that time, the costs of defending claims against professionals have increased substantially. Accordingly, insurers are generally unwilling to provide coverage in addition to policy limits. This rapid growth in defense expenditures has made it difficult for insurers to project such costs, which adds to the already complicated task of developing accurate premium rates for professional liability coverage lines. In view of such problems, reinsurers are also reluctant to participate when policies cover defense in addition to policy limits. The end result is that few major lines of professional liability (insurance agents, media liability, and medical professional liability policies being the exceptions) cover defense in addition to limits.

Implications of Defense Cost Provisions

Of course, under the relatively small percentage of PL policies in which coverage of defense is in addition to policy limits, it is a significant benefit for insureds, considering that defense costs, especially in certain professional liability lines, are enormous. For example, participants in the 2006 Towers Perrin Directors and Officers (D&O) Liability Survey revealed that the average cost of defending a shareholder securities claim in 2006 was $2,798,404, up from $2,140,343 in 2005!

Premium Implications

When comparing policy forms, those covering defense in addition to a policy's limits provide a significant advantage relative to those in which payment of defense is within the limit of coverage. Nevertheless, this advantage might be reflected in the price of the policy, so that a policy premium

covering defense in addition to policy limits is usually substantially higher than for a comparable one in which defense costs are within policy limits.

Policy Limit Implications

The manner in which insurers treat coverage of defense costs is also an important point to consider in selecting policy limits. For example, assume industry statistics demonstrate that defense costs in a particular line of coverage are roughly equal to settlement amounts. It could therefore be said that a $500,000 policy covering defense "within limits" is equivalent to a $250,000 policy providing defense "in addition to" limits. Nevertheless, such a conclusion would be based on averages only, which will vary significantly on a claim-to-claim basis. Accordingly, selecting adequate but affordable professional liability limits is a difficult decision.

Insurer "Bad Faith" Implications

Policies in which defense costs are within coverage limits also pose potential "bad faith" problems for insurers. (Bad faith is blatantly unfair conduct by an insurance company that exceeds mere negligence. For example, an insurer might be accused of committing bad faith if, for example, an auto liability insurer refuses to settle a claim within policy limits, where both the insured's liability and the insurer's obligation to cover the claim under the policy, are undisputed.) Another bad faith claim scenario, this one involving policy limits: assume that a claim alleging damages of $400,000 is made against a physician who has a professional liability policy with a $500,000 limit. Also assume that the insurer had already expended $250,000 to defend the doctor but had not at all times kept the doctor advised concerning these expenditures and settlement discussions. Under these circumstances, the doctor possibly has a valid bad faith claim against the insurer. This is because the claim could originally have been settled within the doctor's policy limits. But at this point in the process, it would be nearly impossible to settle the claim within policy limits since payment of the $400,000 demand, added to the $250,000 that had already been expended in defending the claim, would exceed the $500,000 policy limit.

Application of Deductibles/Retentions to Defense Costs

Most professional liability deductible/retention clauses state that the deductible/retention is applied to both loss payments and claims expenses, regardless of whether a settlement is made on the insured's behalf or a jury renders a verdict against the insured. To illustrate, assume an insurer expended $30,000 to defend an insured but was never required to pay a judgment or settlement on the insured's behalf because the claim was dismissed on a summary judgment basis (i.e., a judge ruled that the case had so little merit that it did not even warrant a jury trial). If the policy contained a $10,000 deductible, the insurer would seek reimbursement from the insured in this amount to satisfy the policy's deductible provision. Clauses stating that deductibles/retentions apply to both defense and indemnity payments are favorable for insurers because they help to reduce the extent of an insurer's actual payout for a given claim.

"First-Dollar" Defense Costs Coverage

In contrast to this approach, some insurers are willing to provide what is known as first-dollar defense coverage, often, although not always, in return for an additional premium. In some instances, such coverage is afforded by means of an endorsement to the policy. When coverage is written on this basis, the deductible applies only to indemnity payments and not to defense costs. Therefore, in the foregoing example, if defense coverage were provided on a "first dollar" basis, the insured would not be required to reimburse the insurer for the deductible since no indemnity payments were involved.

Another example: in a situation where defense costs and indemnity payments were $50,000 and $25,000, respectively, the policy deductible would apply only to the latter amount.

Although more often provided by endorsement, first-dollar defense coverage is also automatically included within the terms of some professional liability insurance policies. Such provisions are favorable for the insured and also provide the insurer with a meaningful marketing advantage.

Covered Supplementary Payments

Most professional liability policies also cover what are termed "supplementary payments" that include first aid expenses, premiums on appeal bonds and bail bonds, interest on judgments, and reasonable expenses incurred by the insured at the insurer's request. The latter item typically involves travel expenses required for attendance at hearings and trials. Such covered supplementary expenses do not, however, under most forms, include the insured's salary or earnings lost as a result of trial attendance or assistance to the insurer.

Coverage within or in Addition to Policy Limits?

The key point of differentiation as respects supplementary payments provisions in PL policies is whether they are covered within or in addition to policy limits. The majority approach is for supplementary payments to be covered within policy limits and therefore they reduce available coverage limits. However, in a few coverage lines, most commonly in agents and brokers professional liability and police professional liability forms, some insurers cover supplementary payments in addition to the policy's limits, which is of course, favorable for the insured.

Defense Provisions

The defense provisions within PL policies consist of: (1) defense procedures and (2) settlement procedures.

Defense Procedures: "Duty To Defend" versus "Non-duty To Defend" Language

Professional liability insurance policies are written with one of two types of defense procedure provisions: (1) "duty to defend" provisions or (2) "non-duty to defend" provisions.

The phrase "duty to defend" in a professional liability policy expressly states that the insurer has the duty to defend any claim alleging a covered act under the policy.

In contrast, other professional and D&O liability policies state that "…we have no duty to defend the insured for claims made under this policy. Rather, it is the duty of the insured to defend claims…" Accordingly, non-duty to defend forms only compel the insurer to pay the defense costs in connection with the insured's executing the defense of the claims (and for that reason, non-duty to defend policies are occasionally called "duty to pay" policies).

Who Controls Defense and Selects Defense Counsel?

Two of the important differences between a "duty to defend" and a "non-duty to defend" policy involve: (1) the right to choose defense counsel and (2) the right to control the process required to defend the claim, which includes control over the decision to litigate or settle a claim (and for what amount of money).

Under a "duty to defend" policy, unless specifically negotiated prior to policy inception, the insurer has the right to choose defense counsel. In addition, the insurer typically has the right to control the defense of the claim (e.g., to determine trial and settlement strategy).

In contrast, under a "non-duty to defend" policy, the insured is able to use any lawyer of its choice. In addition, the policyholder has the right to control the process required to defend the claim.

Claims Handling Issues

In many instances, a "duty to defend" provision may actually benefit an insured, despite the fact that the provision reduces the extent to which the insured can exert control over the counsel selection and claims handling processes. This situation is especially true if the insured is inexperienced in managing the complexities of professional liability litigation. On the other hand, firms that are more familiar with the details of the professional liability claims handling process may prefer a policy containing "non-duty to defend" language. In short, the selection of "duty to defend"/"non-duty to defend" language is an organization-specific issue.

Professional liability, employment practices liability, and directors and officers liability policies written for larger, more legalistically sophisticated insured organizations are most often written on a "non-duty to defend" basis. In contrast, smaller insureds who do not have the expertise or time to become closely involved in the complexities of such litigation generally opt for "duty to defend" policies.

In today's professional liability market, insureds can often choose between a "duty to defend" or a "non-duty to defend" form. However, "non-duty to defend" forms are much more common in employment practices liability and directors and officers liability policies than in professional liability policies. This is because EPL and D&O forms are generally written for larger, corporate insureds who tend to have more experience in handling the complexities of litigation, compared to most professionals who are frequently sole practitioners or operate in small (i.e., less than 10 persons) partnerships or professional corporations.

"All" Allegations Defense: A Key Benefit of "Duty To Defend" Forms

Another significant benefit for insureds of "duty to defend" policies is that under these forms, the insurer is obligated to defend all of the allegations in a lawsuit, as long as at least one such allegation is covered by the policy. The following scenario under an employment practices liability policy illustrates this point. An employee with 20 years of service is terminated by her employer, a small, privately-held company. Her lawsuit against her former employer alleges that: (1) she was wrongfully terminated; (2) she was sexually harassed during her exit interview; and (3) the company owed her unpaid overtime wages (i.e., a wage-and-hour claim).

Although damages arising from the first two allegations are clearly covered by standard EPL policy forms, the wage-and-hour claim is excluded by virtually all EPL policies. However, since coverage exists for allegations 1 and 2, an insurer, under a "duty to defend" policy, must also defend the wage-and-hour claim, although it would not be liable for any potential damages. In contrast, under a "non-duty to defend" EPL policy, the insurer would only be obligated to pay the costs of defending counts 1 and 2, but not count 3.

Settlement Procedures

Settlement procedures are a key element of defense provisions found within PL and ML policies. Disputes between insureds and insurers as to the reasonableness of settlement amounts are often a difficult issue in professional liability insurance. The following areas will be discussed as they apply to settlement procedures.

- The difficulties inherent in "compromise" settlements
- The so-called "hammer clause" settlement provision
- Problems and inequities inherent in the "hammer clause"
- The coinsurance hammer clause as a means of mitigating these problems and inequities

The Difficulties of "Compromise" Settlements

Professionals on one hand, and insurers on the other, sometimes have significantly different perceptions about what constitutes a reasonable settlement amount for a given claim. Complicating the settlement process is the fact that professionals typically perceive an out-of-court settlement as an admission of guilt or wrongdoing. Thus, they often oppose compromise settlements that might otherwise conserve legal costs, save time, and avoid adverse publicity. From the professional's point of view, an outsider learning of the settlement may infer (incorrectly) that a compromise settlement was an admission of wrongdoing. (This is particularly true since the advent of the National Practitioner's Data Bank, which provides a record of professional liability claims made against physicians.) However, from the insurer's perspective, the settlement might save legal costs and, most importantly, prevent the risk of a "runaway jury verdict," factors that could markedly increase the insurer's total payout on the claim, in addition to creating adverse publicity for the professional.

The Hammer Clause Settlement Procedure

The vast majority of PL and ML policies are written with a settlement procedure known as the "hammer clause," which applies as follows.

- **Settlement Amounts.** The insurer is required to seek the insured's consent prior to settling a claim for an amount proposed by the insurer and agreed to by the claimant. However, if an insured does not approve a settlement figure that has been offered by the insurer and agreed to by the claimant, and the claim is later closed for a larger amount, the insurer is liable only for the settlement amount initially agreed upon with the claimant.
- **Defense Costs.** If an insured withholds consent to a settlement recommended by the insurer, any additional defense costs and expenses accrued from that point on are not covered by the policy.
- **Illustration.** An insurer makes an agreement with a physician's patient to settle a claim against the physician for $500,000. The physician refuses to accept the settlement proposal. The claim is settled 2 years later for $750,000 and an additional $150,000 was incurred in defense costs during this 2-year period. Based on the hammer clause, the insurer is not liable for (and the insured must pay) the additional $250,000 in settlement costs (i.e., $750K final settlement – $500K initial recommendation = $250K). Nor is the insurer liable for the additional $150,000 in defense costs that were incurred, following the physician's refusal to settle the claim based on the insurer's initial recommendation.

Is the Hammer Clause Really Unfair to the Insured?

It could be argued that from the insured's perspective, the hammer clause provision is unfair. If the insured's contesting of the claim in the above example had produced a lower total outlay (e.g., the jury returned a verdict of only $250,000 rather than $750,000) he would not have benefited from the lower settlement figure, as would the insurer. However, in the illustration, above, since he chose to contest the claim, the insured was forced to absorb $400,000 of additional defense and settlement costs on an out-of-pocket basis ($250K settlement + $150 defense). But in this second scenario, the hammer clause conveyed a windfall (in the form of a lower judgment) on the insurer, while placing all the risk of an adverse result (i.e., a higher judgment) on the insured.

Problems with the Hammer Clause

Despite the fact that the manner in which this provision applies is clear and unambiguous, there are two problems inherent in the hammer clause. First, few authoritative court decisions have ever directly addressed the enforceability of this clause. Second, insurers are therefore reluctant to adamantly enforce it because to do so might ultimately produce a bad faith claim against them. This is especially true if, for example, an insurer recommended a $2 million settlement amount, but the insured refused to allow it, deciding instead to litigate the matter to its conclusion. In the event the insured is ultimately adjudicated as not liable, (i.e., the insured takes the case to trial rather than settling it and receives a verdict of no liability), the insurer would, under the terms of the policy, have no responsibility for the additional defense costs incurred after the insured's refusal to settle. This is despite the fact that the insurer had saved a substantial sum by not settling the claim, a course of action based solely on the insured's urging!

Given potential scenarios of this kind, the hammer clause is rarely enforced on a "direct" basis, whereby an insured ends up handling his or her own defense. Rather, in actual practice, insurers typically explain to insureds the disadvantages this provision can impose, should the insured contest a claim settlement that an insurer has recommended. And as a result, virtually all claims are settled according to an insurer's recommendation.

Coinsurance Hammer Clause

As already explained, the hammer clause does have the potential to place insureds in a difficult position during the claim settlement process. However, a recent trend that is favorable for insureds is for insurers to offer a "coinsurance hammer clause." Such a provision provides for a sharing of any settlement or judgment that is larger than the settlement amount the insurer wanted the insured to accept, plus coverage of additional defense costs incurred in continuing to contest the claim. The most common sharing percentage is 50/50, but it can go higher (e.g., 70 percent insurer/30 percent insured).

For example, assume an insurer wanted to settle a claim for $100,000 but the insured refused to consent. The claim is eventually settled for $200,000, and $50,000 in additional defense costs are also incurred following the insured's refusal to consent. Under these conditions, the insurer would pay:

- 50 percent of the additional settlement figure (i.e., 50 percent of $100,000), or $50,000, plus
- $25,000 in additional defense costs (i.e., 50% of $50,000), plus
- $100,000, the originally recommended settlement amount, for a total of $175,000.

In contrast, under a typical "hammer clause" without a coinsurance provision, the insurer would not have paid any of the additional settlement or defense costs.

Chapter 2 Review Questions

1. Noah Count, a CPA, wants to find out which services or acts are covered in his professional liability policy. He might find the answer to this question in any of the following sections of his policy, *except*:

   a. application

   b. conditions

   c. definitions

   d. declarations

2. Mary Mason is an attorney who normally handles civil cases. Like most attorneys, she occasionally drafts a simple will for one of her clients and provides them with related advice. Mary's attorneys professional liability policy does not mention estate planning. Is she covered if a client, or the client's estate, claims that she was guilty of an error or omission in connection with a client's will?

   a. Coverage applies, because any professional liability policy covers all types of professional services unless they are specifically excluded.

   b. Coverage applies, because it is common for attorneys to draft simple wills.

   c. No coverage applies because this activity is not enumerated in the policy.

   d. No coverage applies because estate planning coverage requires a separate policy.

3. Genesis Co. was insured under a professional liability policy. Genesis sells two-thirds of the business to Malachi and one-third of the business to Universe Co. Universe then purchases professional liability insurance from a different insurer. Under these circumstances:

   a. Genesis Co. is a predecessor firm of Universe Co.

   b. professional liability policies always cover predecessor firms, as defined.

   c. if Genesis Co. is listed as an insured in Universe Co.'s policy, Universe's policy will cover claims against Genesis for acts committed before Genesis was dissolved.

   d. Universe Co.'s policy automatically covers claims against Genesis Co.

4. After attempting to perform an autopsy on a live patient, Dr. Quince, medical examiner, was required to pay substantial compensatory and punitive damages. In addition, his professional license was suspended, and he was hit with a substantial fine. Dr. Quince's insurer refused to pay some of these items because payment would be contrary to public policy. In this context, "public policy" refers to:
   a. a professional liability policy carried by the public entity that commissioned the autopsy
   b. statutory provisions incorporated by reference within Dr. Quince's professional liability policy
   c. Dr. Quince's own professional liability policy
   d. rules or laws that guide or encourage certain actions
5. After receiving notice of a claim against her, Patty Cake is surprised to learn that her professional liability insurance policy contains a "duty to defend" provision, under which:
   a. Patty's insurer will manage the defense process and also pay defense costs.
   b. Patty must handle her own defense.
   c. Patty has a right to control the claim process.
   d. Patty has a right to choose her own defense counsel.

Answers to Chapter 2 Review Questions

1. b. Conditions merely state the respective rights and requirements applicable to the insured and the insurer under the policy.
2. b. As stated in the facts provided, most attorneys routinely handle simple wills. As a result, estate planning need not be specifically enumerated as a covered professional service.
3. c. Listing the predecessor firm(s) for which coverage is sought on the declarations page of the policy, without actually having to define the term "predecessor firm," is useful in a situation where the insured organization did not take over a majority of the predecessor firm's assets and would therefore not be considered a predecessor firm under most PL policies' definition of the term..
4. d. "Public policy" refers to rules or laws that either guide or encourage certain actions, rather than compel such actions.
5. a. Both duty to defend and non-duty to defend provisions require the insurer to pay defense costs.

Chapter 3
Limits, Deductibles/Retentions, and Coinsurance

There are both similarities and differences in the ways in which limits, deductibles/retentions, and coinsurance clauses are applied under professional liability policies. This discussion addresses key elements of these provisions.

Limits

Professional liability insurance policies use one of three methods in providing policy limits.

- **Single, Annual Aggregate Limit.** A policy contains only a single, annual aggregate limit (also called a "combined single limit"). Such limits indicate the maximum amount that can be paid out on the insured's behalf during a given policy year. The aggregate can be applied to both indemnity payments and defense costs—in any proportion and irrespective of the number of different claims or claimants. An example of this is a policy with a $1 million annual aggregate limit. Under such a policy, $1 million is the most the insurer will pay, regardless of the number of claims made during the policy term. It could, for example, pay 3 claims of $100,000, $300,000, and $600,000, respectively, which totals $1 million. Or, it could pay a single $1 million claim, during the term of the policy.
- **Equal Per Claim and Annual Aggregate Limits.** A policy contains both a per claim and an annual aggregate limit that are equal to each other. In actual practice, however, such policies operate in a manner identical to those using the language described above. An example of this is a policy with a $1 million annual aggregate limit and a $1 million per claim limit.
- **Unequal Per Claim and Annual Aggregate Limits.** A policy contains both a per claim limit and an annual aggregate limit where the limits are not identical (with the aggregate typically being two to three times the "per claim" limit). For example, a hospital professional liability policy is written with limits of $1 million/$3 million. This means that $1 million is the most the insurer will pay on any one claim and that $3 million is the most the insurer will pay for all claims, during the policy period.

Related Claims Provisions

Related claims provisions, also sometimes called "interrelated" claims or "interrelated acts" provisions, are found in nearly all types of PL and ML policy forms. Related claims provisions apply to situations in which more than one claim results from a single wrongful act or from what the policy defines as a series of "related wrongful acts." More specifically, related claims provisions state the following.

Limits

If more than one claim results from a single wrongful act or a series of related wrongful acts, the insured receives the protection provided by the limit of coverage applicable when the first claim was made, rather than the sum of the limits that were applicable to the policy periods during which all the claims were made (if claims are made against the insured during more than one policy period).

Deductibles/Retentions

If more than one claim results from a single wrongful act or a series of related wrongful acts, only one deductible/retention applies to all of the claims.

Application of Related Claims Provisions: An Example

The following scenario offers an example of how a related claims provision functions. An architect purchased professional liability policies (written on a claims-made basis) with the following terms: January 1, 2009–2010, January 1, 2010–2011, and January 1, 2011–2012, at limits of $1 million, $2 million, and $3 million, respectively. The architect draws plans for a structure and seals the plans on January 1, 2005. Construction is completed 2 years later, on January 1, 2007. On January 1, 2009, a portion of the building collapses and injures three people. Each of these individuals makes claims against the architect on July 1, 2009, July 1, 2010, and July 1, 2011, respectively. All three claims resulted from the same wrongful act (i.e., the defective building design), yet the claims in this example are made during three different policy periods. Under these circumstances, only one policy limit (i.e., the $1 million limit applicable during the January 1, 2009–2010 policy period) would apply to all three claims, because that was the year in which the first claim arising from the original wrongful act was made. In addition, only one deductible/retention would apply, because the three claims resulted from just one wrongful act.

Exhaustion of Limits Provisions

Most policies state that once their limits have been exhausted by any combination of claim payments and/or defense expenditures, the insurer's duty to defend any and all claims against the insured ceases.

Exhaustion of Limits Applies to Amounts Paid, Not to Amounts Reserved

It should be pointed out that exhaustion of limits clauses apply only to situations where payments—rather than reserves—have exceeded limits. For example, assume that an insured against whom three claims were pending had a $1 million policy limit. If the insurer had reserved $500,000 (for settlement and defense costs) for each of the three claims, the insurer's obligation to continue defending the insured would not cease until $1 million had actually been paid out on the insured's behalf (in any combination of settlement and/or defense costs, across any combination of the three claims), despite the fact that the initial reserve exceeded the insured's $1 million policy limit.

Deductibles/Retentions

Nearly all PL policies contain either deductible or self-insured retention provisions.

Deductibles versus Retentions

Under a policy written with a deductible provision, the insurer pays the defense and indemnity costs associated with a claim—including the deductible amount—and then seeks reimbursement of the deductible payment from the insured. For example, assume a policy is written with a $10,000 deductible. A claim is settled for a total of $100,000 (defense and indemnity payments). In this situation, the insurer will pay the entire $100,000 and then bill the insured for the $10,000 deductible amount.

Under a policy written with a retention provision, the insured pays defense and/or indemnity costs associated with a claim until the retention amount is reached. After that point, the insurer would make any additional payments for defense and indemnity that were covered by the policy.

For example, assume a D&O liability policy is written with a $100,000 retention. The insured directors and officers, as well as the corporate entity, are sued by a claimant who alleges securities fraud. The corporation will pay the first $100,000 in defense and indemnity amounts that are incurred in conjunction with the claim. After that point, the insurer will pay all subsequent defense and indemnity costs (until the policy limit is reached).

Retentions are generally written for larger organizations, such as corporations insured under directors & officers liability coverage or hospitals covered by hospital professional liability coverage. Conversely, deductibles are found in PL policies written for smaller professional liability insureds, such as solo practitioners in law, medicine, or accounting and even for larger group practices.

Anti-Stacking/Batch Clause Provisions

As recognized by the related claims provision already discussed, it is not uncommon for a single wrongful professional act to produce more than one claim. For example, assume that as part of a company-wide layoff, 25 African-American workers are terminated. In response, they bring a class action discrimination claim against their former employer.

Given the financial hardship the corporation would suffer in having to absorb 25 deductibles/retentions—despite having the fact that all 25 claims emanated from a single event—PL and ML policies often include what are known as anti-stacking provisions, also known as “batch clauses.” They state that only one deductible/retention applies per wrongful act. This is irrespective of the number of occurrences or number of claimants that are produced by an individual wrongful act.

Anti-stacking provisions are critical for insureds since they prevent the application of multiple deductibles/retentions in the event that more than one claim results from a single wrongful act.

Aggregate Deductibles/Retentions

An annual aggregate deductible is advantageous for an insured because it caps the amount the insured would be required to absorb in the event that multiple claims—from more than a single wrongful act—were made against an insured in a single year. Nevertheless, few professional liability policies contain aggregate deductibles. There are two reasons for this: (1) professional liability claims are more “severity-driven” than “frequency-driven,” and (2) most (although, admittedly, not all) professional liability policies cover only a limited number of persons so that the chances of more than one claim being made against an insured during a single policy period is relatively low. Admittedly, a

multiplicity of claims in a single year could be a potential problem for certain insured professional organizations, e.g., a 150-person law firm or a large hospital. From a practical standpoint, multiple claims within a single policy period are generally much less of a concern for more typical insureds under a professional liability policy, e.g., a five-person accounting firm, a sole practitioner attorney, an eight-person technology consulting firm. Nevertheless, aggregate deductibles/retentions are advantageous for insureds and efforts should be made to include them, especially within policies covering more than 25 people.

Reduced Deductible Amount Options

In recent years, professional liability insurers writing various lines of coverage have begun to offer policies that contain options for a reduced deductible/retention amounts—with no commensurate increase in premium. Such options are typically contingent upon the insured's taking certain actions under specific circumstances, which are discussed below.

The Rationale for Reduced Deductibles

The purpose of reduced deductible provisions is to encourage certain activities that will either (1) prevent claims from being made against the insured or (2) mitigate the eventual dollar amount of claims once they are made. The following are three examples of circumstances under which insurers sometimes offer a reduced deductible under professional liability policies.

- **Early Reports of "Incidents."** An architects and engineers insurer agrees to reduce a $10,000 deductible to $5,000 for no additional premium charge. The reduced deductible will apply to any claim which the insured originally reported as an "incident" that appeared to have the potential to give rise to a claim in the future, despite the fact that no formal claim has yet been made. When an insured reports such incidents before a formal claim is made, this allows the insurer to evaluate the incident and, if it deems appropriate, the insurer can promptly begin investigating the circumstances surrounding it. Then, depending upon the circumstances, the insurer might make a "preemptive" settlement offer. Such action often prevents a claim from being made at all or will at least minimize the extent of ultimate damages, given the opportunity for early insurer intervention. (It should be recognized that the insurer's obligation to apply the lower, $5,000 deductible attaches, regardless of the ultimate disposition of the claim. The intent of this provision is to encourage early reports of incidents because the sooner an insurer becomes involved in the claim handling process, the better the chances of resolving it for a reasonable amount.)
- **Arbitration Agreements with Clients.** A lawyers professional liability insurer writes a policy with a $2,500 deductible for the same premium as one containing a $5,000 deductible. This option is available for law firms that require their clients to sign an agreement stating that all disputes between the clients and the firm will be subject to mandatory arbitration rather than the traditional court system. Such a provision is likely to mitigate the dollar amount of potential damages because instead of suing the attorney, clients must submit the dispute to arbitration. This is likely to be less expensive than standard litigation, from the standpoint of both defense and settlement costs.
- **Pre-Termination Consultations with Employment Attorneys.** An employment practices liability policy contains a provision that reduces the deductible by 50 percent for wrongful termination claims. This reduction is conditioned upon the insured having consulted with and followed the recommendations of a labor law firm—provided by the insurer—prior to terminating employees. The rationale for this provision is that by encouraging the insured to

consult with the law firm prior to taking a termination action, potential damages will be reduced because the insured will receive expert advice regarding matters such as severance pay, the wording of releases, exit interviews, and other important issues involving employee terminations.

Coinsurance Provisions

Coinsurance provisions are sometimes found in several lines of PL and ML coverage, most notably in employment practices liability and directors and officers liability policy forms. They are, however, uncommon. This is especially true during soft insurance market conditions when competition between insurers is strong and few buyers (except those considered within the "difficult to insure" category, such as professionals who have a number of claims made against them) are willing to accept coinsurance provisions.

Coinsurance provisions state that the insured must contribute a certain percentage of the costs associated with the defense and settlement of every claim. Normally, the coinsurance percentage ranges from 5 percent to 30 percent per claim. They operate in a fashion identical to that used in healthcare insurance policies, whereby an insured, for example, might be required to pay, on an out-of-pocket basis, 20 percent of the first $10,000 of all costs on a given claim.

Typically, coinsurance provisions are noted on the declarations page of a professional liability policy. Most often, the declarations page will contain a blank line, in which the applicable coinsurance percentage is filled in.

Purpose and Operation of Coinsurance Provisions

There are two purposes of coinsurance provisions. First, they provide the insured with a direct financial interest or so-called "skin in the game" during the claim settlement process. (This is often important, depending on the particular circumstances surrounding a lawsuit against an insured, especially in D&O and EPL claims). Second, they provide an incentive for the insured to prevent losses, given the fact that he or she will be required to contribute a significant portion to any claim settlement or judgment.

Chapter 3 Review Questions

1. Dr. Welby is having a bad year. His current medical professional liability policy has a $1 million single, annual aggregate limit and a 1-year term that coincides with the calendar year. Three unrelated professional liability claims have already been made against him this year. The insurer paid $400,000 in damages plus $100,000 in defense costs to settle the first claim. The insurer has set aside a reserve of $250,000 for the second claim and $400,000 for the third. At this point, the insurer:

   a. has no further obligation to Dr. Welby because claims and reserves exceed the aggregate limit

   b. has no further obligation to Dr. Welby because the one-claim limit of his policy has been exceeded

   c. is obligated to continue defending Dr. Welby but only until it has paid $1 million in damages

   d. is obligated to continue defending Dr. Welby against the second and third claims

2. Pancake Corp.'s employment practices liability policy includes a $1 million limit, an anti-stacking provision, and a $10,000 retention. Twenty of Pancake's employees just filed a claim against their employer alleging that the new image used on its packaging is demeaning to African-American employees and therefore constitutes racial discrimination. Assuming the 20 employees win a judgment against Pancake of $20,000 each, Pancake's retention, if any, will be in the amount of:

   a. $0.

   b. $10,000.

   c. $400,000.

   d. $800,000.

3. Lane Lewis and Kent Clark are aware that any error in surveying one of their clients' properties could impair the client's property rights. Their standard client agreement includes an arbitration agreement, which is likely to:

   a. be more expensive than standard litigation.

   b. mitigate the dollar amount of potential damages.

   c. produce earlier reports of incidents that might give rise to a claim.

   d. reduce the likelihood of a surveying error.

4. Dermatology Clinic's medical professional liability policy has a coinsurance provision that is intended to:

   a. discourage the clinic from reporting losses

   b. encourage patients to prevent losses

   c. ensure that the clinic has a stake in controlling losses

   d. prevent the clinic from contributing to any claim settlement or judgment

Answers to Chapter 3 Review Questions

1. d. The insurer's obligation to continue defending the insured would not cease until $1 million has actually been paid out.
2. b. The anti-stacking provision specifies that only one deductible/retention applies per wrongful act.
3. b. Instead of suiting the surveyors, clients must submit the dispute to arbitration.
4. c. The coinsurance provision gives the insured a direct financial interest in the outcome of the claim settlement process.

Chapter 4
Conditions

Conditions in ML and PL policy forms state the respective rights and the requirements applicable to both the insured and insurer under the policy. Although sometimes considered "boilerplate" material, conditions sections can have a material effect on the actual scope of coverage the policy provides. The major policy conditions that will be discussed in this section include (1) notice of cancellation, nonrenewal, and premium/coverage change; (2) subrogation; (3) other insurance, (4) notice of claim, and (5) miscellaneous conditions.

Notice of Cancellation, Nonrenewal, and Premium/Coverage Change

There is considerable variation between the manner in which the various professional liability insurers handle the issue of policy cancellation, nonrenewal, and notice of premium/coverage change.

Notice of Cancellation

The majority of PL policies require that the insured be given 30 days' notice prior to the date on which an insurer will cancel a policy, although a significant minority of insurers' forms provide 60 days' notice prior to cancellation. (In many states, as will be explained in more detail below, the issue of whether 30 or 60 day cancellation notice periods is provided, is a matter of statutory insurance law.) Still other insurers write policies which cannot be canceled (except for nonpayment of premium or for material misstatements in the application). Various cancellation issues are discussed below.

Cancellation Due to Nonpayment of Premium

Under most PL policies, if cancellation is due to nonpayment of premium, the insurer is required to provide only 10 days' notice to the insured.

Cancellation for Material Misrepresentation in the Application

A few insurers' forms state that they will cancel the policy in the event that the insured has included material misrepresentations within the application for coverage. This is appropriate since the coverage provided by a PL or ML policy is issued in reliance upon the truth of the information found within the application. Material misrepresentations refer to false information regarding critical aspects of a professional liability risk. To illustrate: assume an applicant for physicians professional liability coverage failed to reveal that within the past 5 years, prior insurers settled three claims totaling $500,000 on his behalf. This would be considered a material misrepresentation because had the insurer known about the claims, it may not have agreed to write a policy or would have charged a higher premium. On the other hand, if the physician stated in his application that he had been

practicing medicine for 20 years, when, in fact, he had only been practicing for 15 years, this would probably not be viewed as a material misrepresentation.

Cancellation by the Insured Requires No Advance Notice

Although, as stated above, insurers are required to provide some notice period prior to cancellation, insureds are generally permitted to cancel policies with no advance notice. However, under these circumstances, premium is refunded on what is known as a short-rate basis, i.e., 90 percent of the pro-rata unearned premium. . Thus, if a 1-year policy with a $10,000 premium was in effect for 6 months, at which time it was canceled by the insured, a $4,500 refund would be due the insured (50 percent of $10,000 = $5,000, less 10 percent = $4,500). Conversely, if the insurer cancels, premium is always refunded on a pro rata basis with no short-rate penalty, so that in the previous example, the insured would receive a $5,000 premium refund.

The Effect of State Amendatory Endorsements on Cancellation Provisions

Notice provisions are often extended by the attachment of state amendatory endorsements which, by law, must be appended to all insurance policies written in a given state. An amendatory endorsement is filed with the state insurance department to bring the form into compliance with that state's insurance laws. (However, this requirement does not, in all cases, apply to nonadmitted insurers, many of which write professional liability coverage.) While amendatory endorsements may amend any number of policy terms and conditions, the terms most frequently amended are the notice provisions. Specifically, such endorsements often state that the minimum cancellation notice period is 60 days.

Broadening Standard Cancellation Notice Provisions

The insured should make efforts to broaden the terms of the standard cancellation provisions discussed above. In the event that an insurer cancels a policy, significantly more than 30 days is typically required to apply for and negotiate replacement of most types of PL and ML insurance. Therefore, when the applicable cancellation notice period is less than 60 days, attempts should be made to include a manuscript provision modifying standard cancellation terms so the insurer is required to give at least 60—and preferably 90—days' notice prior to cancellation. This is especially important when a state amendatory endorsement does not apply, and the insurer is required to provide only 30 days notice prior to cancelling a policy.

Notice of Nonrenewal

Some PL forms include a provision requiring that the insurer give the insured advance notice if it intends not to renew the policy. When offered, this period is typically 30, 45, or 60 days and is often the same notice period the insurer is required to give for cancellation. The specific notice period that must be given to an insured prior to nonrenewal is nearly always mandated by state law and in such cases would be specified in that state's amendatory endorsement.

Why Notice of Nonrenewal Cannot Always be Provided

Even if they act in good faith, insurers are not always able to provide advance notice of their intent not to renew. This is because information submitted on a renewal application may indicate a change in the insured's operations (e.g., new types of services or clients, larger/smaller staff) which no longer meet the insurer's underwriting guidelines. For example, a lawyers professional insurer may only

write coverage for firms of less than 20 lawyers. If a firm expands beyond this number, the insurer will no longer cover the firm.

To further illustrate, a certain kind of claim may be reported late in a policy period, which could also indicate that the exposure might no longer comply with the insurer's underwriting requirements. For example, a law firm may report a securities claim made against it, indicating that its attorneys have begun to practice in this high-risk area of the law. The insurer's underwriting guidelines may state that it will not cover firms practicing securities law.

Thus, unless an insured can provide a timely renewal application, it is often difficult for an insurer to guarantee a nonrenewal notice period. Therefore, it is best that an insured submit renewal applications 90 (or at least 60) days prior to policy expiration. Under these circumstances, an insurer would be better able to provide advance notice of nonrenewal for the kinds of underwriting reasons noted above.

Notice of Premium/Coverage Change

There are two other situations in which it is valuable for an insured to be given advance notice of an insurer's intentions regarding changes in the terms of a renewal policy: (1) when the renewal policy will contain a material increase in premium and (2) when it will include a material restriction in the scope of coverage.

It is, of course, impossible to indicate exactly what constitutes "material" in either of these instances. In the first case, a doubling of premium would clearly fit the definition of a material increase in premium. In the second instance, if half of an insured attorney's practice was made up of real estate limited partnership syndication work, and in a renewal policy an insurer decided to exclude this exposure entirely, such action would also fit any reasonable definition of a material restriction in coverage. On the other hand, if the renewal premium were to increase by 10 percent and if real estate syndication work constituted only 2 percent of the attorney's practice, such changes, while not unimportant, may not be considered material.

Despite such ambiguities as to what exactly constitutes "material," it is advantageous for an insured's professional liability insurance policy to contain wording that provides:

- Advance notice 60 days prior to cancellation
- An equal notice period in the event of the insurer's intention to nonrenew
- Advance notice if the insurer decides to renew at a materially higher price
- Advance notice in the event that the insurer intends to renew with a material restriction in the scope of coverage

Subrogation Provisions

Subrogation is the assignment to an insurer from an insured, under the terms of the policy and after payment of a loss, of the rights of the insured, to recover the amount of the paid loss from the party legally liable for causing the loss. For example, an insured hospital is sued by a patient who is injured when a doctor negligently performs surgery on the patient at the insured's hospital. The hospital's professional liability insurer makes a payment to the injured patient on the hospital's behalf. Under the terms of virtually all professional liability insurance policy forms, the professional liability insurer would then have the right to collect the amount of its payment on behalf of the hospital, from the doctor who negligently performed the surgery. As a condition of indemnifying the insured hospital,

the hospital would first be required to sign a release of all claims against the negligent doctor, because in the absence of such a release, the hospital would also have the right to pursue a claim against the doctor. The release prevents this situation from happening, which would amount to "double indemnity" for the hospital. By obtaining the release, the insurer then has the right to collect the amount of its payment (on behalf of the hospital) from the negligent doctor who was responsible for causing the claim. So now, the insurer "stands in the shoes" of the hospital as to the right to seek payment from the doctor.

Subrogation Waivers Prior to a Loss

Standard subrogation provisions sometimes allow insureds to waive subrogation prior to a loss. For instance, a project owner, as a condition of doing business with all design firms, may require that engineers waive their rights to subrogate against the owner in the event the owner is responsible for causing a professional liability claim to be made against the engineers. Under these conditions, most professional liability insurers would be agreeable to allowing this waiver.

While most professional liability policies do not bar arrangements of this kind, a few forms explicitly prohibit subrogation waivers even before a loss. For this reason, subrogation provisions need to be studied and, if an insured has waived subrogation against any third parties, the underwriter should be notified. In such instances, either the policy must be modified to allow such arrangements or the contractual agreement waiving subrogation should be rescinded. Even if their policies contain provisions barring subrogation prior to a loss, underwriters will usually agree to waive subrogation, provided they are given appropriate details as to why it is important for an insured to do so (as in the example above) and in return for additional premium.

Subrogation Waivers are Never Permitted after a Loss

On the other hand, virtually no insurers' forms allow insureds to waive subrogation after a loss. To do so would clearly violate the principle of indemnity.

Waiver of Subrogation Against Insureds

Most professional liability insurance policies contain provisions that prevent the insurer from subrogating against an insured, unless the insured has acted willfully in causing a claim. For example, if an attorney is sued by a client for accidentally missing a filing deadline, this provision would prevent an insurer from subrogating against the attorney, after the insurer indemnified the attorney's client. On the other hand, a few insurers' forms prevent an insurer from subrogating against an insured under any circumstances (e.g., even if the insured's conduct in causing a claim was intentional, such as if a surgeon purposely injured a patient). A provision of this kind is, of course, advantageous from the insured's point of view.

Other Insurance Provisions

Other insurance provisions deal with situations in which the terms of one or more other policies also provide coverage for a professional liability claim that is insured by a given policy. Important areas involving other insurance provisions include the purposes of other insurance provisions, excess other insurance provisions, and potential conflicts associated with other insurance provisions.

Purposes of Other Insurance Provisions

There are two purposes of other insurance clauses in professional liability insurance policies.

First, they are aimed at preserving the principle of indemnity. Specifically, their intent is to prevent possible moral hazard by making certain that an insured is not also compensated for the same claim by more than one insurance policy. In effect, other insurance clauses prevent a professional from making a profit as a result of a claim being made against him or her because he or she maintained multiple policies.

The second rationale for other insurance provisions is to allocate the payment of claims between insurers. In effect, other insurance clauses prevent an insurer from profiting by not contributing to the payment of a claim that it rightfully insured, when a claim is also covered by another insurer's policy.

Excess Other Insurance Clauses

Nearly all professional liability insurance policies are written to apply as excess insurance in the event that another policy exists. In actual practice, and as a matter of law in many jurisdictions, if two policies cover the same claim and both contain this provision, both are primary and must pay the claim on a pro rata basis, i.e., in proportion to their respective limits. Assume that an insured has two PL policies (both with excess "other insurance" clauses) that cover a claim; Policy A has a $500,000 limit and Policy B has a $1 million limit. Defense and indemnity payments applicable to a claim made against the insured total $150,000. In this situation, insurer A will pay $50,000 and Insurer B will pay $100,000.

Potential Other Insurance Provision Conflicts

Another important area in which conflicts can arise from other insurance clauses in professional liability insurance policies involves situations where an insured professional is also an insured under another professional or general liability policy. For instance, a nurse who carries professional liability of his or her own may also be an insured under the PL policy of the hospital where she is employed. Such situations could give rise to conflicts regarding primacy.

Therefore, if a professional carrying PL coverage also has insured status under other entities' policies, the issue of conflicts must be discussed with underwriters. The underwriters may wish to add a manuscript endorsement that clarifies the capacity and/or acts for which the individual is covered under the professional liability policy. It should also address the conditions under which each of the two policies will primary and which will be excess. Nevertheless, the general rule in situations such as these is that the employer's policy is primary.

Notice of Claim Provisions

Most professional liability policies require the insured to promptly notify the insurer in the event that a claim is made against the insured. The purpose of a policy's notice provision is to prevent an insurer from being placed at a disadvantage in investigating and defending a claim because notification of the circumstances surrounding the allegations was delayed.

"Notice" to Agent or Broker Does Not Constitute "Notice"

It is significant to realize that according to caselaw in a number of jurisdictions, notice of claim to an insured's broker often does not constitute notice to the insurer so as to comply with standard PL policy notice provisions. This is because brokers are technically representatives of insureds, rather than insurers. Complicating this situation is the fact that the lines of distinction between brokers and

agents are often blurred, so that it is frequently arguable as to whether a person is acting as a broker or an agent in any given situation. Thus, soon after an insured reports a claim or possible claim to an agent or broker, the agent or broker should send the insured professional a copy of the letter in which the agent/broker formally reported the claim to the insurer. (A "claim" refers to a formal request for money damages, usually in the form of a lawsuit. A "possible claim" is a situation that could, but has not yet resulted in a "claim." For example, after issuing a restatement of its financial data, a corporation may consider notifying its D&O insurer, since financial restatements frequently, although not always, trigger claims against a company's directors and officers.) This procedure will provide confirmation that the policy's notice provision has been complied with completely. Alternatively, the insured can notify the insurer directly in the event of a claim, thereby avoiding potential problems relating to this issue. Typically, the title of the person designated to receive notice at the insurer, as well as the address of the insurer, is specified in the policy's notice provision, which allows the insured to notify the insurer directly.

Miscellaneous Conditions

There are several other "miscellaneous" PL and ML policy conditions that can have a meaningful effect on the manner in which the policies function, including the following.

- Prohibition of Voluntary Payments and Settlements
- Cooperation Clause
- Legal Action Against the Insurer Provision
- Mandatory Arbitration Provision
- Nontransferability Provision
- Severability Provision
- Continuation of Coverage in Bankruptcy Provision

Prohibition of Voluntary Payments and Settlements

Nearly all PL policies contain language barring the insured from making any voluntary payments to settle claims made against them without first obtaining the insurer's consent. Such provisions prohibit the insured from (1) admitting liability, (2) assuming future obligations to compensate a claimant, (3) making payments to a claimant, or (4) incurring any other expenses (e.g., defense costs) in conjunction with a claim.

The purpose of such language is to assist the insurer in defending against a claimant's legal action by preventing the insured from waiving his or her rights associated with the claim. By taking any of the actions noted above, an insured could be foregoing both his or her, as well as an insurer's, right to later deny liability in conjunction with a claim that is made against it.

"Goodwill" Insurance versus Legal Liability Insurance

In some instances, insureds do not always realize that their PL policy is not "goodwill insurance." In effect, the policies are not intended to provide coverage if, after they are rendered, the insured's services are not to a client's liking—regardless of the fact that the insured committed no error or omission and met (or exceeded) normal professional standards in rendering those services. For example, if a critically ill patient dies on the operating table—through no fault of the surgeon attempting to save his life—the surgeon would not be legally liable if the patient's estate later file a

wrongful death claim against him. Accordingly, under such circumstances, the surgeon should not voluntarily offer to make a payment to the patient's survivors.

Voluntary payment provision clauses are included in policies to prevent insureds (in situations comparable to the one described above) from waiving their insurer's rights in defending professional liability claims made against them. In the event that the physician in this example had promised the patient's family a sum of money in compensation, the insurer would have a difficult time in later denying the surgeon's liability when it begins to conduct a defense on the surgeon's behalf. In short, the purpose of such provisions is to prevent insureds from prejudicing their cases when defense must later be conducted. Voluntary payment provisions are therefore intended to preclude insureds from committing insurers to (sometimes) unwarranted financial obligations with their clients, their patients, or with claimants.

Cooperation Clause

Nearly all professional liability policies contain clauses that compel insureds to make "reasonable efforts" to assist and cooperate with the insurer in defending claims made against them. Such provisions are necessary because insureds sometimes believe that because the insurer's money—rather than their own—is at stake, the insurer, rather than the insured, should be the party to expend the time and effort necessary to defend claims under the policy. However, since the insured is the party directly cognizant of the facts surrounding claims, it is virtually impossible to conduct an effective defense in the absence of cooperation from the insured.

Legal Action Against the Insurer

The majority of PL and ML policies include provisions stating that the insured cannot initiate a claim against an insurer in conjunction with a coverage dispute unless the insured has first complied with all terms of the policy and until an insured's ultimate liability for a claim has been established. In other words, an insured cannot sue an insurer (e.g., for refusing to provide coverage for a claim or for not covering a claim in its entirety) until there has been a settlement or a judgment rendered in connection with a professional liability claim made against the insured. Such a provision is sometimes referred to as a "no action" clause.

The purpose of such language is to prevent lawsuits in the event that an insured has not lived up to the terms agreed on in the insurance contract (e.g., breaching the cooperation clause in the policy). Another purpose of this provision is to prevent questionable litigation until an insured's actual dollar liability for a disputed claim made against him or her has been determined.

Mandatory Arbitration Provision

A significant number of PL and ML policies contain provisions that require disputes between the insured and the insurer be submitted to binding arbitration rather than allowing either party to resort to the conventional court system.

The effect of this provision is to expedite the resolution of coverage-related controversies, given the long delays inherent in the conventional U.S. judicial process. Also important is the fact that arbitration typically reduces the cost of settling such disputes compared to utilizing the traditional court system. Although the mandatory arbitration provision benefits both the insurer and the insured for these reasons, arbitration affords greater benefit to the insurer. This is because it is generally believed that arbitrators are less biased against insurance companies than are judges and juries, as evidenced by the rare incidence of astronomical arbitration awards against insurers, compared to the often huge verdicts rendered by juries.

A Criticism of Arbitration: Insurers Benefit from "Continuing Relationships"

One specific criticism of arbitration stems from the fact that insurers regularly hire arbitrators because insurers are repeatedly involved in coverage disputes. Given their continuing need for the services of arbitrators, over time, insurers are in a position to hire arbitrators "more selectively," so that eventually they begin hiring arbitrators whose previous decisions have tended to favor them. Conversely, insureds, given the rarity of their participation in the arbitration process, are not in a position to select arbitrators whose prior decisions have appeared to support their interests. For this reason, arbitration tends to favor insurers.

Nontransferability Provisions

Most PL policies contain wording to the effect that coverage cannot be automatically transferred to another individual or entity without the insurer's consent. Provisions of this kind, also known as nonassignability clauses, are necessary because PL insurance is based on the underwriter's desire to cover only the named insured. In effect, PL coverage is considered as personal to the insured.

For instance, assume that during the term of coverage an accountant (who is a sole practitioner) sells his practice to another accountant. Under these circumstances, the nontransferability provision will reserve for the insurer the right not to extend coverage to the new owner of the practice. Because PL policies are personal contracts, the underwriter must be given the opportunity to evaluate, offer different coverage terms and/or premium, and perhaps reject an individual or entity seeking named insured status under the original named insured's policy.

Additional Insureds are Rare in Professional Liability Coverage

A related point associated with nontransferrability provisions is the fact that PL underwriters will rarely agree to name other persons or entities as "additional insureds" under their policies. Again, the rationale for this position is that the coverage provided under a PL policy is personal to the insured. Absent separate underwriting (as well as payment of premium) of an individual or entity seeking additional insured status, requests for additional insured status are almost never granted.

Severability Provisions

Severability provisions are included in the majority of PL and in nearly all ML forms. Such provisions indicate that the coverage applies separately to each insured under the policy. There are two significant implications of severability clauses: (1) they protect so-called "innocent" insureds, and (2) they reinforce the fact that while coverage can apply separately to different insureds, this does not increase the limits of the policy.

Protection of "Innocent Insureds"

Severability provisions state that if the actions of one insured voids coverage under the policy, such coverage is not invalidated as respects other individuals insured by the policy. For instance, assume that one insured attorney commits a criminal act (e.g., he steals money from a client's trust fund) and, as a result, all partners of the law firm are also named in a lawsuit. In this situation, the severability provision of the policy will afford defense coverage to the other, innocent attorneys despite the fact that defense coverage would not be available to the culpable lawyer.

Similarly, severability provisions also become significant when an individual insured intentionally provides false information on an application for PL coverage. In a claim situation involving an insured that provided false information on a coverage application, most severability provisions in PL

policies would void coverage—but only for that specific insured, while providing coverage for those insureds who were not aware of and were not a party to the false statement made on the application.

For example, assume the chief financial officer of a corporation intentionally provides false financial statements within an application for D&O coverage. Also assume that none of the other officers or directors was aware of such falsification. If a claim is made under the policy, the insurer would have the right to void coverage as to the chief financial officer, but under the policy's severability provision, would still be obligated to cover all of the other "innocent" directors and officers who were not aware that the chief financial officer intentionally falsified the application.

No Increase in Policy Limits

Severability provisions also intend to clarify the fact that although coverage, at times, can apply separately to different individuals, such circumstances do not increase the policy's limit of liability. For example, under a policy containing a $2 million per-claim limit, a total of only $2 million would be available to defend and pay on behalf of all insureds, regardless of how many individuals were named in a single lawsuit.

Continuation of Coverage in Bankruptcy

Most PL policies indicate that coverage continues when an insured has declared bankruptcy. The lack of coverage for an otherwise valid claim—despite an insured's bankruptcy declaration—would obviously add to the hardships being experienced by an insured under such circumstances. Among other things, a coverage denial would make it more difficult for an insured to repay outstanding creditors, thereby impeding the insured's eventual return to professional practice.

Even in the absence of such a provision, as a practical matter, it would be difficult for an insurer to walk away from its obligation to defend and indemnify an otherwise covered claim. Insureds should nevertheless insist that a continuation of coverage in bankruptcy provision be included in all PL policies.

Chapter 4 Review Questions

1. When her son Steven was 6 months old, Cindy returned to part-time work at CMAC's barber shop and purchased professional liability insurance effective June 1, 2007 at an annual cost of $ $1,200. Three months later she decides to become a full-time mother and requests her policy be canceled effective September 1, 2007. Cindy is entitled to a premium refund of:

   a. $0

   b. $810

   c. $100

   d. $135

2. A provision in River Bank's directors and officers (D&O) new liability policy states that the insurer may cancel the policy upon giving the bank 30 days' advance notice. River Bank should:
   a. attempt to have this cancellation period extended.
   b. attempt to have this cancellation period reduced.
   c. insist that the policy be replaced with one that is noncancelable and guaranteed renewable.
   d. recognize that this cancellation provision is required by law and cannot be changed.
3. The other insurance provisions in a professional liability insurance policy are intended to serve all the following purposes, *except:*
   a. allocate the payment of claims among insurers.
   b. enable the insurer to avoid paying valid claims that are also covered by another insurer.
   c. preserve the indemnity principle.
   d. prevent multiple recoveries for a single loss.
4. Seven recently married sisters form a consulting firm and name it "Seven Brothers" in honor of their new brothers-in-law. The severability clause in Seven Brothers' professional liability policy, which names the seven brides as insureds, provides that:
   a. applicable policy limits are divided by the number of insureds—in this case, seven.
   b. applicable policy limits are multiplied by the number of insureds—in this case, seven.
   c. coverage applies separately to each insured under the policy.
   d. each of the seven named insureds is personally responsible for paying a proportional share of the premium.

Answers to Chapter 4 Review Questions

1. b. Cindy is entitled to a short-rate refund of 90% of the pro-rata unearned premium. 9 months/12 months x $1200 = $900 – 10%= $810.
2. a. Thirty (30) days may not be enough time to find a replacement policy. So River Bank should attempt to have the cancellation period extended.
3. b. In effect, other insurance clauses prevent an insurer from profiting by evading payment for a claim that it rightfully insured, when a claim is also covered by another insurer's policy.
4. c. Severability provisions indicate that the coverage applies separately to each insured under the policy.

Chapter 5
Exclusions

Policy exclusions—both those included in the form itself and those added by endorsement—have a profound effect on the scope of coverage provided by professional and management liability insurance policies. In fact, the forms vary more in their exclusionary language than in any other coverage aspect. Consequently, it is necessary to carefully examine the exclusions contained in all PL and ML forms.

There are four general kinds of exclusions contained within the policies.

- Exclusions for uninsurable exposures
- Exclusions removable or modifiable by negotiation, with or without additional premium
- Exclusions for exposures better suited to other types of coverage
- Exclusions for exposures pertaining to a specialized type of work within a given profession

These different types of exclusions are thoroughly examined later in this section.

Policy exclusions provide a meaningful basis for comparing two professional liability policies. In situations where a decision must be made regarding which one of two or more policies should be selected, the presence or absence of certain exclusionary language may serve as a determining factor in the selection process.

Variations between the Scope of the Same Exclusion

It should also be recognized that there is often a great deal of variation between the scope of the same exclusion, from one insurer's policy form to the next. For example, some policies exclude coverage for fraud and criminal acts with no specific language indicating the insurer's duty to defend against allegations of fraud/criminal acts. In contrast, other versions of the fraud/criminal acts exclusion specifically provide coverage for defense of such claims. Given such significant differences between the same exclusion, it is important to examine the actual exclusionary language appearing in different policies when deciding between two otherwise comparable coverage forms.

Such variations will be treated in the coverage discussions of the individual professions. The purpose of this analysis is to provide a broad overview of the most common exclusions found in professional and management liability policy forms.

The Duty To Defend Is Broader than the Duty To Indemnify

Before analyzing the most common exclusions found in professional liability policies, one key point to recognize is that even when a policy contains an exclusion that is worded to exclude both indemnity and defense coverage (known as a "blanket exclusionary provision"), insurers will often provide defense coverage for the insured, in spite of such exclusionary policy language. This is because as an industry practice, and according to caselaw, the duty to defend is considered to be broader than the duty to indemnify. So unless a claim or a specific allegation within a claim is clearly excluded, insurers will often frequently defend the insured in situations where it is uncertain as to whether coverage applies.

Uninsurable Exposure Exclusions

Certain types of activities are not considered to be insurable, regardless of an insured's willingness to pay a premium for coverage. Such exposures are excluded for one of three reasons.

- **Exposures within an insured's control.** Claims arising from these exposures are, at least to some extent, within the control of the insured (e.g., claims against notaries who notarize signatures despite not having signatories personally appear before them).
- **Insurance is against public policy.** Insurance coverage for the exposure is prohibited by law or against public policy (e.g., coverage for intentional injury or criminal acts).
- **Economic or business risk.** The exposure represents a business or economic risk that is not a proper subject of professional liability coverage (e.g., claims for the return of professional fees).

It should be mentioned that in many, but not all, instances, professional liability insurance policies will cover the costs associated with the defense of claims involving these uninsurable exposures. In other words, given the language of some exclusionary provisions, defense coverage would be available if, for example, a claim was made alleging that an insured committed a criminal act. However, under policies offering this extension, defense coverage applies only if the allegation is ultimately not proven (e.g., the defendant-insured is found innocent by a jury or the charges are dropped by a court). Otherwise, the insured would be responsible for returning defense costs paid on its behalf to the insurer, although in actual practice, such reimbursement rarely occurs.

Following is a discussion of exclusions for uninsurable exposures.

Notary Claims

A number of insurers exclude coverage for claims in which, while the insured is acting as a notary, the signatory to a document did not actually sign the document in the presence of the notary-insured. Exclusions of claims involving notarized documents are most prevalent in policies written for lawyers, accountants, real estate brokers, and insurance agents, whose work often requires them to notarize documents.

The following example provides a scenario of how this might occur. A claimant, who owns a piece of real property, files a lawsuit against an insured real estate broker because the insured notarized a document stating that the claimant-owner agreed to sell a piece of real property to a buyer at an agreed price. In reality, the buyer of the property (as noted within the document) forged the claimant's signature and presented the notary with the forged document, but the real estate broker notarized the document nonetheless. But since the claimant-owner's notarized "signature" appeared on the contract of sale, he was legally obligated to sell the property at the price stated.

The rationale for excluding claims in which the signatory did not sign a document in the notary's presence is that preventing the kinds of suits noted above, is within the control of the insured. Certainly, a notary should never notarize a document unless the signatory actually signs the document in the notary's presence—which was not the case in this example.

Trademark or Copyright Infringement

A number of PL policies preclude coverage for trademark or copyright infringement. Such exclusions are most commonly found in professional liability coverage written for architects and engineers. This is because design professionals sometimes use or appropriate the plans or drawings of another architect or engineer within the course of their professional activities. With lesser frequency, trademark and copyright exclusions are also found in lawyers, accountants, and insurance agents' professional liability policies.

The rationale for such exclusions is that acts of trademark and copyright infringement are usually within an insured professional's control and can generally be prevented with relatively little diligence (e.g., seek permission to appropriate another's work product by payment of a fee). Another rationale for this exclusion is that coverage is available for copyright and trademark infringement under what are known as intellectual property liability policies.

On the other hand, media liability policies, such as those for publishers, advertisers, or broadcasters, affirmatively cover claims alleging trademark or copyright infringement. For such firms, coverage of this nature is essential, and for that reason, separate policies have been designed to cover these kinds of exposures. Such coverage is also essential for media firms, given the frequency of claims alleging trademark and copyright infringement, many of which are groundless. For this reason, the defense coverage provided by media policies is essential to these organizations. In contrast, for other types of professionals, like architects and engineers, copyright and trademark infringement represent token exposures, which, for the most part, can be prevented by using a minimum amount of care (e.g., seeking permission prior to using or referencing the work of others).

Claims from Prior Policy Periods, Claims Reported to Previous Insurers, Claims from Known Incidents

Nearly all PL and ML policies restrict coverage of claims involving one or more of the following three situations:

- Claims reported to prior insurers;
- Claims reported under prior policies with the same insurer; or
- Claims arising from incidents that were, prior to the inception of the policy period, known by the insured to have the potential for resulting in claims (i.e., nonfortuitous claims).

A "claim" refers to a formal request for money damages, usually in the form of a lawsuit. An "incident" is a situation that could, but has not yet resulted in a "claim." For example, after being terminated, an employee tells his now-former boss "I'm going to sue you and this company for all it's worth." Although at that moment the company has not yet been sued, there is a good possibility that it will be in the future.

Under some policy forms, separate exclusions are used to eliminate coverage for one or more of these three situations.

The intent of these exclusions is to eliminate coverage for claims that (1) are the responsibility of another insurer, or (2) fall within the scope of another policy period within a policy written by the current insurer, or (3) should not be covered because the insured was aware of the likelihood that a claim would be made, and it is therefore lacking in fortuity (i.e., the so-called "burning building" situation).

Antitrust Violations

Antitrust laws prohibit certain mergers of businesses in situations where such combinations would create possible monopolies and as a result, inhibit competition within a particular industry.

Providing coverage for acts involving antitrust violations is against public policy in some jurisdictions and thus not within the intended scope of coverage under most professional liability policies. Moreover, coverage is also commonly excluded for such acts since prevention of such claims is generally within the control of the insured (e.g., seek legal advice as to the legality of a merger, prior to finalizing it).

Exceptions to the Anti-Trust Exclusion

Nevertheless, a number of policies do not preclude coverage on an absolute basis, meaning they do provide coverage to defend allegations that the insured violated antitrust laws. Specifically, policies designed to cover managed care organizations cover defense of antitrust allegations on an affirmative basis and some actually provide coverage for damages associated with such claims. This is because antitrust claims are a frequent source of liability for managed care organizations so that coverage of this peril is offered in the insurance market.

Return of Professional Fees

This exclusion pertains to situations where the client of a professional pays monies to the professional for services and then, as a result of errors or omissions in the professional's work, the client demands a refund of such fees. If a court were to rule that the professional was liable to return such monies, a policy containing a return of professional fees exclusion would not provide coverage for this item of the claim.

Another very common variation of this scenario, under which this exclusion would also apply, is one in which a professional performs a project of some sort and then, at its conclusion, seeks payment from the client. However, the client is dissatisfied with the work and as a result, refuses to pay the professional's bill. In this situation, a PL policy that excluded coverage for the return of professional fees, would also not cover the professional's loss sustained when the client refused to pay the bill.

(It should be noted that some professional liability forms preclude coverage for the return of professional fees within their definitions of "covered damages" or "loss" rather than in a separate exclusion, a concept that was discussed earlier in this course.)

Coverage for fees earned under these types of circumstances are considered by insurers to be a business risk that cannot be the subject of professional liability coverage. Rather, the purpose of PL coverage is to cover the results of professional errors (e.g., financial loss, bodily injury, property damage) as opposed to reimbursing professionals for the loss of their fees (i.e., a client's refusal to pay, or, a settlement or judgment in which a professional is required to reimburse a fee paid by the client) when they do commit errors.

No Exclusion for Cost of Remedial Services

It should be recognized, however, that professional liability policies do not exclude coverage for the cost of remedial services—as long as they are provided by another professional—to correct errors committed by the insured professional. This is because the cost of such remedial services is considered by insurers as part of the loss sustained by a claimant that would otherwise have to be paid by the claimant on an out-of-pocket basis, in the event that the insured did not have professional liability coverage.

Illegal Personal Profit

Claims that insureds have gained personal profit or advantage to which they were not legally entitled is another exposure that is considered to be uninsurable. An example of illegal personal profit may involve a director of a corporation who owns a firm that is bidding on a contract proposal offered by the organization on whose board he sits. If the director's company wins the bid because he was privy to the bids submitted by the competitor firms or to other "inside" information that assisted his company in securing the contract, a claim of illegal personal profit could be made. Many professional liability policies and virtually all D&O policies exclude coverage for such claims.

The Importance of "In Fact" Wording

However, in nearly all professional and D&O liability policies, the wording of this exclusion is such that illegal personal profit is excluded only if it has occurred "in fact," meaning that defense to allegations of illegal personal profit are covered until or unless it is factually proven that the insured did engage in illegal personal profit-taking.

Nonpecuniary Relief

Most of the policies exclude coverage for claims demanding nonpecuniary relief, which means nonmonetary damages. For example, assume that an insurance agent promises to obtain coverage for a client under a certain type of policy at a specific premium. If the agent were unable to locate an insurer willing to write such a policy, given the presence of an exclusion of claims for nonpecuniary relief, the agent's insurer would not provide a policy of insurance for the client under these circumstances. Exclusions precluding coverage for nonpecuniary relief are necessary, because in many instances, it would be literally impossible to provide the actual relief sought by a claimant (i.e., no insurer may be able to write the specific type of policy requested by the client and promised by the insurance agent, in the example above).

Actual Monetary Damages are Covered

On the other hand, if a claimant were to sue an agent because the claimant suffered an actual monetary loss arising from the agent's failure to secure a policy, coverage would apply. For instance, assume an agent promised to obtain property coverage on a building that was readily insurable. If the agent forgets to secure coverage and a week later, the building burns to the ground, the agent's PL policy would cover his liability to the client for failing to secure coverage on the building. Coverage applies in this situation because the client has sustained an actual monetary loss (i.e., the value of the building). In contrast, no coverage would apply if the agent forgot to obtain coverage but the building sustained no damage.

Coverage for Defense of Nonpecuniary Actions

One final important point: unless specifically excluded, defense costs for claims demanding nonpecuniary relief will generally be covered. In some instances, a policy may affirmatively state that such coverage is available. Thus, in the above example and assuming no damage to the building, if the client were to sue the insurance agent for failing to obtain a policy and yet demanded that he obtain one, the agent's PL insurer would provide defense coverage to the agent.

Bankruptcy of Insured

Most policies exclude coverage for claims arising from claims that result from the insolvency or bankruptcy of a professional. For instance, if a professional experiences financial difficulties, and as a result cannot complete a project or engagement, there would be no coverage for providing him or her with funds to complete the project or to pay another professional to do so. Nor does the policy cover any costs associated with the insured's failure to meet his or her business obligations, such as to pay monies owed to suppliers, vendors, or other creditors. The rationale behind this exclusion is that it prevents the insurer from becoming a surety.

Coverage for Nonbankruptcy-Related Claims Applies

On the other hand, the exclusion does not preclude coverage for garden-variety professional liability claim situations in which the insured's negligence causes damage to a client. Under such circumstances, the professional's declaration of bankruptcy does not relieve him or her of the obligation to make the client "whole." Therefore, this exclusion does not relieve an insurer from indemnifying the insured, simply because he or she has declared bankruptcy. (Note that this approach "complements" the "continuation of coverage in bankruptcy" policy provision discussed earlier in this course under the Conditions section.)

Intentional/Criminal/Fraudulent/Willful/Dishonest Acts

Most professional liability policies contain exclusions for coverage of intentional acts. However, there are numerous situations in which a claim results from acts that were intentional on the insured's part, but the result of the act was unintentional. For example, a surgeon may have intentionally performed a procedure in a certain way but injured a patient in the process. Accordingly, PL policies typically qualify intentional acts exclusions so that there is coverage, unless the act is performed maliciously, willfully, or with the deliberate intent to injure.

Coverage for Defense of Claims Alleging Intentional Acts

It is also important to recognize that nearly all professional liability policies affirmatively provide defense coverage if allegations of willful or criminal acts are made against the insured. If the allegations are ultimately proven groundless, most policy forms state that the insured has the benefit of defense cost coverage.

On the other hand, if the allegations are ultimately proven to be true, the insurer should be entitled to reimbursement of the defense costs that have been paid on the insured's behalf. (However, according to caselaw, insurers have no right to such reimbursement unless this was agreed upon prior to policy inception.)

Coverage for Defense of Innocent Insureds

In addition, most, although not all, versions of this exclusion are worded so that coverage for so-called innocent insureds is provided when allegations of intentional wrongdoing such as fraud and

criminal acts are made against culpable members of a professional organization and, in addition, other innocent persons are also named in a lawsuit. Under such policies, the defense costs of the innocent individuals are covered. In effect, the wording of this exclusion reinforces the severability provision discussed earlier in this course.

When reviewing PL and ML policies, it is essential to verify that both of these key aspects of defense coverage are affirmatively provided: (1) coverage for defense of allegations of criminal, willful acts and (2) coverage for defending innocent insureds.

Are These Two Coverage Exceptions Really Necessary?

Some insurers take the position that an explicit coverage grant for innocent insureds or for defense to allegations of intentional wrongdoing is unnecessary. Given the severability principle of contract law, as well as severability provisions discussed earlier in this course, some insurers contend that while an insurance policy may be void as respects some insureds, it nonetheless applies to other insureds. Thus, even in the absence of "innocent insureds" and "defense of allegations" exception wording, an insurer would normally be obligated to provide defense under both circumstances.

In addition, asserting the concept that an insurer's duty to defend is broader than its duty to indemnify, some insurers likewise argue that explicit coverage for defense of allegations of intentional conduct and for innocent insureds is not necessary under a professional liability policy.

These arguments notwithstanding, it is nevertheless advantageous for an insured if such wording appears in a professional liability policy. Without these provisions, an insured could be forced to litigate the issue in the event of a coverage dispute.

Losses from Professional Guarantees

Many professional liability policy forms contain exclusions of coverage for loss arising from professional guarantees. (For example, a lawyer might "guarantee" that a criminal defendant-client will be acquitted at trial.) More specifically, the policies preclude coverage for situations in which a claim is made because (1) a professional promises that a certain result will follow from his or her performance and (2) this specific result is not realized.

To illustrate: prior to open-heart surgery, a cardiologist promises a patient that after the surgery, he will be "permanently cured of heart disease." A week after the surgery, the patient dies of a heart attack. The patient's estate sues the doctor, alleging that the doctor failed to honor his pre-surgery guarantee that the procedure would cure the patient's heart disease.

Another example: an insurance broker guarantees that he can obtain physical damage coverage for a client's warehouse. In fact, the agent is unable to produce such coverage, and soon after informing the client, the property is destroyed by fire. The client sues the insurance agent for breach of his guarantee.

The rationale for this exclusion is that insurers consider a professional's failure to achieve a specific, desired result—in the absence of negligence—as a "business risk" that should not be the subject of professional liability insurance coverage.

Rather, insurers intend to cover claims that result when a professional fails to perform in accordance with the minimum standards mandated by his or her profession under the specific circumstances that gave rise to the claim (which is, in effect, the definition of negligence) and that, as a result, a client suffers a loss.

Guarantees Excluded but Negligence Is Covered

In the example, noted above, coverage would have been available for the cardiologist, if the claimant's estate could prove that the patient died because the cardiologist was negligent in performing the open heart surgical procedure.

What would not be covered is a situation where a professional did not deliver results that he or she "guaranteed" but, in failing to deliver on this guarantee, performed in accordance with accepted professional standards. For example, prior to performing lasik surgery, an ophthalmologist guaranteed a patient 20/20 vision. However, the patient only achieved 20/30 vision, which fell within the standard results for this type of surgery. Moreover, it was established that the ophthalmologist performed the surgery according to accepted professional standards. In this situation, the exclusion applies and no coverage is available because the professional was not negligent.

Losses from Accounting and Commingling Practices

Also within the category of uninsurable "business risks" are claims resulting from accounting and commingling losses. For example, as a result of the accounting reconciliation process, a professional may discover a shortfall of funds, despite not being able to pinpoint the actual source of such losses. This often occurs in professional practices involving the commingling of monies from a number of clients (e.g., in insurance agencies and stock brokerage offices).

In addition to the fact that insurers consider such losses as uninsurable "business risks," yet another rationale for this exclusion is that comingling and accounting losses often result from embezzlement or dishonesty of employees and/or partners. As a result, insurers consider losses of this nature to fall within the scope of crime or employee dishonesty coverage, rather than professional liability insurance.

Removable/Modifiable Exclusions

In some instances, underwriters impose exclusions that can be removed from the policy—or at least modified—sometimes without the need to pay an additional premium. There are four common exclusions that fall into this category.

- Failure to maintain insurance
- Contractual liability
- Insured versus insured
- Prior and pending litigation

Brief, separate discussions of these exclusions follow.

Failure To Maintain Insurance Exclusion

Some professional liability policies, particularly D&O liability insurance forms, contain exclusions precluding coverage for claims resulting from the failure of insureds to purchase and maintain insurance coverage. This exclusion might be applicable if, for example, a corporation failed to purchase flood insurance and, as a result, suffered a severe uninsured loss at one of its manufacturing plants, resulting in a quarterly loss for the organization and a consequent drop in share price.

If stockholders were to sue the company's directors and officers, alleging that their negligence in not buying flood insurance caused the firm's share price to drop, an insurer could invoke the failure to maintain insurance as a rationale for denying coverage.

Removing the Exclusion

Fortunately, many D&O insurers are willing to delete the failure to maintain insurance exclusion, often without an additional premium charge, provided the insured furnishes the underwriter with a current schedule of property and liability insurance. This schedule normally reveals any obvious gaps or omissions of needed coverage and, after reviewing documentation of this kind, underwriters will sometimes remove the exclusion.

Exclusions for Insurance-Related Operations

A few versions of the failure to maintain insurance exclusion also contain restrictions on claims involving the insured's participation in risk-bearing operations such as captive insurance companies and risk retention groups. Both for-profit and nonprofit organizations sometimes band together with firms in similar industries to form such risk-bearing entities.

If a professional or D&O liability policy form's version of the failure to maintain insurance exclusion insurance also encompasses these kinds of risk-bearing operations and entities, separate coverage is required to provide coverage for such operations.

Contractual Liability Exclusion

Contractual liability exclusions preclude coverage for situations where one professional agrees to hold another professional harmless in conjunction with work performed on a subcontracted basis. For instance, assume that accountant "A" subcontracts a portion of an engagement to accountant "B." Also assume that "B" agrees to hold "A" harmless for any claims made against "A" in conjunction with the project. However, if B's policy contains a contractual liability exclusion, B will have no coverage if it is contractually required to indemnify A for any professional liability claims associated with the project.

Exception for Liability in the Absence of a Contract

It is common, however, for contractual liability exclusions to be worded so they provide an exception (and thereby provide coverage) for liability that would have attached even in the absence of a contract. For example, assume that a construction contract provision required an insured architect to indemnify and hold harmless the project owner for the insured's sole negligence (i.e., if the architect's faulty design caused a loss, he would be required to indemnify the project owner for the loss). In this instance, coverage would still apply under most versions of the contractual liability exclusion. This is because liability (for the professional's sole negligence) would ordinarily apply (as in the above example of the accounting firms, as well), regardless of a contractual provision requiring such indemnification.

Problematic Situations: Acceptance of Liability for the Negligence of Others

In contrast to the above examples are situations in which a professional is asked to indemnify another party for the results of the other party's negligence. Case-in-point: in order to obtain hospital privileges, a surgeon is required to sign a hold harmless agreement in which he promises to indemnify the hospital if the hospital's sole negligence causes injury to any of the surgeon's patients. A possible scenario: during an operation, one of the hospital's heart monitoring machines shuts down due to a

lack of maintenance. As a result, the patient is injured. In this situation, the surgeon would be forced to indemnify the hospital for the patient's injuries, despite the fact that the hospital's sole negligence in maintaining its equipment was the direct cause of the injury. However, a contractual liability exclusion in the surgeon's PL policy would not cover such indemnification, since, in the absence of the hold harmless agreement, the surgeon would not be legally liable to assume the financial consequences of the hospital's sole negligence.

Modifying the Exclusion

Given the kind of situation noted in the preceding paragraph, underwriters are sometimes willing to modify contractual liability exclusionary wording, either for specific contracts or for all assumptions of liability undertaken by an insured. Such modifications are especially important if (1) an insured agrees to numerous hold harmless agreements as part of his or her practice and/or (2) an insured agrees to a hold harmless arrangement that goes beyond acceptance of liability for his or her sole negligence, such as in the example of the surgeon, above.

Under either of these conditions, insureds should contact their underwriters in an effort to seek modifications of the contractual liability exclusions within their policies. Generally, underwriters are agreeable to such changes, first, because these requests allow an insurer the ability to evaluate an insured's individual contractual assumptions of liability and, second, because underwriters usually receive additional premium in return.

Insured versus Insured Exclusion

Insured versus insured exclusions preclude coverage for claims made by one insured under a professional liability policy, against another. An example of an insured v. insured claim is one in which corporate director "A" sues corporate director "B" because of a bad business proposition that "B" advised the company to pursue, such as urging the acquisition of a subsidiary that eventually produced a significant loss for the company.

There are several rationales for the insured versus insured exclusion in professional liability policy forms.

- No intent to cover recoupment for bad business decisions. The insured versus insured exclusion originally came into being in the 1980s when Bank of America began suing a number of its loan officers for losses caused by imprudent extensions of credit. In response to these lawsuits, the officers then sought coverage under Bank of America's D&O liability policy. However, the bank's insurer did not intend for the policy to function as an indemnification vehicle for bad business decisions. (Insurers viewed such claims as affording coverage for "business risk," rather than for professional negligence.) So in response, D&O insurers began inserting insured versus insured exclusions within their policy forms, a practice which was later extended to other kinds of professional and management liability policy forms.
- Other, more "specific" insurance coverage available. Since many insureds also purchase employment practices liability (EPL) coverage, professional liability insurers feel that employment-related claims by one insured against another (e.g., an employee sues his former boss for wrongful termination), are more appropriately covered by EPL policy forms.

- No coverage intended for "infighting." Yet another rationale for not covering claims made by one insured person against another is that, at times, such lawsuits are the result of "infighting" by one insured against another. For example, in an attempt to force a partner in a law firm to resign, the other partners sue him for not bringing in a sufficient number of new clients.

Despite the rationales for excluding claims by one insured against another, a number of policies contain "exception wording" in one specific situation discussed below, which has the effect of providing coverage for certain kinds of insured versus insured claims.

Exception for Performance of Professional Services

About half of all PL policies except, and therefore cover, claims by one insured against another, provided the claim involves the actual delivery of professional services. For example, such an exception would be valuable in the event that one accountant in a CPA firm committed an error when doing the tax return of another accountant within the same firm. Absent such exception wording, such a claim would otherwise be precluded by an insured versus insured exclusion. Exceptions of this kind afford coverage for situations involving actual professional errors and omissions, but appropriately eliminate coverage for "infighting," as noted above in the scenario involving the law firm that was attempting to use a lawsuit as a means of forcing out a nonproductive partner. If the policy does not already contain a "professional services" exception, underwriters will usually agree to provide it by endorsement for no additional premium charge.

Prior and Pending Litigation

Nearly all D&O policy forms, many EPL policies, and an increasing number of PL forms exclude claims arising from litigation that was pending prior to the inception of the policy. The intent of this exclusion is to avoid insuring the so-called burning building, whereby the insurer must cover claims from events that were lacking in fortuity and that sometimes provide the incentive for an insured to obtain coverage. This exclusion thus helps the underwriter to avoid what is termed adverse selection. (Adverse selection refers to a situation where the insured are much more likely to suffer a loss than are the uninsured. For example, people with chronic health problems are much more likely to seek major medical coverage than are people who do not suffer from such conditions.)

As an example, a prior and pending litigation exclusion would apply if litigation against a corporation—rather than individual directors and officers—was pending prior to the inception of a D&O policy. If the lawsuit is amended after inception of the policy, so that it now names the organization's directors and officers, the prior and pending litigation exclusion would preclude coverage for the amended version of the claim.

Consider the following example. On January 1, 2008, a borrower whose home has been foreclosed on by XYZ Bank files a lawsuit against the bank. The suit alleges that the bank misrepresented the actual terms of the loan when the closing papers were signed, because the papers failed to state explicitly that after two years, the monthly payment would double. On January 1, 2009, the borrower amends the lawsuit to also name the bank's directors and officers. A week after receiving the suit papers, the directors and officers file the claim with their D&O insurer under their January 1, 2009–January 1, 2010 policy. However, if the bank's January 1, 2009–January 1, 2010 policy contained a prior and pending litigation exclusion, coverage will be denied, since the claim arose out of a lawsuit that was pending prior to the inception of that policy.

Often, insurers will agree to modify the prior and pending litigation exclusion so that it only applies to litigation prior to or pending at the inception date of the present insurer's first D&O policy. Given

this modification, any litigation initiated during the present insurer's stream of protection is not excluded. This is a reasonably negotiable item and can usually be achieved without additional premium.

Exclusions To Coordinate with Other Insurance

Most professional liability policies exclude coverage for exposures that are more appropriately insured by other types of insurance, such as general liability, automobile liability, and workers compensation policies.

Also in this category are professional liability exposures that are more properly insurable under other types of professional liability policies, such as Employee Retirement Income Security Act (ERISA) of 1974 responsibilities, which are covered under fiduciary liability policy forms.

These exclusions, which pertain to exposures better covered under other types of policies include the following.

- Employment practices liability claims
- Bodily injury\property damage liability claims
- Personal injury claims
- Claims by and against related\affiliated companies
- Claims from the delivery of "related" professional services
- Workers compensation claims
- Claims involving the Employee Retirement Income Security Act
- Claims involving services provided while not employed by the named insured organization
- Claims involving motor vehicles, aircraft, and watercraft
- Pollution claims
- Claims involving nuclear energy

Employment Practices

Coverage for employment practices liability (EPL) claims, namely, allegations of discrimination, sexual harassment, wrongful termination, retaliation, and other workplace torts (e.g., wrongful evaluation, constructive discharge, work-related defamation) is precluded by nearly all professional liability policy forms.

The rationale for the exclusion is as follows. First, EPL claims do not normally involve the delivery of professional services. Rather, they emanate from the employment process. Second, recent years have witnessed rapid growth of a significant market for EPL coverage. More than 50 insurers, as well as the Insurance Services Office, Inc. (ISO), have developed specialized policy forms expressly designed to cover this exposure.

It should be mentioned, however, that D&O insurers are generally willing to provide EPL coverage, via an endorsement to their policies, most often for a premium charge equal to an additional 10 percent of the basic policy. There are, however, a number of drawbacks to this approach, including the fact that: (1) EPL claims can deplete limits otherwise available for covering traditional D&O claims; (2) neither the corporate entity nor non-director/officer employees are insureds under such

endorsements; and (3) the scope of covered employment perils is much narrower, compared to stand-alone EPL policies.

Bodily Injury/Property Damage

Most professional liability policies exclude coverage for bodily injury and property damage liability, because coverage for incidents of this kind (e.g., slip-and-fall claims in a professional's office) are more properly the subject

BI/PD Exclusions Do Not Appear in Certain PL Policy Forms

It should be recognized, however, that policies written for certain kinds of professionals, notably physicians and architects and engineers, do not contain exclusions for bodily injury and property damage because their professional functions frequently result in bodily injury and property damage. Moreover, since GGL policy forms routinely exclude BI and PD claims arising from professional acts against doctors and architects and engineers, to also exclude such claims under PL policies would not be feasible.

"Arising Out of, Related to, in any Way Involving" versus "For" Wording of BI/PD Exclusion

There are two distinct ways in which the BI/PD exclusion is worded in PL policy forms and the difference is significant. Under some policies, there is an exclusion "for" claims involving bodily injury or property damage. In contrast, other policies exclude coverage for claims "arising out of, related to, or in any way involving" bodily injury or property damage.

The following scenario illustrates why, from an insured's standpoint, the "for" bodily injury/property damage version of this exclusion is preferable to the "arising out of" version of the BI/PD exclusion. The XYZ Pharmaceutical Company manufactures a drug for high blood pressure. After being on the market for a year, the drug is found to cause cancer. Upon learning of this problem, the company immediately takes the drug off the market. Nevertheless, following the withdrawal, the company is besieged with lawsuits alleging that the drug caused cancer. As a result of the lawsuits, shares of the firm's stock plummet, and shareholder class action claims against the company's directors and officers follow. Assume that the company's D&O policy was written with an exclusion precluding claims "arising out of, related to, or in any way involving" bodily injury or property damage. Under these circumstances, the insurer could deny coverage for the shareholder class action claims on the basis that the stock price drop arose from, was related to, and involved the bodily injury claims filed by users of the insured's drug.

Conversely, had the exclusion been written to exclude coverage "for" bodily injury and property damage, the insurer would be hard-pressed to deny coverage for the securities class action claims under this scenario because the claims did not arise directly from the claimants' allegations of bodily injury; rather, they emanated from a drop in the drug manufacturer's stock price. The effect of this difference is that "for" wording can only be used to deny coverage for direct BI/PD claims, whereas "arising out of, related to, in any way involving" wording can be used to deny coverage for the consequences of BI/PD; which, in this scenario, was the securities class action claim against the company's directors and officers.

If possible, a policy containing a BI/PD exclusion using "arising out of, related to, in any way involving" wording should be modified and replaced with the much more insured-friendly "for" version of this exclusion.

Personal Injury

Claims involving personal injury caused by libel, slander, false arrest, invasion of privacy, malicious prosecution, and other standard personal injury perils are excluded by many professional liability policies. (Personal injury is a category of harm other than bodily injury, property damage, or financial injury.) This is because CGL forms normally cover such exposures. However, given the presence of professional liability exclusions in CGL policies, personal injury coverage may not always be available, which could cause a problem for certain types of professionals.

Personal Injury Coverage within PL Forms for Certain Professions

Despite the fact that the vast majority of PL policies contain personal injury exclusions, policies written for certain professions, most often attorneys and sometimes accountants, provide coverage for a number of personal injury perils, such as libel, slander, false arrest, malicious prosecution, and invasion of privacy. This is necessary because the nature of such work frequently creates personal injury exposures.

For example, an attorney brings a case against a defendant. However, the case is dismissed on a summary judgment basis and in her decision, the judge states that the case was "completely without merit." As a result, the defendant brings a claim against the attorney for malicious prosecution. Coverage for the claim would be available under the attorney's PL policy, provided malicious prosecution is included within the policy's definition of "personal injury," which is normally be the case.

Related/Affiliated Entities

Related/affiliated entity exclusions are common because frequently, professionals have financial interests in other, related businesses, in addition to their basic professional practice. For example, it is not uncommon for physicians to also own physical therapy clinics or diagnostic testing labs.

Exclusion of Claims Against Related Entities

First, these exclusions eliminate coverage for claims made against related entities that are not named insureds. This is because such firms should either be named on the insured's policy or they should maintain their own professional liability policy. For example, a physician's professional liability policy would exclude coverage for claims made against the physical therapy clinic that she owns (but which is not identified in her PL policy). This is because the clinic should either have a separate policy covering it or should be insured under the physician's professional liability policy.

Exclusion of Claims by Related Entities

Second, related/affiliated entity exclusions also preclude coverage for situations where a claim is made by a related or controlled entity against the insured. For example, an insurance broker also owns an independent claims adjusting firm. The adjusting firm brings a claim against the brokerage alleging that the broker furnished its adjuster with incorrect coverage information about one of the brokerage's clients. As a result, the adjuster wrote a check for a loss that was not covered. This, in turn, caused the insurer the adjuster was representing, to sue the adjusting firm for paying a $50,000 claim not covered by the policy issued by the insurer. The rationale for the exclusion of claims by related entities (against the insured) is that such claims are sometimes (although not always) of a collusive nature, whereby an insured attempts to profit by suing his or her own company.

Related/Affiliated Entity Exclusions: The Ownership Threshold

At times, the extent to which a professional has an ownership interest in another firm is not as clear-cut, as in the examples noted above. Specifically, in these examples, it was assumed that the doctor had a 100 percent ownership in the physical therapy clinic. Likewise, in the second example, it is assumed that the insurance brokerage was the sole owner of the independent adjusting firm. However, there are many situations in which an insured professional may not be the sole owner of a related entity and, in fact, may be a minority owner. Accordingly, in writing the related/affiliated entities exclusion, insurers generally stipulate some "threshold" percentage, below which the exclusion does not apply. Typically, this threshold is in the range of 10 percent to 25 percent, whereby the exclusion only applies if the insured's ownership interest exceeds the policy's stated threshold percentage. From the insured's standpoint, the higher the threshold, the better. If, for example, a policy is written with a 10 percent threshold, a 15 percent ownership stake would bar coverage. On the other hand, if the policy contained a 25 percent threshold, a 15 percent ownership interest would not preclude coverage in a claim situation involving a related/affiliated entity.

Claims from the Delivery of Related Professional Services

A number of professional liability policies contain exclusions for professional services that are related to but different from the kinds of services primarily performed by the insured. For example, real estate brokers' professional liability policy forms usually exclude coverage for lawyers' professional liability exposures. This is because a number of real estate operations, such as title closings, require the services of an attorney and real estate brokers sometimes attempt to provide such services. In effect, the intent of this exclusion is to protect the insurer from having to cover exposures that are related to but different from—and usually pose higher potential loss severity—than those intended to be covered by the policy.

Another example: insurance agents and brokers E&O policy forms usually contain exclusions for coverage of claims involving actuarial services. Such work, while related to the selling of insurance, is still fundamentally different, and thus, insurers typically exclude coverage for actuarial services in policy forms written to cover agents and brokers. (Insurers will, however, sometimes offer to provide such coverage, but in return for additional premium.)

Workers Compensation

Virtually all professional liability policies exclude coverage for any type of obligation under workers compensation, disability, unemployment, or similar laws. Alternatively, some policies preclude coverage for these types of exposures by excluding claims involving bodily injury or sickness of any employee of the insured. The rationale for the workers compensation exclusion is that such exposures should be covered under workers compensation policies.

ERISA Responsibilities

Coverage for claims involving the administration of pension and employee benefit plans are excluded under virtually all professional liability policies, except, of course, fiduciary liability policies—whose essential purpose is to cover claims arising from such exposures.

In some cases, so-called ERISA exclusions are worded so that they specifically preclude coverage for insured professionals' responsibilities as enumerated by the Employee Retirement Income Security Act (ERISA) of 1974 or by similar laws. The rationale for this exclusion is that such exposures are insurable under separate fiduciary liability policies.

Services Not on Behalf of the Named Insured Organization

Most professional liability policies exclude coverage for claims arising from activities that are performed for entities other than the named insured organization. The wording of such exclusions most often applies to: (1) outside directorships and (2) moonlighting activities.

Outside Directorships

The exclusion has the effect of precluding coverage for liabilities incurred in conjunction with serving on the boards of non-profit organizations and public entities. The rationale for the exclusion is that an insured's work on behalf of such groups should be covered separately by the organization on whose board the professional is serving.

Exclusion of "Moonlighting Activities"

Another key purpose of this exclusion is to eliminate coverage for moonlighting activities, such as when an accountant, employed by a CPA firm, moonlights as a tax preparer or when a police officer performs off-duty work as a security guard. Again, the rationale for this exclusion is that the entity on whose behalf the professional is performing services, should provide professional liability coverage.

Motor Vehicles, Aircraft, Watercraft

Liability arising out of automobiles, watercraft, or aircraft or any other types of motor vehicles is excluded by virtually all professional liability coverages, because these exposures can be separately insured.

Pollution

Virtually all PL and ML policies exclude coverage for claims involving pollution. This is because few ML and PL risks (other than medical facilities and architects and engineers) actually generate direct exposures to pollution.

Nuclear Energy

Most PL and ML forms contain broad form nuclear energy exclusions. Their intent is similar to the rationale underlying pollution exclusions discussed in the above paragraph.

Exclusions for Specialized Exposures

To compel disclosure of particularly hazardous activities in which insureds engage, some insurers' policies contain exclusions of exposures they are otherwise willing to cover. However, for additional premium these exclusions can be removed. (This is sometimes referred to as "buying back" the coverage by removing the exclusion.) A number of professions have specialized practices that generate greater-than-average exposures to claims. Notable examples include the following.

- Cosmetic surgery and bariatric surgery (physicians)
- Securities and Exchange Commission (SEC) work (attorneys)
- Investment consulting (accountants)
- Managing general agency (MGA) operations (insurance agents)
- Soil testing (engineers)

Although coverage for these kinds of activities is sometimes excluded by standard policies written for these professions, such restrictions can frequently be removed or modified, in return for the payment of additional premium. By making such exclusions a part of the standard policy forms written for professionals not engaged in these more hazardous specialties, the insurer, in effect, imposes a requirement that it be notified should the hazardous activity ever be undertaken. It may then charge an additional premium to cover the increased exposure.

Concluding Thoughts Regarding PL and ML Exclusionary Language

While all portions of professional liability policies are important, the exclusions sections merit careful study. Not only can exclusions significantly restrict the scope of coverage, but, as has been apparent from the foregoing discussion, the wording of the same exclusion can vary considerably from insurer to insurer. Finally, because they are often added by endorsement rather than being included within the standard policy form itself, exclusions are especially meaningful because when such provisions conflict with the terms of the regular policy, courts of law generally interpret exclusions added by endorsement as overriding standard policy provisions.

Chapter 5 Review Questions

1. In comparing two competitors' professional liability policies available to their law firm, Tom and Jerry should recognize that:
   a. Exclusions have little influence on a policy's scope of coverage.
   b. Most policies contain the same exclusions.
   c. Policy conditions usually preclude coverage for uninsurable exposures.
   d. Tom and Jerry might select a policy because it lacks a critical exclusion.
2. Professional liability policies sometimes exclude coverage for claims in which a notary guarantees a signature that was not actually made in the notary's presence. Which of the following is *least* likely to have a policy with such an exclusion?
   a. Accountant.
   b. Lawyer.
   c. Surgeon
   d. Real estate broker.

3. Prudence Beyer didn't think she could afford the house, but she signed the purchase agreement with no contingencies after real estate agent Sam Sales assured Prudence that her credit rating would qualify her for an affordable 30-year mortgage. Prudence then learns that an affordable 30-year mortgage simply does not exist in the current market. She sues Sam Sales seeking to enforce his promise. Sam turns the claim over to his professional liability insurer. The insurer will do all of the following *except*:
   a. The insurer will provide an affordable 30-year mortgage for Prudence.
   b. The insurer will pay damages equivalent to the financial value of Prudence's loss.
   c. The insurer will pay Sam Sales' defense costs.
   d. The insurer will not provide the actual relief Prudence seeks.
4. Dr. Lamb has admitting privileges at several different hospitals. She should ask an underwriter to modify the contractual liability exclusion in her medical professional liability policy under the all of the following conditions, *except* in a situation where:
   a. she agrees to a hold harmless arrangement that goes beyond acceptance of liability for her sole negligence.
   b. she is willing to pay a higher premium to modify the exclusion.
   c. she signs numerous hold harmless agreements as part of her practice.
   d. the exclusion contains an exception for liability that would apply in the absence of a contract.
5. Most professional liability policies exclude coverage for exposures more appropriately covered under all of the following, *except*:
   a. auto liability insurance
   b. general liability insurance
   c. life insurance
   d. other professional liability policies

Answers to Chapter 5 Review Questions

1. d. The presence or absence of certain exclusionary language may serve as a determining factor in the selection process.
2. c. Exclusions of claims involving notarized documents are most prevalent in policies written for lawyers, accountants, real estate brokers, and insurance agents; surgeons' work typically does not usually requires them to notarize documents.
3. a. It is literally impossible to provide relief that does not exist.
4. d. This common exception to contractual liability exclusions operates in Dr. Lamb's favor.
5. c. There is little if any potential overlap between a liability insurance policy and one providing life insurance coverage.

Chapter 6
Coordinating ML and PL Policies with CGL Coverage

This section will address EL/PL coverage coordination. More specifically, it will discuss how to coordinate EL/PL policies with commercial general liability (CGL) policies.

When a CGL policy is written for a professional or professional organization, the intent is to insure the individual's or organization's liability exposures that are not of a purely professional nature. For example, an injury sustained by an insurance agent's client when the client slips and falls in the lobby of the agent's office should clearly be covered by the CGL policy. On the other hand, if the insurance agent's failure to arrange appropriate coverage, as requested by a client, produces an uncovered loss, the client's claim would be addressed by the insurance agent's professional liability insurance policy.

A Potential Coverage Gap

Most of the time, the line of demarcation between what distinguishes a professional from a nonprofessional act, is usually clear-cut. However, there is one significant "grey area" that has the potential to create a potential coverage gap. This gap between PL/EL policies and CGL policies results when there is no bodily injury liability coverage for claims arising out of the performance of professional services. This can happen when there is a (1) a BI/PD exclusion in the EL/PL policy and (2) a professional liability exclusion in the CGL policy. The following claim scenarios provide examples of how this gap could cause a coverage problem.

There are several ways to afford coverage under these circumstances. First, the professional liability exclusion can be removed from the professional's CGL policy. Second, the bodily injury exclusion can be deleted from the professional liability policy. Unfortunately, few PL or CGL insurers will agree to such changes.

Consolidating Coverage with One Insurer

Third, the gap can be closed by having both the CGL and professional liability policies written by the same insurer. If this were arranged, it would be difficult for the insurer to assert that the claim is excluded under both types of policies. However, since the market for professional liability insurance coverage is limited, placing both PL and CGL coverage with the same insurer is not usually possible to achieve. This is because most of the insurers writing professional liability insurance are not also in the business of offering general liability coverage. For this reason, it is often impossible to purchase general and professional liability insurance from the same insurer.

Exhibit 6.1
Bodily Injury and Property Damage Coverage Gaps Between CGL And PL/EL Policies

- An accountant's client suffers a nervous breakdown after learning that investments suggested by the accountant have deteriorated, resulting in a significant financial loss. A claim of this kind could conceivably be excluded by both policies—from the CGL because of a professional liability exclusion, and from a professional liability policy because of a bodily injury exclusion.
- A software company's computer assisted design (CAD) program contains an error that leads to a design defect in a piece of medical equipment. The defect causes it to malfunction during treatment, and results in bodily injury to a patient. Again, a claim of this type could be excluded from both a CGL and a professional liability policy, for the reasons noted in the previous example.
- False statements, based on legal research by an attorney, are printed in a periodical. They cause the person about whom they are made to suffer such emotional trauma that the individual commits suicide. A bodily injury exclusion in a lawyer's professional liability policy would exclude coverage, as would a professional liability exclusion in a CGL policy.

CGL Professional Liability Coverage Endorsements

A final way to eliminate these types of coverage gaps is to purchase a PL endorsement to a CGL policy form. Examples of two professions for which ISO has promulgated standard coverage endorsements are Optical and Hearing Aid Establishments (CG 22 65) and Druggists (CG 22 69). Purchasing both a CGL policy as well as these endorsements will prevent the kinds of coverage gaps noted above. Unfortunately, these are the only such endorsements that ISO offers.

Eliminating BI/PD Coverage Gaps

The most effective approach to closing this potential gap, and one that will apply to nearly all types of professions, is to obtain a professional liability policy that is written with a modified bodily injury exclusion. Such an exclusion provides an exception (and thus provides coverage) for claims that result solely out of professional services. Exclusions of this kind preclude coverage for bodily injury that is unrelated to an insured's delivery of professional services, which is appropriate. However, they afford coverage when, as in the scenarios discussed previously in Exhibit 6.1, bodily injury results from a purely professional act, error, or omission. The modified wording noted below in Exhibit 6.2 should be requested, if it is not already included within an insured's professional liability policy form.

Exhibit 6.2
Modified Bodily Injury Exclusionary Wording

Coverage under this policy does not apply to any Claim for "bodily injury" "personal injury," or "property damage", unless the claim results solely from professional services performed by the "insured."

Chapter 6 Review Questions

1. A common gap between professional liability and general liability policies can sometimes be covered in any of the following ways, *except*:
   a. Purchase both policies from the same insurer.
   b. Purchase gap coverage.
   c. Remove the bodily injury exclusion from the professional liability policy.
   d. Remove the professional liability exclusion from the general liability policy.
2. Both general liability and professional liability policies written to cover an insured professional often exclude coverage for bodily injury claims. The most effective way to close this potential coverage gap is for the general liability policy to be written so that it excludes all claims:
   a. resulting from the insured's professional services and to add a modified BI exclusion to the insured's professional liability policy.
   b. entirely unrelated to nonprofessional services.
   c. resulting solely because of the insured's negligence.
   d. from non-clients

Answers to Chapter 6 Review Questions

1. b. Gap coverage generally refers to auto lending or leasing arrangements that might involve a gap between the vehicle's insurable value and the amount outstanding on the loan or lease contract.
2. a. The most effective way to close the potential coverage gap for BI claims between general liability and professional liability policies, is for the professional liability policy to (1) exclude all claims resulting from the insured's professional services and (2) to add a modified BI exclusion to the insured's professional liability policy. A modified BI exclusion precludes coverage for claims unrelated to professional services (which is the intent of the policy), yet does cover BI claims when they result solely from a professional act, which is also appropriate.