# PROFESSIONAL AND MANAGEMENT LIABILITY: EXPOSURES AND INSURANCE COVERAGE

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# Professional and Management Liability: Exposures and Insurance Coverage
## Contents

# Chapter 1
# Introduction and Course Overview

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

This WebCE course is designed to give a moderately experienced insurance person an overview of the legal liability exposures to which professionals (e.g., doctors, lawyers, accountants) and managers (e.g., directors and officers, supervisory personnel, trustees, and administrators of employee benefit plans) are subject. The course also offers a summary of the provisions found within the different insurance policies that have been designed to cover these exposures. It concludes by discussing the distinctive loss control, underwriting, claims management, and marketing issues pertaining to these coverages.

- Chapter 2 defines the terms "professional" and "executive" as they are used within this course. It also explains why individualized policy forms are needed to cover the unique liability exposures generated by professionals and executives—exposures that are usually excluded under commercial general liability (CGL) policies. This chapter concludes with a discussion of the sources of legal liability to which professionals and executives are subject.
- Chapter 3 affords an overview of the many different types of insurance policies required by professionals and executives. In some instances, profession-specific forms are available to cover such professionals (e.g., policies covering architects & engineers, policies covering corporate directors & officers). However, in other instances, certain types of professionals (e.g., detectives, interior decorators, auctioneers, and many others) are covered by "generic" policy forms, also known as miscellaneous professional liability (MPL) policy forms.
- Chapter 4 provides a synopsis of the provisions that are common to most types of professional and management liability policies. Among the provisions discussed include: insuring agreements; limits, deductibles, retentions, and coinsurance; conditions; exclusions; and coverage triggers.
- Chapter 5 explains the legal significance of application forms as well as the importance of the information contained within application forms in determining both the price that is charged and the coverage terms that are offered to professionals and executives by underwriters.
- Chapter 6 examines specific factors that underwriters consider when pricing professional and management liability policies. Such factors include practice location, claim history, type of client, deductible/retention amount, limits, and years of professional experience.

- Chapter 7 explains why controlling the risks to which professionals and executives are exposed is crucial in making coverage available and affordable. This chapter also examines the actual loss control techniques that can be applied to all types of professional and management liability risks, including: screening new clients, committing all agreements and proposed services to writing, peer reviews, continuing education, effective client billing practices, and avoiding conflicts of interest.
- Chapter 8 looks at the unique claims handling issues that arise when claims are made against professionals and executives. A number of these issues result from the "shrinking limit" basis upon which professional and management liability policy forms are written. In addition, distinctive claim handling practices are necessitated by the fact that in negotiating claim settlements, professional reputations are very much at stake.
- Chapter 9 analyzes the market structure within which professional and management liability coverage is offered. The limited extent to which professional and management liability policies are available, requires the use of excess and surplus lines markets, specialized insurance exchanges, captives, risk retention and risk purchasing groups, and the expertise of wholesalers and managing general agents, all of which are discussed in this chapter.

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

1. Explain why professionals and executives require specialized, as opposed to standard, insurance policies to cover the legal liability exposures they generate.
1. Analyze the nature and sources of the legal liability to which professionals and executives are subject.
2. Identify and classify the many different types of policies available to cover the legal liability exposures generated by professionals and executives.
3. Describe the key policy provisions that are common to most types of professional and management liability insurance policies.
4. Understand the legal and underwriting significance of the information contained within applications for professional and management liability insurance.
5. List the crucial factors used by underwriters to price coverage and determine professional and management liability policy terms and conditions.
6. Identify the leading methods used to control the legal liability exposures to which professionals and executives are subject.
7. State and discuss the unique issues and considerations associated with the professional and management liability claims handling process.
8. Outline and discuss the distinctive markets and specialized personnel that are used in selling the professional and management liability insurance product.

# Chapter 2
# Introduction to Professional and Management Liability

This introductory chapter will provide an overview of professional liability (PL) and management liability (ML), explain why PL and ML policies are needed, and identify and define the sources of legal liability for professionals and executives.

## What Is a Professional and What Is an Executive?

To begin, it is important to define and distinguish between the terms "professional" and "executive."

A ***professional*** is a person who provides a service in accordance with an established set of standards, depending upon the particular profession. Professionals perform mainly mental or administrative work, as opposed to physical work. Such individuals normally possess a significant body of knowledge, derived from a combination of both formal academic study as well as practical training. Often, yet not always, professionals must be licensed by a formal professional body or by a state licensing board. In addition, to be an accepted member of many, but not all professions, the passing of one or more examinations is also required.

For the purposes of this course, however, a professional will be considered anyone who requires coverage under a professional liability (PL) insurance policy because a number of liability exposures generated by the professional's work is either not covered under or is excluded by a commercial general liability (CGL) policy. For example, a physician commits an error during surgery and injures a patient. If the patient sues the doctor, a professional liability policy is required to cover his or her liability, since this exposure is excluded by a CGL policy form.

Although an ***executive*** is often considered to be the head of a governmental body (such as a president), for the purposes of this course, the term applies to persons who perform executive, managerial, or supervisory functions within a business, at both for-profit and nonprofit firms. (The term will also apply to persons who serve on boards of directors at such organizations.) If, for example, a corporation's chief executive officer (CEO) is negligent in managing the firm's finances, no coverage will be available for the CEO under the corporation's CGL policy if stockholders sue him. Rather, coverage is provided for under a directors and officers (D&O) liability policy for this type of claim. D&O liability policies are one of several types of management liability coverage that will be examined in this course.

## The Need for Professional and Management Liability Insurance Policies

The need for PL and ML insurance coverage arises from four sources: (1) commercial general liability (CGL) insurance policies do not cover economic/financial injury, the major exposure generated by professionals and executives; (2) coverage for most types of professional activities is specifically excluded by standard exclusionary endorsements that are routinely attached to the CGL policy forms written to cover professionals and executives; (3) CGL policy forms for most professionals are also written with what is known as a Designated Professional Services Exclusion, yet another means of eliminating coverage for the professional services they provide; and (4) both businessowners policies (BOPs) and homeowners policies do not cover PL or ML exposures.

### *CGL Policies do not Cover Economic and Financial Injury*

CGL insurance policies cover four types of perils: (1) bodily injury, (2) property damage, (3) personal injury (e.g., invasion of privacy, libel, false arrest, slander), and (4) advertising injury (e.g., copyright infringement, misappropriation of advertising ideas). The problem with this approach, as respects PL and ML exposures, is that it leaves uncovered the most significant exposure generated by these risks. Specifically, the largest exposure for the typical business executive or professional *does not* fall within any of these four categories of coverage. Rather, the major exposure generated by business executives and professionals is liability produced by *financial* or *economic injury* alleged by third parties and clients.

Admittedly, there are a handful of professionals who do have an exposure to the four perils indicated above, notably: physicians (bodily injury), architects & engineers (bodily injury and property damage), police (personal injury and bodily injury) and various media businesses (advertising injury). However, CGL policies written for such risks always contain either standard exclusionary endorsements exclusions *or* are written with a Designated Professional Services Exclusion.

#### What is Economic and Financial Injury?

Economic and financial injury refers to losses that do not fall into one of the four categories of losses covered by a CGL policy as noted above. Such injury usually produces monetary losses but not necessarily as a result of bodily injury, property damage, personal injury, or advertising injury**.** The following examples illustrate the nature of the economic/financial injury exposure inherent in professional activities and in the functions of business executives.

#### *Scenario One (Professional Liability)*

An attorney handling an auto liability injury case fails to file the claim prior to expiration of the 3-year statute of limitations. The client, who suffered serious injuries, sues the attorney for negligently missing the filing deadline and alleges a $2 million loss because he is now unable to pursue a claim against the drunk driver who caused the accident.

#### *Scenario Two (Management Liability)*

The chief financial officer (CFO) of a publicly traded corporation intentionally conceals the fact that the organization has lost $50 million during the latest fiscal year. The concealment is revealed by an audit a year later. Following a public announcement of the loss, the corporation's stock price drops from $50 per share to $5 per share. Stockholders sue the corporation's board of directors for the loss in value of their shares in the company.

Since the attorney's client and the stockholders, respectively, did not suffer bodily injury, property damage, personal injury, or advertising injury, as a direct result of the lawyer's/board of directors' conduct under the two scenarios, there would be no coverage for these claims under a CGL policy written for either the lawyer or the corporation.

### *Professional Liability Exclusions for Specific Professions within CGL Policy Forms*

The second reason why PL and ML insurance is needed is that CGL underwriters routinely add exclusionary endorsements to policies written for insureds in businesses presenting PL and ML exposures. Exhibit 2.1 lists those rating classification codes that call for PL and ML exclusionary endorsements.

**Exhibit 2.1**
**Professional Liability Exclusions for Specific Professions**

| | |
|---|---|
| **Exclusion—Funeral Services (CG 21 56)** | |
| 41603, 41604 | Cemeteries |
| 41696, 41697 | Crematories |
| 43889 | Funeral Homes or Chapels |
| 46004, 46005 | Mausoleums |
| **Exclusion—Diagnostic Testing Laboratories (CG 21 59)** | |
| 46112 | Diagnostic Testing Laboratories |
| **Exclusion—Testing or Consulting E&O (CG 22 33)** | |
| 91135 | Analytical Chemists |
| 97002, 97003 | Laboratories |
| **Exclusion—Professional Veterinarian Services (CG 21 58)** | |
| 99851 | Veterinarian or Veterinary Hospitals |
| **Exclusion—Inspection, Appraisal and Survey Cos. (CG 22 24)** | |
| 96317 | Inspection and Appraisal Companies |
| 97308 | Marine Appraisers or Surveyors |
| **Exclusion—Professional Services—Blood Banks (CG 22 32)** | |
| 40100 | Blood Banks |
| **Exclusion—Products and Professional Services—Druggists (CG 22 36)** | |
| 12374 | Drugstores |
| 12375 | Drugstores—NOC |
| **Exclusion—Products and Professional Services—Optical and Hearing Aid Establishments (CG 22 37)** | |
| 13759 | Hearing Aid Stores |
| 15839 | Optical Goods Stores |

| Exhibit 2.1 (cont.)<br>Professional Liability Exclusions for Specific Professions | |
|---|---|
| **Exclusion—Engineers, Architects or Surveyors Professional Liability (CG 22 43)** | |
| 92663 | Engineers or Architects |
| 99471 | Surveyors |
| **Exclusion—Services Furnishing Health Care Providers (CG 22 44)** | |
| 40031, 40032 | Ambulance Service |
| 43550 | Fire Departments—NOC |
| 43551 | Fire Department—Volunteer |
| 44427, 44428 | Health Care Facilities—Alcohol and Drug |
| 44439, 44440 | Health Care Facilities—Outpatient Only |
| 44429, 44430 | Health Care Facilities—Convalescent/Nursing Homes |
| 44431, 44432 | Health Care Facilities—Homes for the Aged |
| 44433, 44434 | Health Care Facilities—Homes for the Handicapped |
| 44435, 44436 | Health Care Facilities—Hospitals |
| 44437, 44438 | Health Care Facilities—Psychopathic Institutions |
| 46700 | Penal Institutions |
| 66561 | Medical Offices |
| **Exclusion—Specified Therapeutic or Cosmetic Services (CG 22 45)** | |
| 10113 | Barber Shops |
| 10115 | Beauty Parlors and Hair Styling Salons |
| 11127, 11128 | Clothing or Wearing Apparel Stores |
| 11234 | Cosmetic, Hair or Skin Preparation Stores |
| 12356 | Department or Discount Stores |
| 14655 | Jewelry Stores or Distributors |

| Exhibit 2.1 (cont.)<br>Professional Liability Exclusions for Specific Professions | |
|---|---|
| 18911, 18912 | Variety Stores |
| 45190 | Hotels and Motels |
| 45191 | Hotels and Motels |
| 45192 | Hotels and Motels |
| 45193 | Hotels and Motels |
| 47420 | Saunas and Baths—Public |
| 49870 | YMCA, YWCA or Similar Institutions |
| **Exclusion—Insurance and Related Operations (CG 22 48)** | |
| 45334 | Insurance Agents |
| **Professional Liability Exclusion—Computer Software (CG 22 75)** | |
| 51941 | Computer Mfg. |
| **Professional Liability Exclusion—Health or Exercise Clubs or Commercially Operated Health or Exercise Facilities (CG 22 76)** | |
| 44311 | Health or Exercise Clubs |
| **Professional Liability Exclusion—Computer Data Processing (CG 22 77)** | |
| 43151 | Electronic Data Processing Operations |

### *The Designated Professional Services Exclusionary Endorsement (CG 21 16)*

The Designated Professional Services Exclusionary Endorsement, CG 21 16, that functions as a "catchall" exclusion of professional liability exposures, is used by underwriters to preclude coverage for professional activities for which no standard professional liability exclusion exists. For example, since no specific exclusion exists for attorneys, a CGL underwriter would be very likely to attach the Designated Professional Services Exclusionary Endorsement to a CGL policy written to cover a lawyer. The endorsement consists of a schedule noted as "Description of Professional Services," under which the underwriter lists the services for which coverage will be excluded under the CGL policy.

### *No Coverage under BOP or Homeowners Policies*

As noted above, BOP and homeowners policies also do not cover PL/ML exposures. This is despite the fact that, increasingly, people are operating businesses out of their homes as well as the fact that BOP policy eligibility has been expanding to many more types of businesses than in the past. (BOP policies are package policies for which certain types of small businesses qualify; the policies combine property, general liability, auto liability, and several other coverages within a single form.)

In summary, the need for PL and ML insurance policies is driven by the fact that: (1) CGL forms do not cover economic and financial injury, the principal exposure of professionals and executives; (2) CGL underwriters routinely attach standard professional liability exclusionary endorsements to policies written for such risks; (3) in cases where a PL or ML exposure is not addressed by a standard exclusionary endorsement, underwriters attach a Designated Professional Services Exclusion; and (4) PL and ML coverage is absent from BOP and homeowners policy forms.

## Legal Sources of Professional Liability and Management Liability

The legal liability of professionals arises from two major sources: (1) tort and (2) contract. Tort claims are the more commonly alleged cause of action against professionals and executives than are contract claims.

### *Tort Liability*

Tort liability is a civil wrong that gives rise to legal liability and ultimately, payment of monetary damages. (In contrast, criminal liability gives rise to imprisonment and/or the payment of fines or penalties.) When a claim alleging tort liability is made against a professional or executive, it means that the professional or executive was *negligent* in performing specific services. Negligence is the failure to use a degree of care considered reasonable by a comparable professional or executive under similar circumstances. Acts of omission or commission may constitute negligence.

#### Elements of a Tort (Negligence) Claim

To recover under a cause of action for negligence, a claimant must prove the following elements.

1. The professional/executive had a legal duty to conform to a certain standard of conduct. The purpose of this standard is to protect others against harm. This is what is referred to as the "duty" element of the cause of action. For instance, when handling a criminal case, a lawyer has a legal duty to thoroughly investigate the facts and circumstances surrounding that case.
2. The professional failed to conform to this standard, which is another way of saying that the professional/executive breached his/her legal duty to the claimant. This is the "negligence" element of the cause of action. Continuing with the above example, the lawyer's failure to perform the investigation prevented him from discovering a witness who could state that the attorney's client did not commit the murder of which he is accused.
3. There must be a close causal connection between the conduct and the resulting injury. This element is known as "proximate cause." In this example, the attorney's failure to investigate the circumstances resulted in his client being convicted of a murder he did not commit.
4. The claimant must suffer damage as a result of the professional's/executive's act or omission. This is the "damages" element of a tort claim. As a direct result of the attorney's failure to discover the witness whose testimony would have absolved his client, the client was sentenced to 20 years in prison.

#### *The Professional Standard of Care*

In an "ordinary" negligence action (e.g., a motor vehicle accident), the standard applied is that of the "reasonable person"; that is, a person must exercise the care that a reasonable person would have exercised under similar circumstances. In contrast, in a claim against a professional or executive, such a person, due to his or her superior knowledge and skill, must act with the care commensurate of a reasonable member of his or her profession, to avoid potential liability. A classic statement of the

professional standard of care is that one who undertakes to render services in the practice of a profession is required to exercise the skill and knowledge normally possessed by members of that profession in good standing in similar communities.

### *Errors in Professional Judgment*

Because the professional is expected to possess special knowledge and skills accumulated through education, training, and experience beyond that of the ordinary person, the professional is usually not liable for errors in judgment, so long as the professional's course of action was "accepted" practice and if the professional used reasonable care in undertaking the course of conduct. For example, a doctor is not negligent simply because his or her efforts prove unsuccessful. The fact that a doctor may have chosen a specific method of treatment that later proves to be unsuccessful does not necessarily constitute negligence that will give rise to liability—provided the treatment chosen was a standard treatment, accepted within the practice of medicine, and was undertaken on the basis of the information available to the doctor at the time a choice had to be made. On the other hand, a doctor must use reasonable care to obtain the information needed to exercise his or her professional judgment. Therefore, an unsuccessful method of treatment chosen because of a failure to use such reasonable care would be considered negligence.

## Sources of Standards for Professional Conduct

There are several sources that contribute to the establishment of the standards against which the conduct of professionals is measured. These sources include: (1) the particular codes of conduct and ethics within a profession, (2) statutes and regulations, (3) customary practices within a profession, and (4) practices within small niches of the profession created by specialization.

### *Codes of Professional Conduct and Ethics*

In the legal profession, the Model Rules of Professional Conduct, promulgated by the American Bar Association in 1983, provide a model upon which many state bar associations have based their codes of professional conduct. Typically, these codes impose ethical standards governing matters such as: preservation of client confidences, conflicts of interest, and demeanor of attorneys when litigating cases. Likewise, the medical profession has similar rules that govern the preservation of patient confidences by means of the physician-patient privilege, as well as other aspects of the physician-patient relationship. Practices of accountants are governed by statements and opinions of the Financial Accounting Standards Board (FASB), as well as prior statements of the American Institute of Certified Public Accountants (AICPA). These accounting standards and guidelines are given substantial weight in determining whether an accountant has met the performance standards of his or her profession.

### *Statutes and Regulations*

Statutes and regulations also affect the standard of care in a particular profession. Many statutes and regulations have been enacted to regulate physicians and other health care providers. For example, state hospital regulations and national hospital accreditation standards have been admitted in evidence by courts to aid the jury in deciding a hospital's liability for malpractice. Many of the statutory acts governing the medical profession were passed as a result of the wave of tort reform in the 1980s and 1990s. The statutes were enacted as a result of the lobbying efforts of the medical community and their malpractice insurers who were reacting to the dramatic increase in the amount of premiums for malpractice coverage.

### *Customary Practices within the Profession*

Another factor contributing to the establishment of the standard of care is the customary practices of members of the profession. For instance, the standard of care for attorneys is governed in part by the customary practices of the profession. Accordingly, one of the duties of an attorney is to adequately research the status of the law for his or her clients. A professional's deviation from his or her own usual customs and practices will likely provide strong evidence of professional negligence on a particular matter. For example, an architectural firm may maintain an in-house manual of practice setting out guidelines to be used by those architects in designing their projects. Any failure to follow such guidelines could be used to support allegations of negligence.

### *Specialization as a Source of Liability*

Specialization within the medical profession has been the norm for quite some time. Where a professional holds himself out as a specialist in certain areas of practice, he or she is required to have the skill and knowledge common to other specialists in that area. Thus, specialization creates a particularized standard of care applicable to that specialty. Moreover, where a general practitioner in the legal profession determines that a client's case is beyond his expertise, he or she owes a duty to refer the client to an appropriate specialist.

## *Contract Liability*

Historically, causes of action against professionals were based upon breach of contract. Currently, however, claims alleging breach of contract are much less common than are tort claims.

To successfully maintain a breach of contract action against a professional, the claimant must prove:

1. The existence of a contract, oral or written, between the plaintiff and the professional;
2. That the contract was breached by the professional;
3. That the plaintiff suffered damages; and
4. That the plaintiff's damages were caused by the professional's breach of contract.

Because some professionals use contracts to define the scope of the services to be performed for their clients more often than others, those professionals may be more frequently subjected to causes of action for breach of those contracts. Professionals extensively using contracts or engagement letters include architects, engineers, accountants, and, to a growing extent, attorneys.

## *Defenses to Professional Liability Claims*

Of course, the defendant professional has various defenses to a claim alleging either negligence or breach of contract, including the following.

- Statute of limitations
- Assumption of risk
- Failure of the client to fully disclose all information
- Failure to comply with the professional's instructions or advice
- Contributory or comparative negligence
- Written consent by a patient absolving a professional from liability

## Statute of Limitations

One of the most frequently asserted defenses to allegations of negligence or breach of contract is one based on the statute of limitations. Typically, statutes provide that a professional liability claimant has a specific number of years to file a lawsuit against the members of a particular profession, beginning on the date the cause of action accrues. However, the major difficulty with applying a statute of limitations defense is the determination of when the cause of action accrues, i.e., the date from which the limitations period begins to run.

If a court determines that the plaintiff should have reasonably discovered his or her injury at an earlier date, the cause of action would accrue on that date and his or her cause of action could possibly be barred by a statute of limitations. However, in the event the professional fraudulently concealed the injury, statutes of limitation will not begin to run until the client learns of facts, conditions, or circumstances that would cause a reasonably prudent person to make an inquiry that, if pursued, would lead to the discovery of the concealed cause of action.

The statute of limitations can be "modified" under certain circumstances by means of two other legal doctrines: (1) the discovery rule and (2) the continuing undertaking rule.

### *The Discovery Rule*

In the medical profession particularly, one of the doctrines that has emerged in determining when a cause of action accrues is the "discovery rule." Under this rule, where the plaintiff has not had a reasonable opportunity to discover the injury arising out of the alleged malpractice, the cause of action does not accrue until the date the plaintiff discovers, or should have reasonably discovered, the injury. The rationale behind this rule is that a patient may be unaware of an injury until a significant period of time after the actual act giving rise to the injury is committed by the doctor (e.g., it may be a year before a surgical patient discovers that a doctor left a sponge in his stomach during an operation).

### *Continuing Undertaking Rule*

Statutes of limitations have been "tolled" (i.e., temporarily stopped from running) while the allegedly negligent professional services are ongoing, by what is known as the "continuing undertaking rule." For example, the statute of limitations in a medical malpractice action will be tolled under this doctrine where a physician's negligence consists of a series of negligent acts or continuing course of improper treatment. That is, where the doctor has a duty of continuing treatment and care, the limitations period does not begin to run until treatment by the doctor for the particular disease or condition has terminated—unless during the course of treatment, the patient learns or should have learned of negligence. In that case, the statute runs from the time of discovery, actual (i.e., when the patient did learn of his/her injury) or constructive (i.e., when the patient had all of the information required to discover his/her injury and therefore should have been able to discover it). Likewise, in a legal malpractice action, the "continuous representation rule" may apply. Under that rule, the statute of limitations is tolled—or the accrual of the cause of action against the attorney is deferred—while the attorney continues to represent the client and the representation relates to the same transaction or subject matter as the allegedly negligent acts.

## Assumption of Risk

This defense refers to a situation where a client willingly assumes certain risks inherent in a specific professional service or treatment. If a patient was fully informed about the dangers of an operation, he or she is considered to be aware of the possible unexpected results, and assumes the risk of such

results. For example, if a patient is advised that there is a 1 in 25 chance that he will suffer complications following bariatric (i.e., stomach stapling) surgery, his assent to the operation can be considered an assumption of risk.

### Failure of the Client To Fully Disclose All Information

A client's failure to completely disclose all relevant facts about his case or treatment can provide a defense to a claim against a professional. For example, the failure of a patient to fully reveal all information to a doctor, such as a complete medical history, present complaints, and previous treatments, may relieve a doctor from responsibility for an unfavorable result.

### Failure To Comply with the Professional's Instructions or Advice

If a patient, following an operation, engages in strenuous activity—despite a doctor's prohibition against such activity—and the activity worsens his or her condition, the physician may be absolved from liability.

### Contributory or Comparative Negligence

Continuing the previous example, contributory or comparative negligence would include failure to return for follow-up treatment, for example.

### Written Consent by a Patient Absolving a Professional from Liability

If, prior to a risky operation, a patient signs a form waiving liability against a doctor, such an agreement could absolve the physician from liability.

## *Expanding Areas of Professional Liability*

There has been a dramatic increase in the potential liabilities to which for professionals have been subject in recent years. These areas include: (1) liability to third-parties, (2) liability as a "deep pocket," and (3) heightened standards to which nontraditional professionals are being held.

### Liability to Third Parties

The traditional rule was that privity was required for a plaintiff to maintain a cause of action against a professional for liability arising out of the professional's actions. Privity means that a direct contractual relationship exists between two parties, such as when Accounting Firm X enters into a contract to audit Corporation Y's financial statements. In contrast, investors in Corporation Y, although they may have relied on Accounting Firm X's audit, are not in privity of contract with Accounting Firm X.

However, as will be noted below, this doctrine is being eroded.

#### *Limitations upon the Privity Doctrine*

Many states have limited the scope of the privity doctrine and are now holding professionals liable to third parties with whom they do not have a contractual relationship. For example, under the privity rule, if an accountant prepares financial statements that misrepresent the financial condition of a company, the accountant cannot be held liable to lenders or investors who relied upon the truth of the financial statements because the accountant did not have a contractual relationship with such parties. However, in recent years, courts have held professionals liable to such third parties in situations where their reliance on the work of professionals was foreseeable. In other words, if an accountant

was fairly sure that lenders or investors would be relying on the results of the accountant's audit of a client company, the accountant could still be held liable, despite the lack of a direct contractual relationship with the lenders or investors.

### *Negligent Failure to Warn*

Similarly, professionals are increasingly being held liable to third parties in situations where they have been found to have been negligent in failing to warn such third parties in certain situations. For instance, a health care provider has a duty to warn others once he or she knows that a patient poses a serious threat of violence to a readily identifiable individual or group of individuals.

## The Professional as "Deep Pocket"

One of the obvious undercurrents in the amount of litigation against professionals, whether they be attorneys, executives, accountants, or architects, is that these providers of professional services are perhaps the only "deep pocket" against which recovery may be sought. Accordingly, lawsuits against professionals are often viewed as a means to tap the professional liability insurance coverage they maintain. For example, in the case of architects, a disgruntled owner of a defective building will typically sue all parties involved on the project, including the general contractor, subcontractors, the architect, and engineers. Frequently, the actual negligent party may be insolvent or will have no insurance coverage for the particular problem, such as its own defective work. In that instance, the architect—and his or her presumably "deep pocket"—is added to the lawsuit despite having committed no negligence in causing the loss. This is also true of hospitals when patients, despite being injured by the sole negligence of an independent contractor physician, also name the hospital in their lawsuits.

## Imposition of Rigorous Performance Standards on Skilled Service Providers

Errors and omissions liability has also undergone a tremendous expansion in recent years, and now has been held to apply to specially skilled occupations, in addition to traditional professionals. In effect, there appears to be an increasing application of professional liability standards to nontraditional professional service providers. Of late, the law has evolved to the point where one who undertakes to render services in the practice of a service or a trade is required to exercise the skill and knowledge normally possessed by members providing that service or trade, in good standing in similar communities. For example, in one case, a karate instructor's conduct was evaluated against this standard.

# Chapter 2 Review Questions

1. A person who qualifies as a professional typically possesses all the following attributes, *except*:
   a. Licensed by a professional body
   b. Passed a series of examinations
   c. Performs mainly physical work
   d. Possesses a significant body of knowledge

2. Dr. Rudy Toot, a dentist, has liability coverage for his office under a CGL policy. He also has a homeowners policy that includes personal liability coverage. Which of the following describes Dr. Toot's coverage for his professional liability?

   a. Neither the CGL nor the homeowners policy provides professional liability coverage.

   b. The CGL covers economic/financial injury related to professional liability.

   c. Because it covers a dental practice, the CGL automatically includes a Designated Professional Services Endorsement that provides professional liability coverage.

   d. The homeowners policy includes professional liability coverage.

3. Which of the following exclusionary endorsements would most likely be attached to the CGL policy of attorney Sue Lawyer, whose billboard ads encourage plaintiffs injured in auto accidents to engage her services?

   a. Designated Professional Services Exclusionary Endorsement

   b. Exclusion—Insurance and Related Operations

   c. Exclusion—Professional Services—Blood Banks

   d. Exclusion—Services Furnishing Health Care Providers

4. As an undertaker, Mort Shuari is required to exercise which standard of care?

   a. The ordinary care standard

   b. The skill and knowledge normally possessed by a reasonable person

   c. The six-foot standard

   d. The skill and knowledge normally possessed by undertakers in good standing in similar communities

5. Before seeing Dr. Stone for treatment of her condition, Wanda completed a lengthy medical history questionnaire in which she stated that she did not drink alcoholic beverages. Wanda did not want to admit that she is an alcoholic. After examining her and reviewing her medical history, Dr. Stone prescribed a medication that can cause kidney damage when combined with alcohol. Unfortunately, Wanda continued to drink like a fish, eventually showed signs of kidney failure, and sued Dr. Stone. Dr. Stone's most likely defense against Wanda's claim will be based on which of the following?

   a. Continuing undertaking rule.

   b. Discovery rule.

   c. Failure of the client to fully disclose all information

   d. Failure to comply with the professional's instructions or advice.

## *Answers to Chapter 2 Review Questions*

1. c. Professionals perform mainly mental or administrative work.
2. a. CGL policies for professionals routinely exclude coverage for professional activities, and homeowners policies do not cover professional liability exposures.
3. a. CGL underwriter would be very likely to attach the Designated Professional Services Exclusionary Endorsement to a CGL policy to cover a lawyer, since no specific exclusion exists for attorneys.
4. d. One who undertakes to render services in the practice of a profession is required to exercise the skill and knowledge normally possessed by members of that profession in good standing in similar communities.
5. c. The failure of a patient to fully reveal all information to a doctor, such as a complete medical history, may relieve a doctor from responsibility for an unfavorable result.

# Chapter 3
# Types of Professional and Management Liability Insurance Coverage

There are three broad categories within which PL and ML insurance coverage can be classified: (1) management liability insurance, (2) medical professional liability insurance, and (3) non-medical professional liability insurance. Brief discussions of each of these classifications, as well as the specific types of insurance coverage within them, follow.

## Management liability Insurance

There are three specific types of management liability insurance coverage: (1) directors and officers (D&O) liability insurance, (2) fiduciary liability insurance, and (3) employment practices liability insurance (EPLI). In addition, this course will very briefly address kidnap ransom (KR) insurance (also referred to as special crime insurance), although it is not always classified as a type of management liability coverage. This is because KR insurance is not a form of liability insurance. However, it is frequently offered in a packaged format along with D&O, fiduciary, and EPLI coverage because, as will be explained below, KR insurance does protect managers.

### *Directors and Officers (D&O) Liability Insurance*

The directors of a corporation owe a duty to shareholders to ensure that the corporation is managed in the shareholders' best interest. The directors are responsible for determining the corporation's business strategy and appointing and supervising officers to execute that strategy. Because they appoint and supervise the corporate officers who carry out the day-to-day management of the corporation, the directors serve as a link between shareholders and management. D&O liability insurance is designed to cover claims alleging the breach of these duties by a corporation's directors and officers and in effect, functions as errors and omissions coverage for such persons. Directors and officers incur liability when they breach these duties owed to: (1) shareholders and (2) "other" parties.

#### Liability to Shareholders

In the event that the directors and officers breach these duties, they can be subject to lawsuits by shareholders of the corporation. For example, the directors and officers of Company X decide to acquire a subsidiary. Subsequently, the subsidiary loses significant sums of money, and the shareholders of Company X bring a lawsuit against the directors and officers, alleging a lack of due care prior to making the decision to purchase the now-floundering subsidiary.

### Liability to Other Parties

In addition to shareholders, directors and officers can be sued by competitors, employees, and government regulators, for failing to properly execute their duties in managing the corporation. For example, a competitor could sue a company's directors and officers, alleging that they misappropriated certain trade secrets. An employee could sue the directors and officers, claiming to have been wrongfully terminated. Government regulatory agencies, such as the Securities and Exchange Commission could sue the directors and officers, alleging that they falsified a stock registration statement, when the company began offering stock to the public.

## *Fiduciary Liability Insurance*

The Employee Retirement Income Security Act (ERISA) was passed in 1974 to assure that employees participating in pension and benefit plans would indeed receive the benefits promised by such programs. According to ERISA, an individual is considered a fiduciary if that person exercises any discretionary authority over, or has control in, managing an employee benefit plan or its assets. Fiduciary liability insurance is designed to cover claims alleging the breach of these duties. The next two paragraphs will explain: (1) what types of persons and institutions are considered fiduciaries and (2) what types of claims are made against them.

### Persons and Institutions Considered To Be Fiduciaries

The following individuals and entities can be held liable under ERISA: (1) persons working within corporations who administer benefit and pension plans; (2) persons working within business organizations (outside of the client company) that design, administer, and manage pension and employee benefit plans, on behalf of client companies; (3) financial institutions (e.g., banks, insurance companies) who hold the assets of such plans in their care or custody; and (4) individuals (e.g., attorneys, actuaries, consultants, investment advisers) who perform services in conjunction with the pension and employee benefit plans of client companies.

### Potential Claims against Fiduciaries

The following scenario provides an example of how a number of persons and institutions could be held liable for the insolvency of a corporate pension plan. The actuary who designed the plan could face liability when the plan is unable to pay promised benefits, based upon allegations that the actuary's funding recommendations were inadequate to maintain promised benefits. The bank that holds some of the pension's funds could be held liable if the bank's insolvency caused pensioners to be denied promised payments. The investment advisor of the pension plan could be sued if his recommended investments failed to generate sufficient returns to assure promised benefit payments. The trustees at the corporation that sponsored the pension plan could be sued for negligence in selecting the incompetent actuary and investment advisor, and for choosing a financially unstable bank to hold the plan's assets.

## *Employment Practices Liability Insurance*

Beginning in the early 1990s, CGL policy forms began adding blanket, exclusionary endorsements that precluded coverage for employment-related claims made by both: (1) employees and (2) third parties (such as a company's customers, vendors and suppliers). As a result of this change, coupled with a sharp increase in employment-related litigation, employment practices liability (EPL) insurance policies were introduced to cover this exposure.

### Corporate and Individual Liability

For-profit corporations, government entities, and nonprofit organizations of all kinds face exposures to claims from employees who allege: discrimination, wrongful termination, sexual harassment (although legally, sexual harassment is a form of discrimination), retaliation (e.g., an employee is fired in response to filing a workers compensation claim or for reporting misconduct to a governmental regulator), and various other workplace torts (e.g., invasion of privacy, defamation, failure to promote, failure to grant tenure). Not only can these entities be held liable for such claims, but their directors, officers, managers, supervisors, and employees can also be sued for damages that result from employment-related allegations.

### Third-Party Liability

As noted above, in addition to employees, third parties (mainly customers, clients, and vendors) of these entities can also allege discrimination or sexual harassment. For example, customers of Denny's and Cracker Barrel restaurants, as well as patrons of the Adam's Mark Hotels (among other corporations), have received significant settlements based on these allegations.

### Types of EPL Coverage

EPL insurance can be purchased in one of three ways: (1) as a "stand-alone" policy that only covers employment practices liability, (2) as an endorsement to a D&O liability policy, and (3) as part of a management liability package policy that also provides D&O and fiduciary liability coverage.

#### *Kidnap Ransom Insurance*

Corporate executives and managers are faced with the exposure of being kidnapped and then held for ransom. The threat of kidnap is especially acute when these executives and managers are located outside of the United States. In response, insurers offer what is known as kidnap ransom (KR) insurance, a type of coverage also referred to as "special crime insurance." This coverage can sometimes be purchased as an endorsement to a D&O liability policy, as well as on a stand-alone basis, and at times, as a coverage option within a management liability package policy.

In addition to covering specific ransom demands (subject to policy limits), KR insurance also covers the cost of two other important services: (1) hiring specially trained hostage negotiators who are skilled at arranging the return of kidnapped executives, and (2) providing expert security consulting services, aimed at preventing such incidents.

## Medical Professional Liability Insurance

There are five specific types of medical professional liability insurance coverage: (1) physicians professional liability, (2) hospital professional liability (HPL), (3) allied healthcare professional liability, (4) nursing home liability insurance, and (5) managed care organization (MCO) liability insurance. One key point to recognize regarding all five types of medical professional liability insurance coverage is that unlike management liability policies and policies written to cover non-medical professionals, medical professional liability insurance does not exclude bodily injury and property damage.

### *Physicians Professional Liability Insurance*

Doctors can be held legally liable to their patients when they suffer injuries resulting from:

- Misdiagnosis/failure to diagnose, inappropriate treatment,
- Delay in treatment,
- Failure to treat,
- Injuries from therapeutic agents,
- Injuries from equipment and premises,
- Failure to admit/inappropriate discharge, and
- Intentional torts (e.g., assault, invasion of privacy, sexual misconduct).

Physicians professional liability insurance, also known as "medical malpractice insurance," was designed to cover these exposures.

### *Hospital Professional Liability Insurance*

In addition to the claim allegations that can be made against physicians, the following acts of negligence can also be made against hospitals.

- Failure to admit to a hospital/inappropriate discharge
- Failure to monitor or observe
- Failure to notify appropriate physicians or seek appropriate consultations
- Failure to prevent falls or other self-inflicted injury
- Failure to hire qualified personnel
- Failure to use care in credentialing physicians or allied health care professionals
- Failure to adequately supervise personnel
- Failure to staff adequately, and
- Failure to promulgate appropriate policies and procedures.

Hospital professional liability (HPL) insurance was designed to cover these exposures.

### *Allied Health Care Liability Insurance*

A broad range of non-hospital/non-physician medical practitioners and facilities have been termed "allied health care professionals," by the insurance industry. The two major classes of risks that fall within the scope of allied health care professionals insurance are institutions and individuals. The former consists of entities such as testing labs, day surgery centers, blood banks, and ambulance services. The latter is composed of specific professional occupations such as emergency medical technicians, psychologists, podiatrists, nurses, and physical therapists. The number of new specialties in the medical field is rapidly increasing, and additional allied health care professions and types of specialized institutions continue to emerge. Allied health care liability insurance was designed to cover these exposures.

### Legal Duties and Types of Claims Applicable to Allied Health Care Risks

Although they engage in different professional activities, allied health care professionals and institutions are subject to most of the same common law and statutory standards of professional conduct as are physicians and hospitals. Moreover, they are exposed to many of the same claim allegations to which identical legal defenses apply.

#### *Nursing Home Liability Insurance*

Nursing home liability insurance covers the liability exposures of facilities that provide medical, nursing, custodial, social, and community services over an extended period of time. These services are designed to help people with chronic health impairments or forms of dementia who may not be able to perform normal daily activities, such as eating, bathing, using the bathroom, or taking medication, without assistance. Nursing home liability insurance contains many of the same coverage elements as are provided by physicians, HPL, and allied health care professional liability insurance policies. This is because nursing homes share many of the same premises and operations exposures as hospitals. In addition, nursing homes typically employ a broad range of allied health care professionals such as nurses and physical therapists, as well as physicians who serve as what are known as "medical directors" in these institutions.

#### *Managed Care Organization Liability Insurance*

Managed care organization (MCO) liability insurance covers organizations engaged in delivering medical services on a managed-care basis, such as health maintenance organizations (HMOs) and preferred provider organizations (PPOs). Representative types of claims covered by the policies include allegations of: negligent provider selection, direct professional liability (i.e., when the HMO's employ physicians), and wrongful denial of treatment based upon financial considerations.

## Non-Medical Professional Liability Insurance

There are five specific types of non-medical professional liability insurance. Such categories include coverage for: (1) "traditional" professionals, (2) errors and omissions (E&O) liability, (3) media liability, (4) public entity liability, and (5) miscellaneous liability.

#### *Coverage for "Traditional" Professionals*

Within this category of non-medical professional liability insurance includes policies for lawyers, accountants, and architects & engineers.

### Lawyers Professional Liability Insurance

These policies provide attorneys with liability coverage for financial loss suffered mainly (but not solely), by clients, arising from acts, errors, and omissions in providing professional, legal services. Unlike a number of other types of professional liability coverage, the policies provide coverage for personal injury perils (i.e., defamation, invasion of privacy) since allegations of such acts occur frequently in the legal arena. The two main classes of claims against attorneys involve those from either (1) litigation or (2) non-litigation services. Another way to "group" claims against attorneys is by type of legal error: (1) administrative (e.g., failure to file a claim prior to statute of limitation expiration), (2) substantive (e.g. as a result of his lawyer's failure to search a public record, a client purchases real estate with a defective title), (3) client relations (e.g., failure to obtain a client's consent prior to settling a claim in which the client was injured in an automobile accident), and (4)

intentional wrongdoing (e.g., filing an intentionally baseless lawsuit, solely for the purpose of harassment).

### Accountants Professional Liability Insurance

These policies provide coverage for financial loss resulting from the delivery of professional accounting services. As is true of lawyers' professional liability insurance, accountants professional liability policies exclude coverage for fraud, intentional acts, criminal acts, bodily injury, and property damage. In recent years, claims pertaining to audits have been those with the highest loss severity, while claims made in conjunction with tax preparation constitute the most frequent type of professional liability claim made against accountants. In addition, as the scope of services provided by accountants has branched out into related areas, claims involving consulting, also known as "management advisory services," have also increased. Coverage for higher risk and niche activities, such as advisory investment services and Securities and Exchange Commission (SEC) work is available by endorsement.

### Architects and Engineers Professional Liability Insurance

These policies cover individuals involved in designing or preparing plans and specifications for construction projects. "Architects and engineers professional liability" coverage is also referred to as "design professional liability insurance," and covers claims involving three functional areas: (1) design, (2) management (i.e., construction project supervision), and (3) payment authorization (i.e., approving payment to contractors for completed work). Unlike virtually all management liability policies and policies written to cover non-medical professionals (but like medical professional liability insurance policies), architects and engineers professional liability insurance does not exclude bodily injury and property damage. The reason for this is fairly obvious, since by far, an architect or engineer's greatest exposure to liability is that an error in design causes a defective building to be constructed, which, in turn, results in bodily injury to persons in or near the structure, as well as property damages to the structure itself.

## *Errors and Omissions (E&O) Liability Coverage*

This category of non-medical professional liability insurance includes coverage for insurance agents and brokers, real estate brokers, technology professionals, and coverage for exposures generated by intellectual property.

### Insurance Agents Errors and Omissions Insurance

These policies cover claims resulting from errors and omissions caused by insurance agents and brokers. The two major classes of claimants are clients and insurers. Among the most common allegations made by clients are failure to place coverage promptly, failure to place the type of coverage requested, failure to increase the coverage limit, failure to recommend needed coverage, failure to explain limitations of coverage, verbal extensions of nonexistent coverage, inadvertent cancellation or failure to renew, and failure to place coverage with a solvent insurer. Among the most common allegations made by insurers against insurance agents and brokers are failure to follow underwriting guidelines, failure to exercise reasonable diligence in discharging duties to the insurer, failure to act in the best interests of the insurer, failure to revise coverage on request, failure to cancel on request, failure to disclose material information about an insured or applicant, and exceeding underwriting authority.

## Real Estate Brokers Errors and Omissions Insurance

These policies cover people engaged in buying, selling, leasing, or otherwise dealing in real estate on behalf of others. Depending on the scope of the actual policy, coverage may also apply to persons working in property management, real estate appraisal, real estate consulting, or other related aspects of the business, although coverage for these, more specialized exposures usually requires a special endorsement to a standard real estate brokers policy form. Typical claim allegations against real estate brokers for which coverage is afforded under the policies include misrepresentations about creative financing arrangements, failure to reveal important information about the surrounding physical features of a property, failure to ascertain title problems, failure to advise a buyer/seller that he/she can get a better price, negligence in screening prospective tenants who end up in bankruptcy or do damage to leased premises, and appraisal errors that produce inaccurate valuations.

## Technology Errors and Omissions Insurance

These policies cover two types of companies: those that (1) sell tech-related products and (2) those that provide tech-related services to third parties. Examples of the kinds of firms that require technology E&O coverage include computer hardware/software installers; Internet service providers; computer leasing companies; software developers; technology consultants; and manufacturers of electronic components, accessories, consumer electronics, and office equipment.

The policies cover five major types of exposures. Each of these exposures involves a third party sustaining a loss (financial, personal injury, or both), for which an insured technology professional is potentially liable. These losses include the following.

- *Errors or omissions*: loss caused by an act, error, or omission committed by the insured technology professional while performing services for another.
- *Product failure*: loss caused by the failure of the insured technology professional's product or service to perform as intended or promised.
- *Security failure*: loss caused by failure on the part of the insured technology professional to prevent unauthorized access to an online system.
- *Professional liability*: loss caused by the insured technology professional's infringement of copyright, trademark, or trade dress.
- *Personal injury*: loss caused by the insured technology professional's acts, errors, or omissions while supplying a product or providing a service, such as defamation or invasion of privacy.

## Intellectual Property Insurance

Intellectual property refers to creations of the mind, such as musical, literary, and artistic works; inventions; and symbols, names, images, and designs used in commerce, including copyrights, trademarks, patents, and related rights. Under intellectual property law, the holder of one of these abstract "properties" has certain exclusive rights to the creative work, commercial symbol, or invention which is covered by it. There are two basic types of "IP coverage." (1) Intellectual property defense cost reimbursement insurance reimburses insureds for legal expenses incurred to defend against lawsuits alleging that the insured has committed patent, trademark, or copyright infringement. Since the purpose of the policy is to pay defense costs only, there is no coverage for damages awarded against the insured if it is found that the insured, in fact, infringed upon another's intellectual property. This approach is unique to IP coverage, since virtually every other type of PL and ML

policy also covers damages (i.e., settlements and judgments) as well as defense costs. (2) Intellectual property infringement abatement insurance covers insureds for legal expenses incurred when an insured enforces a patent, trademark, or copyright against infringers. Since the purpose of the policy is to pay legal costs required to enforce intellectual property rights, there is no coverage for damages suffered by the insured that result from the infringement (e.g., lost profits because a valid patent was infringed upon by a competitor).

### *Media Liability Coverage*

Within this category of non-medical professional liability insurance is coverage for: (1) traditional media and (2) non-traditional media.

*Traditional media liability* refers to nonelectronic media and covers the liability exposures of such businesses and individuals as advertisers; authors; book, magazine, and music publishers; cable access companies; public relations firms; advertising agencies; public speakers; and radio and TV stations.

*Non-traditional media liability* is used to describe what is known as "electronic" or "cyberspace" liability. These exposures result from communicating or conducting business online, via e-mail or the Internet. Specifically, activities from these online media could result in claims alleging breaches of privacy rights, infringement or misappropriation of intellectual property, employment discrimination, violations of obscenity laws, the spreading of computer viruses, and defamation. Although most firms do not consider themselves to be in the technology business, any company that uses e-mail, sells its product online, or has access to the Internet, has electronic liability exposures—thus this exposure applies to nearly all business entities conducting operations in the United States today.

### *Public Entity Liability Coverage*

Public entities are those entities not owned by private individuals or corporations. They are often, but not always, governmental bodies and frequently provide actual services to the public. This category of non-medical professional liability insurance includes coverage for public officials, police departments, and educational institutions.

#### Public Officials Liability (POL) Insurance

This form of insurance provides liability coverage for the errors and omissions of public officials. It serves the same function for elected/appointed officials of federal, state, and local government as D&O insurance serves for the directors and officers of both for-profit and nonprofit corporations. However, there are two major differences between D&O and POL coverage. First, under POL forms, employees as well as elected/appointed public officials are insureds. In contrast, under D&O forms, only directors and officers are insureds. Second POL forms also cover the public entity, whereas with D&O policies, coverage for the corporate entity must be purchased separately. Second, specific coverage for employment practices liability is built into POL policy forms, whereas this is not true of D&O policy forms.

#### Police Professional Liability (PPL) Insurance

This type of insurance covers police officers and police departments, in conjunction with acts, errors, and omissions while performing their professional duties. The policies cover such perils as false arrest and civil rights violations. Unlike most professional liability insurance which are typically written on a claims-made basis, the PPL policies are sometimes written with occurrence triggers. Two important exclusions in PPL policies pertain to bodily injury/property damage from premises and operations

exposures and claims involving automobile operations. These exclusions apply since both types of exposures are covered separately under CGL and auto liability policy forms, respectively.

### Educators Legal Liability (ELL) Insurance

This coverage applies to a broad range of non-bodily injury/non-property damage liability claims made against the administrators, employees, and staff members of both schools and colleges. ELL usually combines D&O, errors and omissions, EPL, and sometimes media liability coverages in a single policy form. Typical claims covered by ELL insurance include: negligent financial management, wrongful termination of a faculty member, wrongful dismissal of a student, failure to grant tenure to a faculty member, and negligent academic counseling.

## *Miscellaneous E&O Liability Coverage*

Within this category of non-medical professional liability insurance is coverage written for the many types of professionals for whom profession-specific policy forms do not exist. Miscellaneous professional liability (MPL) policies are therefore "generic" professional liability policies written to cover a broad range of professionals including, but not limited to interpreters, sports agents, interior decorators, process servers, detective agencies, auctioneers, customs house brokers, title abstractors, and franchisors, just to name a few. Consultants are one of the most common types of businesses covered by MPL policies.

### Customizing Endorsements

There is no standard miscellaneous professional liability policy form. Rather, each insurer writes its own policy to which customizing endorsements are added, based upon the particular profession being covered. For example, the typical MPL policy form contains an exclusion for copyright, trademark infringement, and plagiarism. However, when an MPL form is written to cover a literary agent, an endorsement will be added that removes this exclusion. Similarly, the standard professional liability exclusion for bodily injury and property damage will be removed within an MPL policy written to cover a detective agency.

### Hazard Class Ratings

One distinctive feature of MPL policy forms is that they are rated on what is known as a hazard class basis. Given the fact that there are more than 100 different professions covered under such forms (a number that is increasing continuously), underwriters do not have sufficient claim data with which to develop accurate rates for each individual profession. Thus, most insurers group the many different professions they cover into hazard classes, from 1 to 5; with those in 1 and 5, being the least/most prone to claim frequency/severity, respectively, and then charging each of the professions a specific rate per $1,000 of annual revenues, based on the specific hazard class for which it applies.

## Chapter 3 Review Questions

1. Penny Shilling has direct responsibility for managing the investments held in her employer's defined benefit pension plan. Under ERISA, Penny is considered to be a(n):

   a. Director

   b. Fiduciary

   c. Officer

   d. Trustee

2. Because a practical joke at her wedding went very bad, Bridget ended up in the emergency room at St. Eligius Hospital where doctors ripped open her wedding dress to get to her wound, which was bleeding profusely. Bridget later brought a claim against the St. Eligius Hospital board and the doctors who treated her alleging they are liable for bodily injury for mistreating her wound and property damage for ruining her expensive wedding dress. The hospital has directors and officers liability insurance and medical professional liability insurance. How will these policies apply to Bridget's claim against the hospital?

   a. Directors and officers liability insurance covers the bodily injury claim but excludes property damage to the wedding dress.

   b. Directors and officers liability insurance covers the bodily injury claim and the claim for property damage to the wedding dress.

   c. Medical professional liability insurance covers the bodily injury claim but excludes property damage to the wedding dress.

   d. Medical professional liability insurance covers the bodily injury claim and the claim for property damage to the wedding dress.

3. Edith Buckler is an architect who designs plans and specifications for active adult communities. What kind of insurance does she need?

   a. Design professional liability insurance.

   b. Intellectual property liability insurance.

   c. Real estate brokers errors and omissions insurance.

   d. Technology errors and omissions insurance.

4. All the following people who live and work in Town would be eligible for coverage under some form of public entity liability coverage, except:

   a. Ann Architect, whose firm is drafting plans for Town's new municipal building.

   b. Harry Dirty, Town police detective.

   c. Lili Person, administrative assistant to Local's mayor.

   d. Sue Printendent, head administrator of the Town school district.

## *Answers to Chapter 3 Review Questions*

1. b. According to ERISA, an individual is considered a fiduciary if that person has control in, managing an employee benefit plan's assets.
2. d. Medical professional liability insurance does not exclude either bodily injury or property damage.
3. a. Design professional liability policies cover architects and engineers who are involved in designing or preparing plans and specifications for construction projects.
4. a. Ann is not a Town employee, nor is she an elected or appointed Town official. Therefore, she is not eligible for public entity liability coverage.

# Chapter 4
# Common Features of Professional and Management Liability Policy Forms

Although PL and ML insurance policies differ significantly, depending upon the type of individual coverage being addressed, there are also many similarities between these various forms. This chapter will describe the key common features of these policies. These include:

- Insuring agreements
- Limits, deductibles/retentions, coinsurance
- Conditions
- Exclusions
- Coverage Triggers

It concludes with a brief discussion about coordinating PL and ML policies with other types of insurance coverage.

(Note: Subsequent courses in this series will examine in more detail the distinctive features of the different types of PL and ML forms.)

## Insuring Agreements

The insuring agreements common to PL insurance policies include covered persons, covered acts/covered services, covered organizations, covered territory, covered damages, defense procedures, and defense cost provisions.

### *Covered Persons*

PL and ML forms typically cover professionals while they are acting within the scope of their professional duties. The definition of "covered persons" extends to: employees, directors, officers, managers, supervisors, stockholders, owners, principals, volunteers, and interns.

Independent contractors are generally not found within the definition of "covered persons," but in some instances they can be covered by endorsement for an additional premium. PL and ML insurance policies may also cover former employees, spouses, and personal representatives, as indicated below.

### Coverage of Former Employees

Most, although not all, PL and ML policies cover "former" employees. This is advantageous because such coverage assures the cooperation of former employees in the event a claim is made against both the former employee and the insured organization.

### Coverage of Spouses

When sued, professionals sometimes transfer their assets into the names of their spouses as a means of protecting those assets. In recent years, plaintiffs' attorneys have responded by also naming spouses in lawsuits against the professionals. As a result, most PL and ML forms also afford coverage for the spouses of insureds.

### Coverage of Personal Representatives

Since PL and ML claims are personal to the individual against whom a claim is made, such claims survive the death or incapacity of covered persons. For this reason, the policies cover the insured's heirs, executors, trustees (including trustees in bankruptcy), and personal representatives.

## *Covered Organizations*

The covered professional firm, corporation, public entity, or individual (if a sole practitioner), is designated as the "named insured" or "insured organization" under most PL and ML policies. In addition, the policies automatically cover subsidiaries of the covered organization, provided the covered organization is a majority owner of the subsidiary. However, the policies do not cover joint ventures or partnerships, unless these entities are specifically named on the policy as insureds. Usually, additional premium is required for such coverage to apply, the amount of which is a function of the size and type of operations of such entities.

### Coverage of Predecessor Organizations

It is important to recognize that many PL policies also provide coverage for what are known as predecessor organizations. For 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." Assume this new combination purchases a PL policy. Under most insurers' forms, coverage would be available for errors and omissions committed during the "A & 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 firm coverage: (1) defining the term "named insured" so that "predecessor firms" (i.e., the A& B partnership in the aforementioned example), is included within that definition or (2) listing specific predecessor firms as "named insureds" on the policy's declarations page.

## *Covered Services/Covered Acts*

Depending on the particular profession involved, PL policies indicate the specific scope of covered services/acts, in one of four places; in the policy's: (1) definitions section, (2) insuring agreement, (3) declarations page, or (4) by means of an endorsement to the policy (this can be either a standard or manuscript endorsement).

It does not matter which of the four methods is used to indicate the scope of the insured's services. However, it is important to verify that the description provided by any of these four methods matches the correct and complete scope of the insured's activities or is consistent with acts that are a generally accepted part of a given profession. For example, real estate brokers routinely handle

escrows of transactions in which they are also the broker of record. In addition, they often broker or make mortgage loans, and they frequently offer notary services. As a result, these services need not be specifically enumerated by any of these four approaches for coverage to be afforded, other than having the policy cover "real estate brokerage services." On the other hand, if an insurance agent also performed actuarial work (services not usually offered by insurance agents), this must be specified within the policy's declarations or be noted by endorsement.

### The Application: An Important Indication of the Scope of Covered Services

The application for PL coverage describes in detail the exact scope of the insured's professional activities. To assure that all of the insured's various activities 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.

## *Covered Territory*

There are two types of territorial provisions used in PL and ML policies. The first type provides (1) unrestricted worldwide coverage, meaning that coverage applies regardless of where the wrongful act took place and/or where a claim is brought against the insured. The second, and most common territorial provision 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.

### The Importance of Worldwide Coverage

Insurers are usually willing to amend PL and ML 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 in non-U.S. locations as well as for businesses that have any kind of international electronic exposures (e.g., a hospital that subcontracts the reading of radiological scans to firms in India; an insurance company that subcontracts data entry operations to a company in Ireland). Absent a worldwide territorial provision, these exposures might not be covered if claims are made against an insured, outside of the United States.

## *Covered Damages/Covered Losses*

PL and ML insurance policies cover damages/losses for which the insured is legally liable and when such damages result from the delivery of professional services or during the course of business operations. Covered damages/losses are comprised of: (1) the costs to investigate and defend a claim against insureds and (2) amounts that result from either a judgment in a court of law against the insured(s) or a settlement between the insurer and the claimant. (Both settlements and judgments are termed "indemnity payments.")

### 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 fee paid. An architects and engineers professional liability 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 claimant for doing so. Such coverage is precluded since the loss of professional fees is considered a "business risk," rather than a professional liability exposure.

### Other Items That Are Not "Covered Damages"

In addition, the following items generally do not fall within the typical PL and ML policy's definition of "covered damages" or "loss": (1) sanctions, (2) fines, (3) penalties, and (4) taxes. Such items are excluded because they are often triggered by willful misconduct that exceeds ordinary negligence and to cover these losses is considered to be against public policy.

### Coverage of Punitive Damages

Punitive damages are frequently awarded against professionals and executives. Such damages 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. Although most PL and ML policy forms provide affirmative coverage for punitive damages, a significant minority exclude them. The extent to which such coverage is found within a given policy is largely driven by the laws of individual states, many of which do not allow punitive damages to be covered by an insurance policy.

## *Covered Defense Costs*

As noted previously, all PL and ML policies cover the costs required to investigate, defend, and settle claims. These items encompass: attorneys' fees, the cost of expert witnesses, court costs, bonds, and related expenses involved in the loss settlement process.

## *Defense Costs are within, Not in Addition to Policy Limits*

Under the vast majority of PL and ML policies, defense costs are covered within, rather than in addition to, policy limits. Accordingly, when monies are expended to defend an insured, this has the effect of reducing available policy limits. This approach contrasts with that used in CGL policies, whereby defense costs are covered in addition to policy limits. When coverage is written on this basis, the expenditure of defense costs does not reduce the policy's limit of coverage, so that under a CGL form, an unlimited sum could be spent to defend an insured, without reducing the amount of money available to pay indemnity costs (i.e., settlements or judgments). Exhibit 4.1 illustrates this important concept.

**Exhibit 4.1**
**Defense Cost Coverage Case Study**

**Defense "within" Limits (Typical PL and ML policies)**

*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.

**Defense "in addition to" Limits (CGL policies)**

*Policy Limit: $1 million*

Regardless of how much money has been expended to defend a claim against an insured, the full $1 million policy limit remains available to cover: (1) $1 million of indemnity payments and (2) an unlimited amount of additional defense costs. The policy's $1 million limit can only be exhausted by indemnity payments.

### *Application of Deductibles/Retentions to Defense Costs*

Most PL and ML deductible/retention clauses state that the deductible/retention is applied to both loss payments and claims expenses, regardless of whether a loss payment is made. To illustrate, assume an insurer expended $30,000 to defend an insured but since the claim was dismissed before going to trial, the insurer was never required to pay a judgment on the insured's behalf. 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. Note that in this example and in actual practice, a deductible does not apply twice for a single claim. (i.e., $10,000 for the loss payment and $10,000 for the claims expense).

However, a minority of PL policies do not apply retentions/deductibles to defense costs, which is favorable for the insured. Under these policies, deductibles/retentions apply only to indemnity payments. Such policies are said to be written on a "first-dollar defense" basis.

### *Covered Supplementary Payments*

Most PL and ML 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 incurred during attendance at hearings and trials. Such expenses do not, however, under most forms, include the insured's salary or earnings lost as a result of trial attendance or claim defense assistance.

### *Defense Provisions*

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

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

PL and ML policies are written with one of two types of defense procedure provisions: (1) "duty to defend" or (2) "non-duty to defend" provisions. The phrase "duty to defend" in a PL or ML policy expressly states that the insurer has the duty to defend any claim alleging a covered act under the policy. In contrast, the phrase "non-duty to defend" indicates that the insurer does not have the duty to defend claims; rather, it is the duty of the insured to do so. 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.

Smaller insureds generally select policies with duty to defend provisions because insurers have much more experience in, and are thus better equipped to manage, the complexities of PL and ML litigation. On the other hand, large corporate insureds (particularly those covered under D&O policies), often select non-duty to defend provisions because such organizations have the in-house expertise to manage major claims and therefore prefer to have control over such matters, rather than delegating defense to an insurer.

### Settlement Procedures

Disputes between insureds and insurers as to the reasonableness of settlement amounts are often a difficult issue in PL and ML insurance. 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 or a nuisance settlement was an admission of wrongdoing. However, from the insurer's perspective, the settlement might save legal costs and, most important, avoid 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 agree. 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 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.

## Limits, Deductibles/Retentions, and Coinsurance Provisions

There are both similarities and differences between the ways in which limits, deductibles/retentions, and coinsurance are applied under PL and ML policies.

### *Limits*

PL and ML 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.
- **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). An example of this is a policy with a $1 million per claim limit and a $3 million annual aggregate limit.

### "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." Specifically, related claims provisions state the following.

1. **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).
2. **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.

Here is an illustration of how the related claims provision applies. The XYZ Corporation receives sexual harassment claims by three different female employees, all working in the same department, based on the conduct of one of its male supervisors. The lawsuits are filed in three separate years: 2008, 2009, and 2010. According to the terms of the related claims provision, the policy limit that was in force during 2008 would be applicable to all three claims, rather than the sum of the limits that applied during 2008, 2009, and 2010. In addition, only one deductible would apply to all three claims.

### Exhaustion of Limits

Most PL and ML policies state that once their limits have been exhausted by any combination of indemnity payments and/or defense expenditures, the insurer's duty to defend any and all claims against the insured ceases. However, exhaustion of limits clauses apply only to situations where payments—rather than reserves—have exceeded limits. Assume that an insured against whom three claims were pending had a $1 million policy limit. Also assume the insurer had reserved $500,000

(for settlement and defense costs) for each of the three claims (a total of $1.5 million). In this situation, the insurer's obligation to continue defending the insured would not cease until $1 million had been paid on the insured's behalf (in any combination of settlement or defense costs, across any combination of the three claims), despite the fact that total claim reserves exceeded the insured's $1 million policy limit.

### *Deductibles/Retentions*

Nearly all PL and ML 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.

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 makes any additional payments for defense and indemnity that are covered by the policy.

Retentions are generally written for larger insureds, such as corporations with D&O coverage or hospitals with HPL coverage. In contrast, deductibles are normally found in PL policies written for smaller professional insureds, such as solo practitioners in law, medicine, or accounting and under MPL policies.

### *Coinsurance Provisions*

Coinsurance provisions are sometimes found in several lines of PL and ML coverage, most notably in EPL and D&O liability 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) 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. Coinsurance provisions operate in a fashion identical to that used in healthcare indemnity 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.

## Conditions

The conditions section of a PL or ML policy 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 and nonrenewal, (2) subrogation, (3) other insurance, and (4) various miscellaneous conditions.

### *Notice of Cancellation and Nonrenewal*

There is considerable variation between the manner in which the various insurers handle the issue of policy cancellation and nonrenewal.

### Notice of Cancellation

The majority of policies require that the insured be given 30 days' notice prior to the date on which an insurer will cancel a policy. A significant minority of insurers' forms provide 60 days' notice prior to cancellation. Still others write policies which cannot be canceled (except for nonpayment of premium or for material misstatements in the application), which is favorable for the insured. In many instances, the length of the required notice of cancellation period is a function of individual state law.

### Notice of Nonrenewal

Some PL and ML forms include a provision requiring that the insurer give 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. As is the case with notice of cancellation provisions, the notice of nonrenewal provision period is sometimes mandated by state law and in such cases would be specified in that state's amendatory endorsement.

## *Subrogation Provisions*

Subrogation is the assignment to an insurer, by terms of the policy, after payment of a loss, of the rights of the insured to recover the amount of the loss from one legally liable for it. For example, assume 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 indemnifies the hospital by making a payment to the injured patient on the hospital's behalf. Under the terms of virtually all PL forms, the hospital's insurer would then have the right to collect the amount of its payment from the doctor who negligently performed the surgery.

### 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, especially if the insurer is notified prior to inception of the policy.

### Subrogation Waivers are Not 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.

## *Other Insurance Clauses*

"Other" insurance provisions address situations in which the terms of one or more other policies also provide coverage for a PL or ML claim that is insured by a given policy.

There are two purposes of other insurance clauses in PL and ML 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. As a result, 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 PL and ML policies are written to apply as excess insurance in the event that another policy exists. However, 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 therefore pay the claim on a pro rata basis, that is, in proportion to their respective limits.

## *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.

### 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.

### Cooperation Clause

Nearly all PL and ML policies contain clauses that compel insureds to provide "reasonable efforts" to assist 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 should be the party to expend all of 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 a strong defense in the absence of cooperation from the insured.

### Legal Action against the Insurer

The vast 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 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 this 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). These provisions also can prevent questionable litigation against an insurer 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 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 probably 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 sometimes huge verdicts rendered by juries.

### Nontransferability Provisions

Most PL and ML 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. 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 another individual or entity seeking named insured status under the original named insured's policy.

### Severability Provisions

Severability provisions are included in the majority of PL and 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 provide coverage for so-called "innocent" insureds, in situations where the conduct of one insured would otherwise void the policy (e.g., partner "A" in a law firm absconds with a client's trust fund; partner "B" the other, "innocent" partner would still have coverage for a claim made against him if the client sues both partners A and B) and (2) they reinforce the fact that while coverage can apply separately to different insureds, this does not increase the limits of the policy (i.e., an accountants professional liability policy is written with a $1 million limit; a claim is made against each for the firm's three partners; a total of $1 million of coverage applies to all three partners—not $1 million for each partner).

### Continuation of Coverage in Bankruptcy

Most PL and ML 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. Nevertheless, 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 in an otherwise covered claim situation.

## 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 PL and ML 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 policies.

### *The Duty To Defend Is Broader than the Duty To Indemnify*

Even when an ML or PL policy contains an exclusion that is worded to exclude both indemnity and defense coverage (known as a "blanket exclusionary provision"), insurers will usually provide defense coverage for the insured, in spite of such exclusionary policy language. As an industry practice and according to caselaw, an insurer's duty to defend is considered to be broader than its duty to indemnify. So unless a claim (or a specific allegation within a claim) is clearly excluded, insurers will often defend the insured, even when an exclusion might preclude coverage for indemnity payments associated with the claim.

There are four general kinds 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 coverage under other types of policies; and (4) exclusions for exposures pertaining to a specialized type of work within a given profession.

### *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).
- **Insurance is against public policy.** Insurance coverage for the exposure is prohibited by law or is 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 as described earlier).

#### 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 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 rationale for excluding claims in which the signatory did not sign the document in question in the notary's presence is that preventing the kinds of suits noted above is within the control of the insured.

#### Trademark and Copyright Infringement

Trademark and copyright infringement exclusions are most commonly found in coverage written for architects and engineers, because design professionals sometimes may use or appropriate the plans or drawings of another architect within the course of their professional activities. With lesser frequency, trademark and copyright exclusions are also found in lawyers', accountants', and insurance agents' PL policies. The rationale for such exclusions is that trademark and copyright infringement is within an insured professional's control and can generally be prevented with relatively little diligence. On the other hand, media liability policies, such as those for publishers, advertisers, or broadcasters, do not contain this exclusion; rather, they affirmatively cover such perils. This is because such perils involve "core" PL exposures for media businesses, 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 such firms.) In contrast, for other types of professionals, such as architects and engineers, copyright and trademark infringement represent minimal exposures, which, for the most part, can usually be prevented by using a minimum amount of care (e.g., seeking permission prior to using or referencing the work of others).

### Previously Reported Claims and "Known" Incidents

Virtually all policies restrict coverage of claims pertaining to one or more of the following three exposures.

- Claims reported to prior insurers.
- Claims reported under prior policies with the same insurer.
- 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., non-fortuitous claims).

The intent of this exclusion (which is sometimes broken up into two or even three separate exclusions) is to eliminate coverage for claims that (1) are the responsibility of another insurer, (2) are within the scope of another policy period under 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 the claim is therefore lacking in fortuity (i.e., in such situations, the insurer should not be asked to cover the so-called "burning building").

### Antitrust Violations

Providing coverage for acts involving antitrust violations is against public policy in some jurisdictions and therefore not within the intended scope of coverage under most PL and ML policies. (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.) Moreover, coverage is also commonly excluded for such acts since they are generally within the control of the insured.

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 and some actually provide coverage for damages associated with such claims. This is because antitrust allegations are such a frequent source of liability for managed care organizations that coverage of this peril is offered by the 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 portion of the claim. (As noted earlier, coverage for the return of professional is also precluded under a number of PL policies by means of the forms' definition of "damages" or "loss.")

### 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 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 other competitor firms or possessed other "inside" information that assisted his company in securing the contract, a claim of illegal personal profit could be made. Many PL and virtually all D&O policies exclude coverage for such claims.

### Nonpecuniary Relief

Most of the policies exclude coverage for claims seeking 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. (Although, if the claimant were to sue the agent, the policy would provide monetary damages that resulted from the agent's failure to secure the policy, for example, where a building that an agent "promised" to insure burned to the ground.) Exclusions precluding coverage for monetary 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).

### Bankruptcy of Insured

Most policies exclude coverage for claims arising from the insolvency or bankruptcy of a professional. For instance, if a professional experiences financial difficulties and 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.

### Intentional, Criminal, Fraudulent, Willful, or Dishonest Acts

Virtually every PL and ML policy contains exclusions for coverage of criminal, fraudulent, or 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, policies typically qualify intentional acts exclusions so that there is coverage, unless the act is performed maliciously, dishonestly, or with the intent to injure.

Importantly, nearly all PL and ML policies affirmatively provide defense coverage if allegations of 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 coverage. On the other hand, if the allegations are ultimately proven to be true, the insurer may 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.

Another key point regarding this exclusion: many versions are worded so that coverage for so-called "innocent insureds" is affirmatively provided when allegations of intentional wrongdoing, such as fraud, are made against culpable members of a professional organization and yet other innocent persons are also named in a lawsuit. Such wording within this exclusion has the effect of covering the defense costs of these "innocent insureds."

### Losses from Professional Guarantees

Many PL forms contain exclusions of coverage for loss arising from professional guarantees. (For example, a doctor might guarantee that following Lasik surgery, a patient will have 20/20 vision in both eyes.) More specifically, the policies preclude coverage for situations in which (1) a professional promises that a certain result will follow from his or performance and (2) this specific result is not realized.

### Losses from Commingling and Accounting 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).

## *Removable/Modifiable Exclusions*

In a few 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: (1) failure to maintain insurance, (2) contractual liability, (3) insured versus insured, and (4) prior and pending litigation.

### Failure To Maintain Insurance Exclusion

Some directors and officers (D&O) 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 subsequent drop in the firm's 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. However, many insurers will remove this exclusion if the insured submits a schedule of insurance, indicating to the underwriter that there are no major property and liability exposures that are uninsured.

### 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 PL 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. 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 would ordinarily apply (as in the above example of the accounting firms), regardless of a contractual provision requiring such indemnification.

### Insured versus Insured Exclusion

Insured versus insured exclusions preclude coverage for claims made by one insured under a PL or ML policy against another. There are several rationales for the insured versus insured exclusion. First, the exclusion is aimed at precluding coverage for recouping losses from bad business decisions. Case-in-point: during the mid-1980s, in response to losses suffered from imprudent extensions of credit, Bank of America began suing its loan officers, who then sought coverage under the bank's D&O policy. After receiving a number of such claims, D&O insurers began to insert insured versus insured exclusions into their forms, explaining that the policy was not intended to function as an indemnification vehicle for bad business decisions (viewing this as coverage for "business risk" or speculative risk, rather than professional negligence). Second, since many professional organizations purchase employment practices liability (EPL) coverage, insurers feel that covering claims by one insured against another is more appropriately the function of EPL policy forms rather than a PL policy. Third, suits by one insured against another are sometimes the result of "infighting," yet another situation that really does not involve professional liability. For example, one doctor in a group practice may sue another doctor in the partnership, claiming that he or she owed money to the doctor or the practice.

### Prior and Pending Litigation

Nearly all D&O policy forms, many EPL policies, and an increasing number of PL policies exclude claims arising from litigation that was pending prior to the inception of the policy. For example, assume that a breach of contract lawsuit was brought against a corporation—rather than individual directors and officers—prior to the inception of a D&O policy. After inception of the policy, the suit is amended to name the organization's directors and officers. The claim against the company's directors and officers would be precluded by the prior and pending litigation exclusion. The intent of the exclusion is to avoid insuring the so-called "burning building," whereby the insurer is being asked to cover claims from events that were lacking in fortuity and that sometimes provide the incentive for an insured to obtain coverage.

## *Exclusions To Coordinate with Other Insurance*

Most PL and ML 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 PL exposures that are more properly insurable under other professional liability policies, such as Employee Retirement Income Security Act (ERISA) responsibilities under fiduciary liability policy forms.

### Employment Practices

Coverage for 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 PL forms. There are two reasons for this. 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.

### Bodily Injury/Property Damage

Most PL and ML policies exclude coverage for bodily injury (BI) and property damage (PD) liability because coverage for incidents of this kind (e.g., slip and fall claims in a professional's office) are more properly the subject of CGL insurance. (However, as already noted, BI/PD exclusions do not appear in the policies written for certain professionals such as doctors and architects and engineers.)

### 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 PL policies. This is because CGL forms normally apply to such exposures. As with BI/PD exclusions, personal injury exclusions do not appear in PL policies written for certain professions such as lawyers, because the nature of their work frequently creates personal injury exposures, coupled with the fact that PL exclusions within their CGL forms would otherwise eliminate coverage for these types of claims.

### Related/Affiliated Entities

First, these exclusions eliminate coverage for claims made against related entities that are not named insureds. 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, because the clinic should either have a separate policy covering it or should be insured under the physician's professional liability policy.

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 about one of the brokerage's clients. As a result, the adjuster wrote a check for a loss that was not covered, which, 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.

### Claims from the Delivery of Related Professional Services

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

### Workers Compensation

Virtually all PL and ML policies exclude coverage for any type of obligation under workers compensation, disability, unemployment, or similar laws. Such exposures should be covered under workers compensation policies.

### ERISA Responsibilities

Coverage for claims involving the administration and management of pension and benefit plans are excluded under virtually all PL and ML forms (except fiduciary liability policies). In some cases, this exclusion is worded so that it specifically precludes 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.

### Public Service Positions/Service for Another Entity

Most PL and ML policies exclude coverage for claims arising from activities outside the employing entity. For instance, this would include liabilities in conjunction with serving on the boards of for-profit/nonprofit organizations and for the insured's work on behalf of public agencies. The exclusion is primarily intended to preclude coverage of an insured's work on behalf of nonprofit groups because separate coverage should be purchased to cover these individuals (i.e., a D&O policy is normally required to cover such exposures). This exclusion is also intended to preclude coverage for moonlighting activities, for example, when an accountant, employed by a CPA firm, moonlights as a tax preparer.

### Motor Vehicles, Aircraft, Watercraft

Liability arising out of automobiles, watercraft, aircraft, or any other types of motor vehicles, is excluded by virtually all PL and ML forms. These exposures must 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 & 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, insurers sometimes include in policies exclusions of exposures they are otherwise willing to cover. 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 operations (insurance agents)
- Soil testing (engineers)

Coverage for these and similar activities are sometimes excluded by standard policies written for these professions. However, these restrictions can frequently be removed or modified, in return for the payment of additional premium. By making exclusions of this kind 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.

## Coverage Triggers

A liability insurance policy's coverage trigger is the provision defining the nature and sequence of events that must take place for the policy to cover a claim against an insured. The coverage trigger determines which policy, often in a series of policies spanning a number of years, will respond to a particular liability claim.

The vast majority of PL and ML policies contain claims-made coverage triggers. This is in contrast to the more familiar occurrence coverage trigger, typically found in most CGL and umbrella liability forms. Occasionally, however, occurrence triggers are found in professional liability policies written for media liability, police liability, medical malpractice, and hospital professional liability policies.

Coverage applies under an occurrence policy when an act occurs during the policy period that causes an injury or damage. The policy is triggered, regardless of how far in the future a claim associated with that act results in a formal claim. (Note: Occurrence coverage triggers will be examined in a future course in this series.)

### *How Claims-Made Coverage Triggers Function*

For coverage to apply under a claims-made policy, the following three conditions must be fulfilled:

- The claim must be first made,
- Against the insured during the policy period, and
- The act giving rise to the claim must have taken place on or after the policy's retroactive date.

#### First-Made Language

First, coverage applies under a claims-made policy only if a claim is first made against the insured during the policy period. This means that the claim must not have been previously made during a prior policy period—regardless of whether or not such policy was written by the current insurer or by a different insurer. "First made" wording has two key implications: (1) it precludes coverage for claims that should rightfully be the responsibility of a previous insurer, and (2) it prevents the insured from obtaining coverage under a subsequent policy written by the same insurer that may be more favorable to his or her interests (e.g., one written with a higher limit). Given these reasons, virtually all claims-made policies are written with "claims first made" language.

#### Against the Insured, during the Policy Period

Second, for coverage to apply, the claim must be made against the insured during the policy period. This means that during the policy period, the insured must receive formal notice (most often by means of a summons and complaint) that a claim seeking damages is being made against him.

Coverage will apply only if such notice is received during the actual term of the claims-made policy. Claims made against the insured either before the inception date of the policy or after the policy term has expired, will not be covered.

## On or after the Policy's Retroactive Date

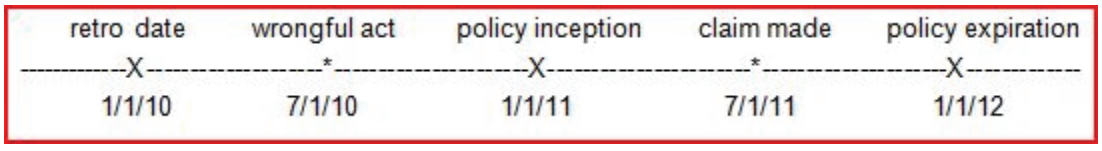
Third, for coverage to apply, the act giving rise to the claim must have taken place on or after the policy's retroactive date. A retroactive date is usually noted on the policy's declarations page, and indicates that coverage will apply only if the act giving rise to the claim took place on or after that date.

For example, assume a policy is written with a term of 1/1/10–11 and a retroactive date of 1/1/08. For coverage to apply to a claim, the alleged wrongful professional act that gave rise to the claim must have taken place on or after 1/1/08. Assume a surgeon operates on a patient on July 1, 2009. The surgeon receives notice of a lawsuit on March 1, 2010. Coverage applies because the alleged wrongful act (i.e., the surgery) was performed on July 1, 2009, which is after the policy's 1/1/08 retroactive date and because the claim was made against the insured during the 1/1/10–11 policy period. (Note that if the operation had been performed prior to the policy's January 1, 2008 retroactive date, coverage would not have applied despite the fact that the claim was made during the 1/1/10–11 policy period.)

## The Purpose of Retroactive Dates

There are two purposes of retroactive dates: (1) to eliminate coverage for situations or incidents that insureds recognize have the potential to produce a claim in the future and (2) to preclude coverage for "stale" claims that arise from events far in the past, even if such events are unknown to the insured. In the former case, the retroactive date preserves the principle of "fortuity," that is, the insurer should not be called upon to cover the so-called "burning building." In the latter instance, the retroactive date makes policies more affordable by precluding coverage for events that are remote in time. Exhibit 4.2 provides another example of how coverage is triggered under a claims-made policy.

**Exhibit 4.2**
**How a Claims-Made Policy Functions**




In this example, coverage applies because: (1) the claim was first made, (2) during the 1/1/11–12 policy period, and (3) the wrongful act took place after the policy's 1/1/10 retroactive date. Had the surgery been performed prior to the policy's 1/1/10 retroactive date, coverage would not have applied. Similarly, there would have been no coverage, had the claim been made against the insured prior to 1/1/11 or after 1/1/12.

### *The Rationale for Claims-Made Coverage Triggers*

It is inherently difficult to project the amount of money that will ultimately be paid out under a given set of insurance policies written with occurrence triggers. This is because often, an act that took place during the term of an occurrence policy will not result in a claim until a number of years after the policy has expired (often referred to as long-tail claim exposure). In addition, even after the claim is made, it may require an even longer period of time to litigate and ultimately settle. Thus, at the expiration of an occurrence policy term, an underwriter will have only a vague idea as to the ultimate claim liabilities that will result from a given policy, and even more so under an entire book of business written on an occurrence basis.

#### Unique Aspects of Professional Liability Exposures

The inherent time lag between an occurrence and the making of a claim related to that occurrence, is especially prevalent with respect to PL and ML exposures. Case-in-point: a number of years sometimes pass before a patient even realizes that he has been injured by a doctor (e.g., when a sponge is left in a patient's stomach during an operation). Similarly, there is usually a significant time lapse between the date when an architect designs a defective building and the date on which it collapses, injuring pedestrians or occupants. In a D&O context, the misconduct of Enron's directors and officers did not produce financial ruin for the company until about 5 years after dishonest accounting practices had begun. In short, there are significant time lags between the commission of wrongful professional acts, the filing of claims, and conclusion of the litigation that ultimately settles such claims. As a result, if underwriters wrote PL and ML coverage on an occurrence basis it would be very difficult to estimate accurately their ultimate dollar liability on the day a book of recently-expired business.

#### Easier to Price Coverage

In contrast, under a claims-made policy, coverage applies only to claims that are made against the insured during the term of the policy. Thus, shortly before the date on which a policy expires, an underwriter will be in a position to make a fairly accurate estimate of the ultimate claim liabilities associated with that policy, and by extension, the liability associated with a book of ML/PL business. This, in turn, makes it easier for a PL/ML underwriter to price coverage for policies that are about to renew. For this reason, nearly all PL and ML policies are written on a claims-made rather than on an occurrence basis.

### *Discovery Provisions*

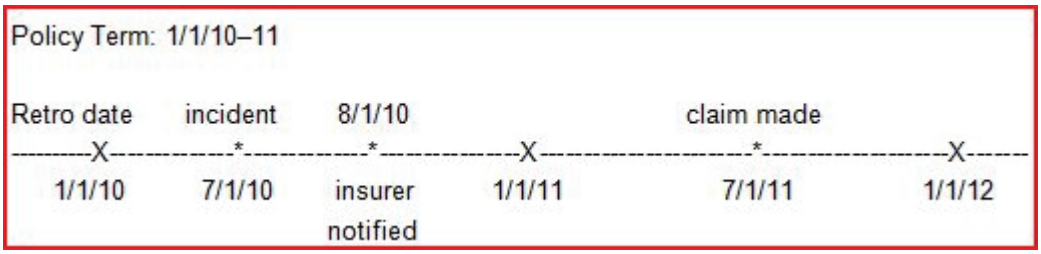
Nearly all claims-made policies state that if the insurer is notified of a circumstance or incident that takes place during the policy period, but before a claim associated with that circumstance or incident is made, claims arising out of that circumstance will be considered to have been made during that policy period. This is despite the fact that the actual claim is made against the insured many years after the policy period has terminated.

#### Illustration

After being terminated without prior notice, an employee who worked 20 years for a company tells a co-worker (as he is being escorted out of the building by security): "They've got no right to do this. I'm going to sue them for this!" Given this situation coupled with the employee's statement, it is quite possible that a lawsuit will be forthcoming. Accordingly, the insured would be well-advised to notify its EPL insurer of a potential claim under the policy's discovery provision. If the insured does make a

claim, coverage will apply under that policy, regardless of how far in the future the ex-employee brings a lawsuit. This concept is illustrated in Exhibit 4.3.

**Exhibit 4.3**
**How a Discovery Provision Functions**




In this example, coverage applies because the insurer was notified by the insured of an employment-related "incident" on 8/1/10. Although the claim associated with the incident was not made against the insured until after the 1/1/10–11 policy had expired, coverage applies nonetheless because the insurer was notified of the incident under the policy's discovery provision.

### The Purpose of Discovery Provisions

Discovery provisions protect insureds whose policies might be canceled or nonrenewed between the occurrence of some event that makes a claim likely (as in the above example) and the time the claim is actually brought against the insured. Without such a provision, it would be difficult for an insured to change insurers. For instance, in the example in Exhibit 4.3, if the insured sought to change insurers at the expiration of the 1/1/10–11 policy term, a replacement insurer would exclude coverage for the possible wrongful termination claim of which the insured was aware. However, by virtue of having notified its current insurer under the policy's discovery provision, coverage is "locked in" by the current insurer for any claim that ultimately results from the incident—regardless of how far in the future a lawsuit is received. Since coverage is now available under its expiring policy, the insured has the flexibility to change insurers, without having to be concerned about the fact that coverage for the potential claim/incident will be excluded by the new insurer.

## Extended Reporting Provisions

Extended reporting periods (ERPs)—also known as extended discovery or "tail" provisions—allow insureds to report claims after a policy has expired or been canceled. For coverage to apply under an ERP, a wrongful act must take place during the expired/canceled policy and a claim associated with that act must be made and reported to the insurer during the ERP.

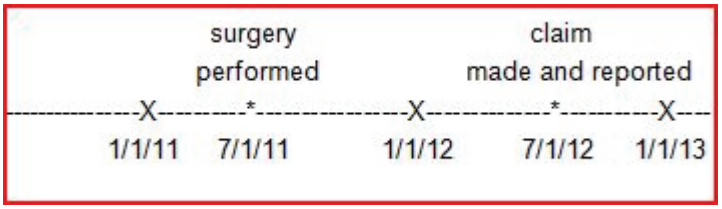
ERPs are valuable for two reasons. First, they allow insureds to change insurers (without producing a coverage gap) even if the new insurer does not cover prior acts. (Policies covering "prior acts" cover claims from acts that took place on or after the date on which continuous PL or ML coverage was first purchased.) Second, if the insured did not continue buying PL/ML insurance, the ERP will cover claims made against the insured after the policy expired. An ERP literally "extends" the period of

time during which claims under an expired (or canceled) policy can be reported to and thus covered by an insurer.

The illustration in Exhibit 4.4 demonstrates how an ERP functions.

**Exhibit 4.4**
**How an Extended Reporting Period Functions**

- Insurer A's Policy Term: 1/1/11–12
- Insured buys an ERP from Insurer A, with a term of 1/1/12–13
- Wrongful Act: 7/1/11
- Claim Made and Reported: 7/1/12




Coverage applies under the ERP because the wrongful act took place during Insurer A's 1/1/11–12 policy term and a claim associated with the act was made and reported during the term of Insurer A's 1/1/12–13 ERP. One final, key point regarding ERPs: no coverage would have applied in this example if both the wrongful act took place and the claim were reported during the 1/1/12–13 ERP period. Rather, the wrongful act must take place during the expired/cancelled policy period for coverage to apply during the ERP.

### ERPs and Discovery Provisions Compared

Often, there is confusion between ERPs and discovery provisions. The two provisions can be distinguished on the following basis: ERPs afford coverage for claims made after a policy has expired. In contrast, discovery provisions apply to incidents reported to an insurer during a policy period, if the incident later matures into a formal claim (and regardless of how far in the future the claim is made).

## Coordinating ML/PL Coverage

There are a number of situations in which ML and PL coverages must be coordinated, first, with each other, and second with non-ML/PL policy forms. This discussion will deal only briefly with this issue, since it is best left to the profession-specific material in subsequent courses within this series.

### *Coordinating ML/PL Policies with Each Other*

There are a handful of situations in which decisions must be made as to which type of ML/PL policy should be used to insure a particular exposure. For example, as was already mentioned, separate policy forms are available to cover EPL exposures while, at the same time, D&O forms can also be endorsed to do so. Depending upon an insured's particular situation, there may be times in which a stand-alone policy should be purchased. On the other hand, an EPL endorsement to a D&O form is

sometimes the better approach for covering this risk. This and similar issues will be addressed in the profession-specific courses within this series.

### *Coordinating PL/ML Policies with Other Types of Policies*

In addition, under certain circumstances, PL/ML forms must be coordinated with other types of coverage. For example, the use of Employee Benefits Liability endorsements available under CGL policy forms may be appropriate under certain circumstances. On the other hand, use of a fiduciary liability policy form, which in addition to covering fiduciary exposures, also covers the employee benefit liability risk, is warranted. Again, this and similar situations will be examined at length within the profession-specific courses in this program.

## Chapter 4 Review Questions

1. Wesson and Smith, LLC, is covered by professional liability insurance. Which of the following is *least* likely to be a covered person under a typical policy?

   a. Cathy Winchester, a former employee of the firm

   b. Sam Wesson, co-owner of the firm

   c. Tom Smith, husband of the firm's other co-owner

   d. Webb Master, an independent contractor who maintains the firm's web site

2. Despite spending $300,000 in attorneys' fees and other defense costs, Goldfinch Associates lost a suit alleging professional liability and must pay $2 million in compensatory damages to a client. Goldfinch Associates is covered by a professional liability policy with a $1 million limit. The insurer will pay damages in the amount of:

   a. $700,000 if defense is in addition to limits.

   b. $700,000 if defense is within limits.

   c. $1 million if defense is within limits.

   d. $2 million if defense is in addition to limits.

3. Denny, Pool, and Smith (DP&S) currently carry employment practices liability insurance with a $5 million limit. Last year's policy had a $3 million limit, and prior policies had a $1 million limit. All policies had a $10,000 deductible or retention. Four years ago, an employee charged Denny with sexual harassment. Last year another employee brought a similar charge, and a third employee's claim has just been received. According to the related claims provision in DP&S's policy, coverage for these three claims is subject to:

   a. A $1 million limit.

   b. A $3 million limit.

   c. A $5 million limit.

   d. Three separate deductibles/retentions.

4. Hamstrung Insurance Agency is sued by a customer who alleges that Hamstrung's sales representative failed to suggest she purchase collision coverage. The customer, a single mother with two small children, discovered this problem when she was involved in a minor accident in which her car sustained $1,000 in damage. According to the provisions of a typical professional liability policy, Hamstrung is required to voluntarily:
   a. admit liability.
   b. assume its own defense costs.
   c. cooperate with the insurer in defending the claim.
   d. pay damages to the claimant.
5. A television newscast played a video of Hillsboro police officers beating "Trip" Wilson, an innocent person who was apprehended on grounds of suspicious behavior. This incident triggered a decision by Hillsboro officials to purchase police professional liability insurance in case "Trip" decides to press charges. How will the policy provide coverage if "Trip" makes a claim?
   a. The policy will cover Hillsboro if Trip makes a claim after the policy is in effect.
   b. The policy will not cover this incident.
   c. The incident involving "Trip" will be covered, but future incidents of this type will automatically be excluded.
   d. A claim by Trip would be fortuitous.

## *Answers to Chapter 4 Review Questions*

1. d. Independent contractors are generally not covered persons unless added by endorsement for an additional premium.
2. b. The insurer will pay $300,000 in defense costs, leaving $700,000 available to pay damages.
3. a. 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.
4. c. Nearly all PL and EL policies contain clauses that compel insureds to provide "reasonable efforts" to assist the insurer in defending claims made against them.
5. b. Virtually all policies restrict coverage for 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.

# Chapter 5
# The Application Form in Professional and Management Liability Insurance

An application form must be completed by a person (or institution) seeking PL or ML coverage and submitted to an insurer. Information contained within an application is important because it is used by underwriters to decide: (1) whether to insure a given professional liability risk, (2) what coverage terms apply, and (3) at what premium.

## Information Contained in Applications

Applications inquire about several key areas of a professional's practice or business operations. Using a standard application form for architects and engineers professional liability insurance as a model, Exhibit 5.1 provides examples of both the categories of information and the kinds of specific questions contained in applications for PL coverage.

Although no two insurers' application forms are exactly alike (even for the same line of PL or ML coverage) they all require the insured to provide essentially the same information. Whatever differences exist are principally those of form rather than substance. Nevertheless, every insurer has its own application form, and many underwriters are very particular about obtaining information on such forms.

**Exhibit 5.1**
**Information in Professional Liability Applications**
**(For Architects and Engineers)**

| Category | Specific Information |
|---|---|
| **General Company Data** | Firm name, address, type of organization (e.g., partnership, corporation, joint venture), ownership percentages, previous company name(s), predecessor firms, date(s) established, states in which firm is registered or licensed |
| **Nature of Insured's Professional Practice** | Types of design disciplines, kinds of projects, locations, revenues segregated by design or construction, nature of other services performed, major clients, specific projects constituting 10 percent or more of annual revenues, anticipated changes in types of work during the next year, details of joint ventures |
| **Insured's Staff (partners, principals, managers, senior staff members)** | Names, number of years and nature of professional experience, areas of specialization, professional associations to which individuals or the firm belongs, formal education, licenses held in various specialty disciplines |
| **Financial Data** | Current and 3–5 years of income statements/balance sheets, financial institutions where lines of credit have been established (noting specific "line" at each bank and duration of existing credit relationship), latest Dunn & Bradstreet report |
| **Prior Claim History** | Nature of allegations, dates, claimants, open/closed claims, reserved and paid amounts, final disposition |
| **Knowledge of Potential Claims** | Known incidents or circumstances that could, in the future, give rise to claims against the insured, potential claimants, anticipated monetary damages |
| **Prior and Current Insurance Coverage** | Kinds of insurance (both professional and all other liability), policy dates, insurers, limits, deductibles |

## The Significance of the Information within the Application

The information contained within a PL or ML application is significant because (1) the information within the application becomes part of the policy; (2) this information forms the basis upon which a policy is written; and (3) the insurer relies upon the truth of the information within the application.

### *Application Information Incorporated within the Policy*

Information provided within the application becomes part of the policy. This is accomplished by one of two approaches: (1) the application contains wording to the effect that it is incorporated within the policy; or (2) the policy contains language stating that the application will be incorporated within the policy.

### *Application Information Forms Basis upon Which Policy Is Written*

Information within an application is considered by an underwriter to constitute the basis for writing a given policy. Items such as the particular design discipline(s) in which an engineering firm is engaged, its financial statements, and the professional credentials and experience of principals in the firm are the basis of the underwriter's decision to offer coverage. For example, if the application noted that the applicant is a soils engineer, rather than a mechanical engineer, this would produce a higher premium. Or, if the application indicated that the applicant had 20 years' experience, this would produce a lower premium than if the applicant had recently graduated from engineering school.

### *Insurer Relies on Truth of Application Information*

The insurer accepts all statements made in the application as being true. In other words, the coverage granted is predicated on the assumption that the information contained in the application is both correct and complete. If such information turns out to be false or incomplete, the insurer may be able to deny coverage for a specific claim or even void the policy entirely.

## Warranties and Representations

Information contained in applications for professional liability insurance is classified as being either a warranty or a representation.

### *What Constitutes a Warranty?*

Warranties are considered to involve the kinds of critical items that directly affect important elements of coverage, such as breadth of insuring conditions, price, and whether an underwriter would have provided coverage for a particular insured—to any extent—had he or she been aware of a difference in a specific statement contained within the application. For example, an applicant's prior claim record is generally considered to be a warranty. Thus, if an applicant for architects and engineer's coverage stated that he had a $2 million claim made against him during the previous year, this would clearly have an effect on the nature and price of coverage offered. The general rule of warranties is that if an insured makes a false statement with respect to a warranty item—or fails to reveal information that could be considered a warranty— the insurer can deny coverage for a specific loss and/or void the policy entirely.

### *What Constitutes a Representation?*

Representations relate to information that is not critical in determining price and coverage terms or whether a policy will be offered at all. For example, assume that a lawyer is practicing in an office sharing arrangement, whereby he and another attorney share office space but are not partners and are therefore not legally liable for each other's professional's acts (as would be the case in a partnership). On an application form, the applicant attorney checks the box indicating "sole practitioner" rather than checking the box noting "office sharing." In contrast to the example of the applicant for A&E's coverage above, such information would not affect the price and nature of lawyers professional liability coverage offered and is therefore considered a representation. The general rule of representations is that if an insured makes a false statement or omission with respect to a representation, the insurer would not be able to deny coverage for a specific claim and/or void the policy.

### *Warranties versus Representations: The Distinctions Can Blur*

Although these two examples demonstrate clear distinctions between these two terms, there are many situations where the distinctions between warranties and representations are blurred. Case in point: assume an application asks for the number of years a physician has been practicing. The applicant states "10 years" although in reality, she has only been practicing for 5 years. In this situation, some insurers might have charged a slightly higher premium if they knew that the physician had only been practicing for 5 years. On the other hand, a number of other insurers do not make such distinctions in promulgating rates. So the question arises as to whether this is a warranty or a representation.

#### The Materiality Standard

Given the potentially contentious nature of such situations, the distinction between warranties and representations within application forms has become less important in recent years. Accordingly, when an insurer seeks to deny coverage for a claim or void the policy entirely, the key question is not whether a given statement is a warranty or a representation. Rather, it becomes a question of whether or not the statement is material to the risk involved in writing the coverage. The test of materiality is this: if the insurer had received the correct information, rather than what was provided on the application, would it have: (1) declined to cover the risk, (2) covered the risk but at a higher premium, or (3) covered the risk but on different terms (e.g., required a higher deductible or added an additional exclusion)? If any of these applies, a statement can be considered "material."

## Remedies for Providing Material Misinformation or Omitting Material Information

The insurer has available a number of remedies when an applicant provides material misinformation or omits material information within an application for PL or ML coverage. These remedies include: (1) rescission, (2) reformation, (3) cancellation, and (4) nonrenewal.

### *Rescission*

An insurer may rescind a policy if it discovers that the insured gave material untrue or material incomplete answers to questions in the application. If an insurer rescinds a policy, the policy is treated as though it never existed. Upon rescinding the policy, the insurer must return the full premium to the insured.

### *Reformation*

Reformation of the insurance policy is another remedy available to an insurer. Reformation is available when a valid policy does not fully or accurately express the agreement of the parties because of fraud, inequitable conduct, or mutual mistake. When the policy fails to express the parties' intent, a court may reform the policy to express the actual nature of the agreement between the parties. For example, in the above example, where the physician misstated the number of years of her professional experience, an insurer could seek to reform the insurance policy to accurately reflect such experience and therefore charge a higher premium.

### *Cancellation*

Cancellation—the termination of an insurance policy, before its expiration date, by either the insured or the insurer—is available to insurers when there has been a material misstatement or omission in the application. An insurer's cancellation of a policy does not void the policy from its inception, as does rescission. Rather, it takes effect only upon the cancellation's effective date. Thus, an insurer is liable for losses occurring before the cancellation. Upon cancellation, the insurer must return the unearned premium to the insured. For this reason, and especially in certain ML coverage lines, namely D&O insurance, where premiums can be as high as $10 million or more, insurers often seek to cancel a policy rather than to rescind it. This is because when it cancels, an insurer need only return premium on a pro-rata basis rather than return the entire premium (as when it rescinds coverage). For example, if a D&O policy premium was $10 million and the term was 1/1/10–11, if the policy were canceled on 10/1/10, the insurer would only be obligated to return approximately $2.5 million (i.e., 25 percent) of the premium. On the other hand, if it rescinded the policy, the insurer would be obligated to return the entire $10 million premium.

### *Nonrenewal*

Generally, an insurer has the right to decline to renew a policy at the end of the policy period for any legal reason. (Nonrenewal occurs when, at the expiration of an insurance policy, either the insurer or the insured decides not to renew the policy for another term.) However, this right may be limited by provisions in the policy, such as by a notice of nonrenewal provision stating that the insurer must provide the insured with a certain number of days' notice prior to nonrenewal (usually 30 or 60 days).

#### Nonrenewal and the Application

If a new application is required for a renewal policy, material misstatements/omissions in that application may be sufficient to void the policy. On the other hand, if the insured is not required to complete a new application, the insurer's renewal is based on the original application, which can form the basis for nonrenewing the policy. It should also be recognized that some renewal applications specifically state that they incorporate information that was contained within prior applications. If this is the case, material misstatements/omissions in prior applications can also void the renewal policy.

## Miscellaneous Issues Relating to Applications

There are several other issues relating to PL and ML insurance applications, including (1) using the application to give notice of potential claims, (2) severability provisions, and (3) the insured's duty to update applications.

### *Notice of Potential Claims*

Questions regarding the applicant's knowledge of potential claims comprise some of the most critical parts of an application for PL and ML insurance.

#### Notice of Potential Claims in the Initial Application

A typical set of questions reads this way:

> "There has not been nor is there now pending any claim(s) against any person proposed for insurance in their capacity of either Director or Officer of the Corporation.... or its Subsidiaries except as follows: (attach complete details) (if no such claims, check here: _____NONE)
>
> "No person who will be an Insured has knowledge or information of any act, error or omission which might give rise to a claim under the proposed policy except as follows: (attach complete details) (if they have no such knowledge or information check here: _____NONE)

This statement is commonly referred to as the "claim warranty." The question is critical since there will be no coverage for any incidents, circumstances, or situations indicated in the answer to this question, if, in the future, these incidents form the basis for a claim. As a result, it is strongly recommended that if the applicant answers "yes" to any of these questions, the details surrounding such circumstances or incidents should be reported to the applicant's current insurer under the policy's discovery provision. Discovery provisions, previously discussed, allow an insured to report incidents to an insurer that have the potential to result in claims. In the event that such an incident does form the basis of a claim, coverage will be afforded under the policy, regardless of how far in the future a claim is made in conjunction with that incident. Since coverage will not be available under the policy being applied for, it is imperative to secure coverage for such potential claims under the discovery provision of the applicant's current ML or PL policy.

#### Notice of Potential Claims in Renewal Applications

There usually are no claim-related questions (i.e., "does the insured know of any incidents or circumstances that have the potential to give rise to a claim in the future?") on renewal application forms. However, in the unusual event that the question does appear, the insured should make a concerted negotiating effort to remove such a question.

The following example demonstrates why such questions could create a coverage gap for the insured. An insured was covered by Insurer X during the 1/1/06–07 policy period and by Insurer Y during the 1/1/07–08 policy period. The retroactive date on Y's policy is 1/1/07. Assume that on 9/1/07, the insured submits a renewal application for coverage with Insurer X for the 1/1/08–09 period. Also assume that during the previous month, the insured became aware of circumstances that took place during the 1/1/06–07 policy period that have the potential to cause a claim in the future. If the insured indicates on the renewal application that such circumstances could give rise to a claim, no coverage would apply under the 1/1/08–09 renewal policy if a claim from these circumstances is made against the insured during this period. However, since the 1/1/06–07 policy is no longer in effect, it is too late to report these circumstances to Insurer X under that policy's discovery provision. This is because discovery provisions can only be triggered during the policy period. In addition, since the incident took place prior to the 1/1/07 retroactive date applicable under Y's policy, the incident cannot be reported under the discovery provision applicable under Y's policy. This example demonstrates why potential claim questions in renewal policies place insureds in a "Catch-22 situation" that could

produce an unfair coverage denial. For this reason, insureds should strongly resist such questions in renewal applications.

### *Severability Provisions*

Severability provisions in PL and ML application forms state that the policy will not be rescinded for material misstatements in the application, except as to those persons who made the statement or knew such statements to be false. Case-in-point: the CEO of a corporation, in completing a D&O application, intentionally inflates the company's profits for the just-ended fiscal year. However, he is the only director or officer who knew of the misstatement. As a result of the severability provision within the application, if a claim is made as a result of this misstatement, coverage will only be voided as to the CEO, but not as respects the company's other directors or officers, given their lack of knowledge of the CEO's intentional misstatement of material information.

### *Insured's Duty To Update the Application*

The submission of a PL or ML application does not terminate the applicant's obligation to reveal all relevant information that is material to the risk. Therefore, if a change occurs or the applicant discovers new information before the insurer issues the policy, the applicant has a duty to inform the insurer of these changes. If the applicant fails to update the application, the insurer can refuse to issue or void the policy. However, the insured is only obligated to provide such updates prior to the inception of the policy.

## Chapter 5 Review Questions

1. Mac Swamp, an insurance broker, has gathered the information necessary to complete an application for architects and engineers professional liability insurance on X, Y, & Z, Inc. He plans to submit this application to several insurance companies and obtain competitive quotes. To ensure efficient processing of the application, Mac should confirm that all of the following tasks are done *except*:

   a. The application includes a description of X, Y, and Z's professional practice.

   b. The application includes detailed X, Y, & Z company data, including a company history and a description of its ownership.

   c. To make sure all quotes are comparable, Mac should submit photocopies of the same application form to all insurers that will quote the account.

   d. X, Y, & Z's Financial data is included with all applications.

2. In her application for lawyers professional liability insurance, Kelli mistakenly provides her home ZIP code rather than the ZIP code for her office, which is in the same city. How would the insurer likely classify Kelli's misstatement?

   a. It is most likely considered an omission.

   b. It is most likely considered a guarantee.

   c. It is most likely considered a representation.

   d. It is most likely considered a warranty.

3. Because its underwriter misunderstood information provided in the application, which was accurate, a policy issued by Mighty Fortress Insurance Company uses the wrong classification in describing the insured's operations. The policyholder thought the classification seemed a bit strange and reported it to the underwriter who agreed to reform the policy. This means that:
   a. The entire premium will be refunded to the policyowner.
   b. The policy will be revised to include the correct information.
   c. The policy will be treated as though it never existed.
   d. The insurer will grant indulgence to the policyholder and allow the error to stand until the next renewal.
4. The application for Warren Tea's professional liability policy refers to a "claim warranty." Warren's agent explains to him that a claim warranty is:
   a. A cut-through provision that permits the policyholder to proceed directly against the reinsurance company if the primary insurer is unable to pay the entire claim.
   b. A provision in the body of the policy guaranteeing that the insurer will pay claims for a limited time period after which the warranty expires.
   c. An optional endorsement that extends the discovery period.
   d. A question or statement in the application concerning past claims or incidents that might give rise to a claim.

## *Answers to Chapter 5 Review Questions*

1. c. Many underwriters are very particular about obtaining underwriting information on their company's own application form. Mac should not submit photocopies of the same application form.
2. c. Representations relate to information that is not critical in determining price and coverage terms or whether a policy will be offered at all.
3. b. A policy that is reformed is revised to express the actual nature of the agreement between the parties.
4. d. A claim warranty in the application describes potential claims of which the insured knows.

# Chapter 6
# Underwriting Professional and Management Liability Insurance

The key point to recognize concerning the rating of ML and PL insurance is that pricing is not based on manual or filed rates. Rather, these coverage lines are normally rated on the basis of each individual insurer's experience. Thus, determining premium is a subjective exercise, especially in coverage lines for which claim data is based on a small number of insureds and/or the claims data lacks an adequate number of years during which to develop rates.

## Rating Bases

PL and ML policies use a variety of rating bases, depending upon the type of coverage. These differences are explained in more detail within future courses in this series. Following are several examples of how rating bases vary with the specific type of PL or ML coverage line.

Architects and engineers (A&E) professional liability policies are rated per $1,000 of annual professional fees. Lawyers and accountants professional liability policies are priced on a per professional basis (also known as “head count”). EPL policies are rated per employee. D&O policies are priced on the basis of the insured corporation’s assets. Bottom line: the specific rating approach used to price PL and ML policies is a function of the individual type of coverage in question.

## Premiums Are Not Subject to Audit

Few, if any, types of ML or PL policies are subject to audit at the end of the policy period. However, when policies are renewed, appropriate premium adjustments are made for the next policy period, based on changes in staff size and/or anticipated revenue for the upcoming year.

## Modification Factors in Pricing

Insurers use rates that have been developed internally (or, in some cases, they devise rates based on industry claim experience). In either case, rates are typically subject to a number of modification factors. Some of these factors are specific to individual professions and are discussed in subsequent courses within this program. In contrast, others are generic and, in many instances, apply across the board to numerous professions. These generic factors are discussed below.

### *Professional Specialty*

The specialty in which a professional practices is perhaps the most important rating factor. There is a significant variation between the potential frequency and severity of claims across different practice disciplines within the same profession. For example, gynecologists pay a much higher rate for coverage than do dermatologists. Similarly, attorneys who specialize in Securities and Exchange Commission (SEC) work are subject to higher premiums than lawyers whose practices are limited to trusts and estates work. High tech companies pay a higher premium per dollar of assets for D&O coverage—compared to manufacturing companies—because high tech firms are much more likely to be involved in securities class action lawsuits.

### *Mix of Professional Specialties/Services*

Many professional organizations are made up of individuals who specialize in a variety of practice areas. Thus, the overall "mix" of services provided by such firms also affects premium levels. For instance, an accounting firm that receives 80 percent of its fees from bookkeeping work will pay a much lower premium than one for which annual fees are equal but are generated from a corresponding percentage of audit work, an accounting specialty that tends to generate a much higher frequency and severity of claims.

### *Practice Location*

Professionals in certain regions of the country generate higher frequency and severity claim rates than those working in other locations. In certain locations, their clients hold professionals to higher performance standards, and are therefore more inclined to sue. Moreover, jury awards in these areas tend to be relatively higher than in other regions. All other things being equal, professionals working in larger metropolitan areas and heavily urban states (e.g., New York, California, Illinois) pay higher rates than those practicing in states with lower urban concentration (e.g., West Virginia, South Dakota, Mississippi).

### *Type of Client*

Large corporate clients have a greater propensity for suing professionals than do relatively smaller ones. In addition, professionals serving large corporations are often sued by so-called third-party plaintiffs, that is, parties who were financially injured as a result of the services the professional provided to its client corporation. For example, creditors and shareholders of Enron Corporation have brought massive lawsuits against Arthur Andersen (Enron's accounting firm), as well as against the law firms that represented Enron, alleging that these professionals failed to detect Enron's fraudulent business practices, which, in turn, caused these creditors and shareholders to suffer losses. Thus, professionals whose clients are mainly large corporate organizations pay higher rates than do professionals whose clients are individuals and small businesses.

### *Years of Professional Experience*

The extent of a professional's experience is an important factor in rating PL insurance coverage. Thus, a person who opens a solo law practice a year out of law school will probably be surcharged. On the other hand, if two lawyers who had each been partners at a large law firm for 20 years were to start a partnership, such a surcharge would not be imposed. Similarly, a start-up corporation will pay a higher D&O premium, relative to its assets, compared to a company that has been in business for many years.

### *Education and Training*

An underwriter's perception of an insured's education and training will affect the rate charged for PL insurance. For example, doctors who have received degrees from foreign medical schools and accountants with less than a year of experience would, for example, ordinarily be surcharged.

### *Prior Claim History*

As respects prior claim history, underwriters are typically more concerned about frequency than severity. A frequency problem, as evidenced by a proclivity for being sued or committing repeated professional errors, is more an indication of incompetence than is a single major claim in which bad luck, rather than gross negligence, produces a high dollar loss. For example, the typical insurer would be more likely to cover a surgeon whose one error during the past decade resulted in a patient's death and a million-dollar claim, than a surgeon who has had six smaller claims made against him during the same period of time. In addition to charging a higher-than-usual premium as a result of a poor claim record, insurers also sometimes impose larger-than-normal deductibles/retentions on a professional seeking coverage. Situations where a professional's claim record is especially problematic will sometimes cause the outright rejection of a request for coverage. (When PL/ML underwriters review an account, they take particular note of what the professional now does differently or what substantive changes have been made in his or her practice , to prevent large losses in the future.)

### *Continuity of Insurer Relationships*

Underwriters are wary of professional firms that have a history of changing insurers frequently. Instability of insurer relationships could mean the insured is a "price shopper," in which case, insurers will often be reluctant to even provide a quotation.

### *Policy Limits*

From an actuarial standpoint, higher limits expose underwriters to higher potential loss payments. However, the cost per unit of coverage drops substantially at the $1 million annual aggregate level. This is because of two factors. First, there are underwriting economies of scale once a policy limit reaches a certain point. In other words, the cost of underwriting a policy with a $2 million limit is not twice that of underwriting one with a $1 million limit. Second, the higher a policy's limit, the lower the probability that a given claim (or series of claims) will exhaust that limit. Nevertheless, firms with higher coverage limits will, of course, pay more total premiums than firms with lower limits (even if their cost per $1,000 of insurance is lower).

### *Deductible/Retention Level*

The larger the portion of each loss that a firm is willing to self-insure, the lower the probability that an underwriter will be called upon to participate in a loss that contributes to the payment of indemnity and defense costs. This, of course, reduces premium rates. Higher deductibles/retentions also provide the insured with added incentive to control losses, which is why underwriters look favorably on firms that are willing to accept more than minimal deductibles available.

### *Extent of Prior Acts Coverage*

Most PL and ML policies provide prior acts coverage, especially for individuals and firms who have coverage in place at the time that they change to a new insurer. Policies covering prior acts cover claims from acts that took place on or after the date on which continuous professional or management liability coverage was first purchased. The further back in time prior acts coverage is provided, the greater the underwriter's exposure to claims. Premium will therefore be affected by the number of years for which prior acts coverage is granted.

### *Loss Control Programs*

An underwriter's perception of a given PL or ML risk will be influenced by the extent to which the applicant for coverage has implemented a robust loss control program. Coverage submissions that are accompanied by written documentation of such programs will normally receive special, positive consideration. In some cases, an insurer's rating structure will grant premium credits (generally from 2 percent to 5 percent) when an insured (or members of the insured's firm or professional practice) has completed specific, loss-control-oriented coursework.

### *Competition*

However tight the insurance market may be (in general or for a specific line of coverage), insurers are always interested in writing a handful of so-called "good" accounts. Profitable, well-established professional firms and corporations with favorable loss experience and strong claim control programs are usually granted preferred pricing and coverage terms—especially when other insurers are also competing for the business.

### *Broker Representation*

The ability of an insured's broker to "sell" a risk also plays a role in PL and ML insurance pricing. This is especially true in cases where there is a long-standing and successful relationship between the insured's broker and the underwriter. The total premium volume written through a particular agent or broker, as well as the agent/broker's loss ratio on business written for the insurer, can also significantly influence premiums.

## Chapter 6 Review Questions

1. Walter, an accountant, is wondering how professional liability insurance policies are rated. When he asks Ursula Underwriter, she tells him:

   a. A given accounting firm is rated on the same basis as other accounting firms, regardless of the firm's mix of services.

   b. Professionals in some states tend to be charged lower rates than those in other states.

   c. Professionals whose clients are mainly large corporate organizations generally pay lower rates than professionals whose clients are individuals and small business.

   d. Underwriters charge higher premiums to clients that require high retention levels.

2. An underwriter is likely to reduce Sandborn Maternity Hospital's professional liability insurance costs if Sandborn does which of the following?
   a. Accepts a later retroactive date.
   b. Accepts an earlier retroactive date.
   c. Provides an accurate claims history.
   d. Provides no evidence of loss control program.

## *Answers to Chapter 6 Review Questions*

1. b. Professionals working in states with lower urban concentration pay lower rates than those in heavily urban states.
2. a shorter period of time for which priors acts coverage is provided gives the underwriter less exposure to claims.

# Chapter 7
# Professional and Management Liability Risk Control

Despite the fact that professionals or professional organizations have purchased liability coverage for their activities or services, they are nevertheless exposed to a number of potentially uninsured losses when a claim is made against them. The following pages analyze the nature of these losses and provide suggestions for reducing the exposures to claims in which errors or omissions are alleged against a professional or corporation.

## Reasons for Risk Control

Professionals and corporations have multiple incentives to reduce the incidence of claims made against them.

### *Damage to Professional or Corporate Reputation*

PL and ML claims, are, by their very nature, an assertion that a professional's or corporation's work failed to meet the standards required by the profession or industry. Claims can damage a professional's or corporation's reputation, which has three important negative consequences: (1) inability to obtain repeat business, (2) inability to obtain referrals, and (3) damage to corporate reputations. One specific problem encountered by "institutional" professional risks is that claims against them make it more difficult to locate the kinds of highly experienced businesspeople who would be willing to serve on the organization's board of directors.

### *Disruption of Internal Productivity*

Despite the availability of funds from an insurer to pay settlement and legal costs, the process of defending claims requires professionals and executives to burn up considerable time and effort. Internal examination and analysis of the work that caused a claim, depositions, strategy meetings with insurers and attorneys, attendance at trials, and extended settlement conferences require the expenditure of substantial resources. While the approximate dollar cost of a professional's or corporate executive's time can generally be measured, the demoralizing effects of claims are not only much more difficult to measure, but, depending upon the situation, can sometimes prove equally if not even more costly. Take, for example, the morale problems that result when a manager must assist in the defense of a sexual harassment claim made against him by one of his employees. Productivity in the affected department will be impaired for the duration of the period in which the claim is pending and may, in fact, never return to its prior level even after the claim is resolved, given the loss of trust between the manager and his employees, owing to the litigation process.

### *Absorption of Deductibles/Self-Insured Retentions*

Since PL and ML policies are normally written with deductibles/self-insured retentions, the insured will almost always be required to bear some portion of every claim, even in situations where the professional or corporation is completely absolved of liability. For example, assume a law firm is sued but the case is dismissed on a summary judgment basis. Also assume that the law firm maintained a $10,000 deductible under its PL policy. In this situation, it is likely that the defense costs required to obtain the dismissal approximated $10,000, costs that were paid for entirely by the insured—rather than by the insurer.

### *Future Premium and Deductible Level Increases*

PL and ML insurance is not rated on a formalized experience basis. Rather, underwriters price policies using a number of rating factors but do not apply a specific "experience modifier," as is the case with workers compensation or general liability insurance. However, in the long run, premiums are significantly affected by an insured's loss ratio. Absent a favorable loss record, an insured faces almost certain future premium and deductible increases, especially in hard insurance markets.

### *Avoidance of Cancellation or Nonrenewal*

A favorable loss record is necessary to forestall the possibility of having a PL or ML policy canceled or nonrenewed. This is especially important because almost all types of ML and PL coverage is written on a claims-made basis. Although insurers normally provide insureds with the opportunity to buy extended reporting period coverage when the insurer initiates the cancellation or nonrenewal, such endorsements are usually expensive. Alternatively, when a replacement insurer agrees to provide full prior acts coverage (thereby eliminating the need to buy an extended reporting period endorsement), such a concession is normally reflected by a higher level of premium charged.

### *Exclusion of Coverage for Certain Claim Types*

If an insured has had previous claims of a certain type made against it, there is a possibility that under future policies, such claims will now be excluded. For example, if a D&O insured is sued based upon a restatement of its financial data, it is very possible that under future D&O liability policies, that the insurer will now exclude coverage for financial restatement claims.

### *Cost of Potential Insurer Insolvency*

Even if a claim is covered under the terms of a PL or ML insurance policy, there is no guarantee that the insurer will have the financial ability to pay settlement and defense costs on the insured's behalf. This is especially true considering the long tail that characterizes PL and ML claims. Under such circumstances, an insurer that was solvent at the time a policy was written may be in a much different position 10 to 15 years later, when a claim is finally settled. Case-in-point: up until only a year or two prior to its bankruptcy, Kemper had been one of the country's most stable and respected professional liability insurers.

### *Inability To Offer Competitively Priced Services*

Liability insurance costs are a major cost component in most kinds of professional practices and corporations. Thus, professional firms, individual practitioners, and corporations unable to control risks will be adversely affected by premium increases that must be built into the firm's or the practice's cost structure. Ultimately, this makes it more difficult to offer professional services or products at competitive prices.

### *Reduced Coverage Availability*

Availability crises have long been a fact of life in PL and ML insurance. When such crises make coverage more difficult to obtain, firms with poor claim histories will be more adversely affected in terms of premium levels and breadth of coverage offered, compared to those with good loss records.

## Professional and Management Liability Risk Control Techniques

While the activities of lawyers, doctors, accountants, architects, corporate executives, and other professionals may vary significantly, many of the business operations associated with these professions are essentially the same. Consequently, there are a number of risk control measures that pertain equally well to all types of professions and corporate organizations. Universally applicable risk control techniques are discussed in this section. Risk control approaches relevant only to specific professionals or specific types of ML coverage are discussed in other courses within this program.

### *Develop a Clearly Defined Scope of Services*

Professionals should develop standard forms describing the exact nature of their intended services in plain, unambiguous language. Adherence to these guidelines will assist in providing a strong affirmative defense if a client alleges that the professional has not lived up to prior commitments, which in fact, may never have been made at any time.

### *Commit Oral Agreements to Writing*

A great many misunderstandings (which later become formal claims) can be avoided if written documentation is created and retained. This is especially important when the verbal instructions involve (1) changes in the initially agreed-upon scope of services, (2) changes in the original fees for those services, and (3) instructions from clients which give the professional the authority to pursue a specific course of action on the client's behalf (e.g., allowing an attorney to accept any settlement offer of $100,000 or more).

### *Document All File Activity*

Thorough, accurate file documentation will often provide a professional firm with its strongest single piece of evidence that services were properly performed. Documentation is so important that, in some firms, the detail with which professional employees record their activities in client, case, or project files is considered in periodic performance reviews. Such documentation also assists in preventing/mitigating D&O liability claims, wherein careful recording of conversations and decisions made at board of directors meetings can be similarly effective in defending claims. Finally, documentation in the form of thorough information within employee personnel files is also useful in refuting allegations of wrongful employment practices.

### *Conduct Peer Reviews*

Although the peer review process requires expending considerable time and effort, the long-run cost savings produced by avoiding claims can be meaningful. Accordingly, peer reviews should be conducted on every major engagement, with the work being reviewed by at least one professional who did not personally perform it. In larger organizations, it is a common practice to describe the procedures for peer review in a formalized quality control manual. Such documents note the types of work to be peer reviewed, and are distributed to and discussed periodically with all professional employees. Peer review is especially important on large-scale service projects in which the bulk of the work has been performed by less experienced members of a firm.

### *Maintain Reasonable Workloads*

Stress caused by unreasonable workloads can produce professional errors. Accordingly, professional firms should continually evaluate and maintain reasonable levels of work per individual. An overload of clients, files, or projects can cause the kinds of undue stress, fatigue, or even depression which ultimately lead to mistakes. To counteract this tendency, some professional firms periodically review workloads in an effort to ensure a fair division of labor. Others actually require that firm members and employees take a minimum number of vacation days each year.

### *Consult Specialists If Necessary*

On projects, cases, and engagements that are outside the professional's area of expertise or are especially complex, the possibility of hiring an outside firm or expert to review the work should be considered. Practice areas within many professions are becoming increasingly specialized. Thus, consultation with practitioners who concentrate in a more narrowly defined specialty is often necessary to avoid allegations that the professional's services were not in keeping with state-of-the-art practices. Similarly, there will be situations in which a professional, given a complete lack of expertise in an area required by a potential client, would be prudent to refer the person to another professional or simply forgo the opportunity to provide services.

### *Conduct Quality Control Audits*

Claims can sometimes be prevented by periodic audits of a firm's operations. For example, once each year, an outside consultant might review an insurance agency's files and processing procedures. Audits of this type can be conducted by either internal or external personnel in an attempt to discern specific problems regarding ongoing work or as respects general professional practices and methods. Some insurers believe that audits of this kind are extremely valuable, and, in certain situations, they may grant premium credits to firms that undergo such audits on a periodic basis. In some cases, insurers will only write coverage on a firm subject to a satisfactory audit. In other instances, insurers provide their insureds with audits as a so-called "value added" service. (This approach is most common among insurers writing EPL insurance.)

### *Encourage Continuing Professional Education*

Depending on the individual profession, in many states a stipulated minimum annual number of hours of continuing education must be completed for a professional to maintain certification in his or her specialty. However, many individual professional firms go beyond such requirements and mandate even higher levels of continuing professional education. Continuing education exposes professionals to the latest advances in their field, thereby reducing the possibility for errors in performing their work, as well as assisting in defense of claims alleging that their work did not meet state-of-the art standards. A number of insurers' professional liability application forms ask specific questions regarding the extent to which professionals within a firm pursue continuing education activities.

### *Avoid Making Warranties or Performance Guarantees*

Claims against professionals frequently emanate from allegations that they breached express warranties in performing their services. Whenever possible, professionals should not provide any statements, either orally or in writing, that could be construed as warranties concerning their work. Nor should professionals guarantee a specific outcome or result with respect to their proposed services. Often, claims arise because a professional generated false client hopes that were not realized

at the conclusion of an engagement or service—even though the work was performed in a highly professional manner.

### *Require Alternative Dispute Resolution Approaches*

Where possible, professionals should attempt to insert provisions in contracts with clients requiring both parties to seek resolution of disputes by mediation or arbitration, prior to filing a lawsuit. Problems resulting from professional services can often be resolved by mediation (or other alternative dispute resolution techniques) rather than resorting to formal litigation, which is almost always more expensive and time-consuming. Moreover, a few insurers provide premium credits to insureds whose standard contract requires that clients submit disputes associated with the professional's work to alternative dispute resolution, rather than the standard—and much more costly—litigation process.

### *Screen New Clients*

Some organizations/individuals are more prone than others to sue or be sued. Persons and firms that are heavily leveraged will generally be more inclined to make a claim against a professional than those that are not. Similarly, professionals should think twice about establishing a professional relationship if it appears that the client will have a problem paying for services. Professional organizations should avoid working with those who have sued other professionals in the past, because this indicates a pattern likely to continue.

### *Negotiate and Explain Fees in Advance*

Many suits against professionals result from misunderstandings about fees—some of which would have been avoided if early clarification had been provided. Therefore, fees should be discussed in detail during the initial client meeting. Although it is often difficult to propose a fixed price for many types of services at the outset of a professional relationship, the basis on which fees are computed should be explained (e.g., the professional's hourly rate). Depending upon the circumstances, it is sometimes a good idea for a professional to request a retainer once a client has decided to engage the professional but before the actual work or service has commenced. A client's inability or unwillingness to provide such a retainer could indicate that the client will have future difficulties in paying for services—or might predict other kinds of problems—if the relationship continues.

### *Bill Clients Monthly and Discuss Payment Problems with Them*

Aside from simply being good business practice, timely fee collection is also helpful in preventing lawsuits. Often, late payments can be early warning signs of client financial problems—the kind that increase the likelihood that the client will bring a lawsuit against the professional. If there is dissatisfaction with the nature of the work (or the size of the fee), frank discussion is the best way to resolve the problem. Early interaction could reveal that services were not initially up to standard, but are rectifiable nonetheless. On the other hand, failure to pay could indicate that the client is having financial problems, in which case, an extended payment plan should be discussed.

### *Keep Clients Informed with Periodic Status Reports*

A lack of communication sometimes makes clients feel that the professional has been lax in making sufficient efforts on their behalf, despite the fact that the inherent nature of the process—rather than lack of effort—is responsible for delays. For example, to an injured plaintiff, personal injury lawsuits involve seemingly interminable delays, despite the best efforts of attorneys. Regular progress reports can avoid claims produced by client dissatisfaction caused by extended resolution periods in such

situations. Accordingly, it is usually a good idea to "copy" a client on correspondence and on documents that relate to services being performed on his or her behalf.

### *Avoid Conflicts of Interest*

Obvious conflicts of interest are relatively easy to identify (e.g., an attorney should not represent both parties in a divorce). The difficult problems, however, are those in which conflicts of interest are more subtle. For instance, if a senior partner of an accounting firm has a close personal relationship with the chief executive officer of a major competitor of one of its audit clients, this may or may not compromise the firm's independence. Conflicts of interest should also be avoided with respect to selecting persons to serve on corporate boards of directors. For example, if a pharmaceutical corporation provides a substantial annual donation to a medical research foundation, the director of the foundation should not be asked to serve on the corporation's board.

### *Preserve Client Confidentiality*

It is always important to preserve the confidential nature of the client-professional relationship. Even in situations where it is common practice to release client-specific information to third parties, clients should be advised and requested to "sign off" when professionals receive such requests. Claims involving breaches of confidentiality are especially prevalent with respect to the medical professions.

## Chapter 7 Review Questions

1. As a result of recent shareholder claims against Bear Witmey's Board of Directors, all the following are likely to occur, *except*:
   a. Premiums on future policies will increase.
   b. Bear Witmey's D&O policy will not be renewed.
   c. Bear Witmey's current D&O policy will be canceled.
   d. The insurer that issued Bear Witmey's D&O policy will become insolvent.
2. Which of the following describes a sound risk control practice applicable to most professionals?
   a. Avoid documentation practices that fail to create a paper trail.
   b. Avoid peer reviews that might identify quality control problems.
   c. Avoid precisely describing the professional services the professional will provide, thereby reducing the likelihood of claims based on a failure to meet commitments.
   d. Avoid written agreements, to avoid claims based on a failure to live up to those agreements.

3. Charlotte used to bill her professional clients upon completion of an engagement but now bills all clients monthly. She believes a monthly billing is helpful in preventing lawsuits because:
   a. A dissatisfied client is likely to pay the bill and cancel the engagement.
   b. Deferred payment plans work for tangible products but are never a good idea for services that cannot be repossessed.
   c. Late payments can signal that a client is financially stable and unconcerned about his or her credit rating.
   d. They provide a frequent opportunity to gauge client satisfaction and address problems before they get out of hand.

## *Answers to Chapter 7 Review Questions*

1. d. The insurer may become insolvent at some point, but it is unlikely that they insolvency will directly result from one policyholder's claims.
2. a. Thorough, accurate file documentation will provide a professional firm with its strongest single piece of evidence that services were properly performed. Creating a paper trail is important.
3. d. Frank discussion can often resolve problems if they are detected early enough. Monthly billing helps detect and open up discussion of potential problems.

# Chapter 8
# Professional and Management Liability Claims Management

Professional liability claim management is a unique area of insurance claim responsibilities. Adjusters managing professional liability claims must adopt a different perspective compared to that employed when handling other types of claims.

## Unique Management Aspects

Professional liability claims analysis and resolution is more man-hour intensive than most other lines of insurance. While a competent claims adjuster can conduct field investigations of several routine claims per day, this is not the case in the professional liability arena. Investigating a single claim and meeting with an insured can last the better part of a day—or more—depending on the complexity of the claim, the profession involved, and the amount of documentation that needs to be reviewed. In contrast, general liability or workers compensation claims typically require relatively little field documentation because often the claim arises out of a simple error or accident, such as a slip-and-fall on a wet floor. These types of claims do not have the factual complexity associated with them as do professional liability claims. While general liability claim departments may allow examiners to have 250 (or more) claims on active diary, it is not uncommon for an insurer to limit professional liability claims to 150 or fewer per adjuster.

### *Settlement Sensitivity*

Adjusters and attorneys handling PL and ML claims must also reorient their thinking as respects settlements. Although first-call settlements and expedited claim resolutions are popular in concluding automobile and premises liability claims, this mind-set can be disastrous in handling professional liability losses. Indeed, PL and ML claims are sensitive, since they deal with reputations. Further, as already noted in this course, virtually all PL and ML policies require the insured's consent to settle. Resolving claims without permission may expose the insurer or adjuster to what is known as a "bad faith" claim from the policyholder.

### *Professional Liability Claims Adjusting: A Specialized Area*

It is also important to select an investigative adjusting service or third-party administrator (TPA) skilled at handling professional liability claims. This is easier said than done, however, because few adjusting companies fit the bill. Professional liability loss adjustment is a specialty. The ordinary independent adjusting service (or adjuster) receives such an assignment only once in the proverbial blue moon. Nor is such expertise a skill necessarily transferable from one type of professional

liability loss to another. While certain principles of professional liability claims management are generic, the nuts and bolts of claims handling and investigation are not. For example, proficiency in adjusting architects and engineers liability claims does not necessarily translate into skill in handling a medical malpractice lawsuit or a shareholder suit against an accounting firm that supposedly botched a financial audit.

## The Use of Attorneys

Due to the specialized nature of professional liability claims, coupled with the scarcity of professional liability expertise among adjusting firms, a number of insurers designate attorneys—in-house or outside counsel—to handle professional liability claims. Some programs restrict professional liability claims handling to adjusters holding law degrees. For example, the American Psychiatric Association operates a professional liability program for member psychiatrists. Most of its claims staff consists of in-house attorneys.

### *Outside Counsel Selection*

In addition to the adjuster who is either employed by the insurer or an independent adjuster who represents the insurer, professional liability claims also usually require the hiring of outside defense counsel. Selecting counsel is a critical decision because defending professional liability claims is a demanding specialty; an all-purpose insurance defense firm, popular with many insurers, may not be the best choice for defending a professional liability case. Failure to select counsel with expertise and experience in defending such claims may hamper the defense of the professional, raise defense costs, and even expose the insurer or claims manager to professional liability for inept claim handling.

## Unique Coverage Issues

Frequently, PL and ML claims raise issues of insurance coverage. Sources of concern over "gray areas" of coverage include the following.

- Demands for punitive damages when the PL/ML policy excludes them, or, if the jurisdiction in which the claim is made, as a matter of public policy, does not allow an insurer to pay punitive damages claims.
- Allegations of fraud, assault, criminal acts, or intentional acts which might exclude coverage for the claim.
- Coverage conflicts when intentional conduct precludes coverage for one, but not all insured persons. This is an especially acute problem in D&O claims, when one or more insureds have committed fraud, and other "innocent insureds" must be defended.
- Situations in which some, but not all, allegations that are part of a claim, are covered by the policy.
- Coverage trigger issues, involving questions as to which claims-made policy, in a series of policies, is responsible for covering a claim.

## Diminishing Limits Issues

Another key issue associated with PL and ML claims management is the problem of diminishing limits. Given the fact that the expenditure of defense costs reduces policy limits under PL and ML forms, both defense counsel and the insurer must keep the insured adequately informed as to the amounts of: (1) defense monies already expended, (2) future, anticipated defense expenses, and (3) remaining limits. Defense counsel must be especially sensitive to this issue since failure to communicate with the insured on such matters could lead to a bad faith allegation by the insured against the insurer and a professional liability claim against the defense attorney.

### *To Whom Does Defense Counsel Owe Its Primary Allegiance?*

It has long been held that defense counsel, although retained by the insurance company, owes its primary duty and obligation of professional services to the client-insured, which is traditionally defined as being the policyholder—not the insurance company paying the attorney's bill. Thus, defense attorneys must demonstrate that in providing a full and complete defense to the policyholder, they did not wastefully incur expenses in defending the policyholder, thereby reducing remaining policy limits. However, exercising this duty has the potential to create a conflict of interest between the insurance company, defense counsel, and policyholder and is sometimes the source of significant claim problems disputes.

## Communication Issues

As already noted, excellent communication between the claims department and the policyholder is needed so that the policyholder is kept abreast of what is occurring and what decision-making process is taking place behind the scenes. In addition, it is usually necessary for the insurance company to seek the insured's assistance and input during settlement negotiations. Moreover, as has already been discussed, the policyholder has the right to make the decision as to whether or not a nuisance settlement—or any settlement—should be agreed upon with a claimant, or, alternatively, if the claim should be defended. Whether of the nuisance variety or not, the insured must be kept fully informed of all developments relevant to the claim, especially in those instances where policy language requires his consent to settle (which is the case under the vast majority of PL and ML policy forms).

## Trial Strategy Issues

Additional diminishing limits problems often arise when proceeding to trial. Such controversies occur when, on the eve of a trial, reserves set aside to pay a given claim, exceed the available remaining policy limits. Under these circumstances, there may not be enough money available to pay both an adverse verdict and defense counsel's fee. Complications could also result if defense counsel seeks a guarantee of payment for its legal services from the insurer in the event of an adverse verdict exceeding the remaining policy limits. Since, under such circumstances, the insurer is effectively being asked by defense counsel to increase the limit of the policy covering the claim, this is yet another situation that is ripe for controversy.

A final problematic trial strategy scenario arises if the insurer refuses to make such a guarantee, prompting counsel's withdrawal on the eve of trial. Certainly, numerous bad faith and professional liability exposures could arise. This scenario becomes even more complex when there are other, unrelated, claims pending against an insured that also involve the applicable policy and its limits. In this situation, the outcome of the claim proceeding to trial could affect the availability of future funds for payment and defense of these other pending claims.

## Settlement Issues

Claims professionals must practice the art of "selling" when communicating the wisdom of settlement to reluctant professionals. When reputations are challenged, emotions run high. There is a tendency for insured professionals to want to "fight all the way to the Supreme Court." Accordingly, attorneys and adjusters must explain tactfully, but forcefully, why settlement is often prudent: the jury sympathy risk, the possibility of a runaway verdict, the attendant negative publicity, and the continued drain on the professional's time and energy that must be expended in defending the case.

## Chapter 8 Review Questions

1. As compared with other liability claims, professional liability claims generally:
   a. Can be settled more quickly.
   b. Can be settled without consulting the policyholder.
   c. Require less of an adjuster's time because facts are clearly documented.
   d. Require more of an adjuster's time due to their complexity.
2. Determining coverage for professional and managment liability insurance claims frequently involves all the following "gray areas" *except:*
   a. Whether coverage applies to a punitive damages award.
   b. Allegations of wrongdoing that might preclude coverage.
   c. Which of a series of claims-made policies is triggered.
   d. Situations in which all allegations are within the scope of coverage.
3. With respect to the settling of a claim, how much communication should there be between the claims department and the professional liability policyholder (insured)?
   a. In most cases, the policyholder need not consent to any settlement unless the amount exceeds policy limits. So the claims department need not be in contact with the insured.
   b. The claims department should keep the policyholder abreast of any behind-the-scenes decision making process.
   c. The policyholder's assistance and input is rarely needed during settlement negotiations. So the claims department need not be in contact with the insured.
   d. To avoid collusion, the claims department should withhold settlement details from the policyholder until the claimant has agreed on an amount that will settle the claim.

### *Answers to Chapter 8 Review Questions*

1. d. Professional liability claims analysis and resolution is more man-hour-intensive than most other lines of insurance, and investigating a single claim can last the better part of a day—or longer.
2. d. Situations in which all allegations are within scope of coverage may involve questions of fact but present no gray areas of coverage.
3. b. Excellent communication between the claims department and the policyholder is needed so that the policyholder is kept abreast of what is occurring.

# Chapter 9
# The Professional Liability and Management Liability Insurance Marketplace

Although many types of PL and ML insurance coverage are written by admitted insurers in the "standard" marketplace, a great deal is also provided by a variety of so-called alternative markets. These markets include: excess and surplus lines insurers, insurance exchanges, captives/risk retention groups, and risk purchasing groups. This chapter will examine these types of markets.

## Excess and Surplus Lines

*Admitted insurers* are licensed by regulators in a given state to do business in that state. They are required to make rate and form filings in accordance with that state's insurance laws. Admitted insurers comprise the so-called "standard" market.

In contrast, *nonadmitted insurers* are insurers that are neither licensed nor registered to do business in a given state. (These insurers often write unusual or "niche" business typically not subject to as much insurance regulation as are other types of coverage.)

However, many states have what are known as "white lists" of excess and surplus lines insurers who are approved to write coverage in their jurisdictions. Nonadmitted insurers are part of the excess and surplus lines insurance market and can also sometimes called "nonstandard" insurers.

### *The Need for Excess and Surplus (E&S) Lines Insurance*

The types of risks typically insured in the excess and surplus lines marketplace can usually be categorized as substandard risks, e.g., risks with adverse loss experience, unusual risks, and risks for which there is a shortage of capacity within the standard market.

PL and ML insurance involves unique risks. During the 1970s and 1980s when capacity in the standard marketplace for such coverage was limited, PL and ML coverage was frequently written in the excess and surplus lines marketplace. Now, however, there is abundant capacity, and the standard market has accommodated the types of risks that were once the domain of the E&S market.

### *The Excess and Surplus Lines Market*

Despite the overall soft insurance market, the domestic excess and surplus lines insurance market continues to grow, albeit slowly. Most of the growth in surplus lines during the past several years has been in professional lines. Specifically, this growth has been in two areas: first, in a variety of new miscellaneous errors and omissions (E&O) classes of business and second, in employment practices liability coverage.

### *The Regulatory Environment for Excess and Surplus Lines*

Excess and surplus lines markets are characterized by freedom from regulation, which has two effects: (1) insurers can set premiums for coverage as they see fit and (2) they can offer policy forms on a nonstandardized and often case-by-case basis.

If such coverage were written in the admitted marketplace, underwriters would be forced by state insurance codes to adhere to a more standardized rating methodology and to use only policy forms that have been filed with state regulators. In contrast, the minimal regulation of the excess and surplus lines marketplace gives PL and ML liability underwriters the flexibility they need to write specialized lines of coverage. In fact, many lines of PL and ML insurance would probably be unavailable if this marketplace did not exist.

Although the excess and surplus lines market is basically unregulated as respects forms and rate filings, state surplus lines laws do affect, among other things, taxation, licensing, and what companies are permitted to write insurance on a nonadmitted basis in that state.

### *Distribution System for Excess and Surplus Lines*

The marketing structure for excess and surplus lines is unique in that such coverage is often sold by wholesalers. In standard lines of insurance written through the American agency system, a retail agent generally operates as an intermediary between the insured and the marketplace. However, in the excess and surplus lines marketplace, a wholesaler often acts as an intermediary between the retail agent and the insurer(s) and has no direct contact with the insured.

#### Types of Wholesalers

Wholesalers can be classified into two categories: the wholesale surplus lines broker and the managing general agent.

The *wholesale surplus lines broker* (usually called a surplus lines broker) works with the retail agent and the insurer to procure insurance for the retail agent's client-insured. However, surplus lines brokers do not have underwriting or binding authority from the insurer(s) with whom they deal. Surplus lines brokers may work independently of the insurers with whom they place coverage or they may be owned by the surplus lines insurer.

The *managing general agent (MGA)* also acts as an intermediary, but has the authority to produce and underwrite business for certain insurers. MGAs perform certain functions ordinarily performed only by insurers, such as binding coverage, underwriting and pricing, appointing retail agents within a particular area, and handling claims.

#### The Need for Wholesalers

The question often arises as to why a wholesaler is needed in the excess and surplus lines market, since, as some believe, this intermediary adds unnecessary cost to the insurance product. In recent years, some excess and surplus insurers have bypassed the wholesaler, instead, marketing directly to

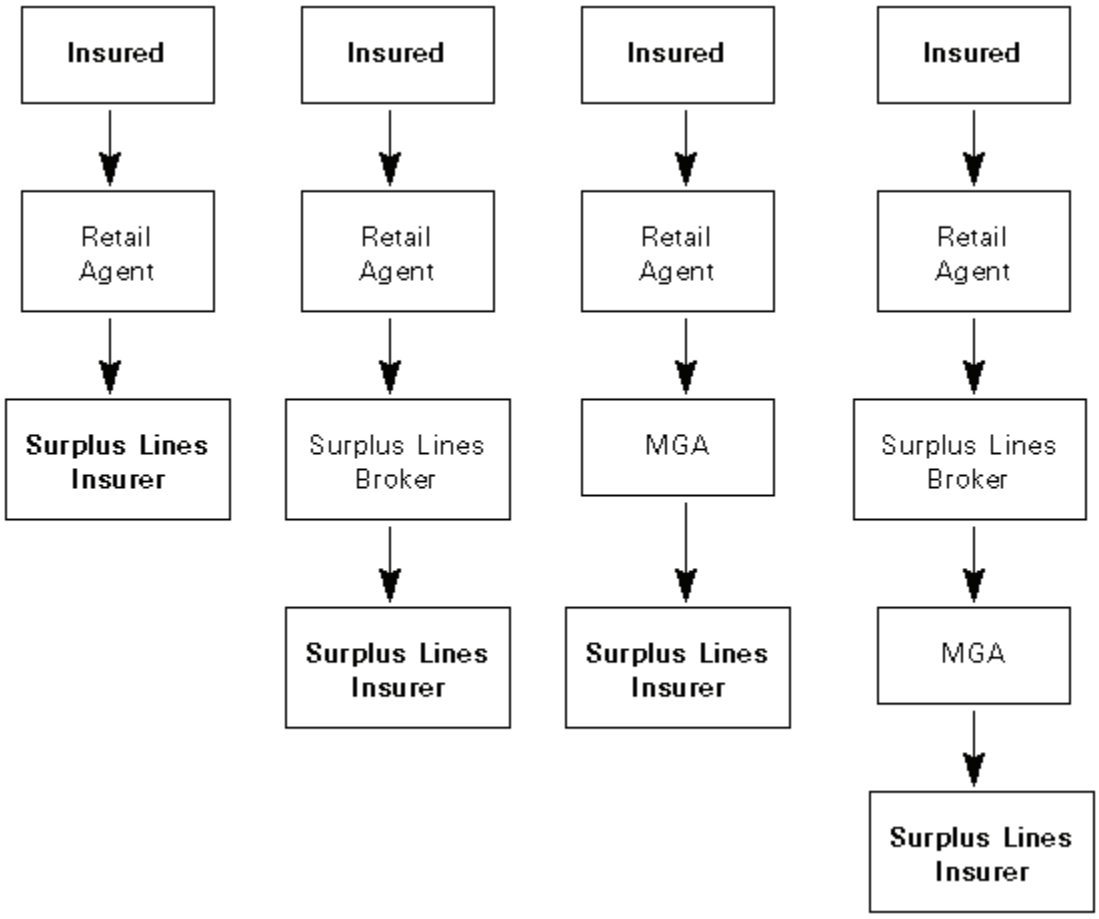
the retail agent. However, the inherent specialization of the surplus lines market helps explain the necessity of wholesalers, which are usually staffed by individuals with expertise in particular classes of business.

Many retail agents do not work with certain lines of professional liability insurance frequently enough to develop a significant amount of expertise in these lines. A knowledgeable wholesaler can provide these agents with the expertise to write accounts they would otherwise be unable to handle properly. The wholesaler can help prepare a professional underwriting submission, identify markets to approach, analyze the coverage quoted, and explain the coverage particulars to the retail agent.

### Alternatives to Wholesalers

It should be recognized that an insured does not necessarily have to utilize a wholesaler to reach a nonadmitted insurer. Retailers associated with large brokerage houses often work directly with the excess and surplus lines market, including alien and foreign insurers, to procure coverage in the nonadmitted market. (Alien insurers are insurers domiciled outside the United States. Foreign insurers do business in a state other than the one where they are domiciled.) Thus, surplus lines insurers may accept business directly from the retail agent, work exclusively with either surplus lines brokers or MGAs, or accept business from both types of agents or brokers, depending on the risk. Exhibit 9.1 illustrates some of the ways a risk can be placed with a surplus lines insurer. In addition, other intermediaries can be involved in the process, typically at additional cost to the insured.

**Exhibit 9.1**
**Possible Surplus Lines Distribution Systems**




## Lloyd's of London

Lloyd's of London, the world's oldest, largest, and most well known insurance exchange writes a considerable amount of PL and ML coverage. Lloyd's began more than 300 years ago when, over cups of coffee at various coffee houses in London, merchants, ship owners, and captains exchanged and assumed maritime-related risks. Much of the confusion surrounding Lloyd's stems from the fact that Lloyd's is not an insurance company—it is an international insurance exchange connecting buyers and sellers of insurance. Lloyd's is made up of wealthy active and inactive members—called names—who form groups called syndicates to underwrite everything from specific risks to entire books of business.

### *Syndicates*

Syndicates vary in size and specialty. The coverages written by Lloyd's are categorized as professional indemnity, aviation, catastrophe, marine, and motor. Professional liability coverage is usually written by nonmarine syndicates. Syndicates typically specialize in one of these areas or in a particular facet of one of these areas, such as crime or aviation insurance. Names often join a number

of syndicates who take very small portions of a large number of risks. By assuming a modest premium limit from a number of syndicates, the member spreads its risk of being adversely affected by the poor loss experience from a particular syndicate or a general book of business. Lloyd's names are typically not insurance people; they are well-to-do individuals who use their "names" to support a promise to pay in the event of a loss. (However, in the past decade, Lloyd's has allowed corporations, including U.S. corporations, to participate as "names.") Due to their lack of insurance expertise, members agencies look after individual members' personal investments in the syndicate. They do not manage the syndicate. These agencies have the insurance background and the experience necessary to negotiate placements on desirable syndicates. They are paid a low fixed fee plus a percentage of profits accruing to members.

### *Lloyd's and U.S. Risks*

For U.S.-based insureds, Lloyd's of London is a major market for risks requiring large capacity, specialty coverages, nonstandard or unusual risks, and reinsurance. A substantial amount of professional liability insurance is written by Lloyd's. In the United States, Lloyd's operates on a nonadmitted basis, except for Illinois and Kentucky, where it functions as an admitted market. To safeguard its American operations, the American Trust Fund was established with more than $5 billion in cash and U.S. government securities. Access to Lloyd's is through accredited brokers who secure U.S. business from an excess and surplus lines agent (a "coverholder" or "correspondent").

## Captives, Risk Retention Groups, and Risk Purchasing Groups

Passage of the Liability Risk Retention Act of 1986 (LRRA) has been the catalyst to the formation of numerous alternative risk financing arrangements for professional liability coverage. The Act was passed in response to the hard market conditions that characterized liability coverages during the mid-1980s. The purpose of the Act was to make liability insurance coverage of nearly all types (other than personal lines liability, workers compensation, and employers liability) more available and affordable to businesses that were having difficulty in obtaining it. The Act authorized firms to band together for the purpose of obtaining liability insurance coverage, via risk retention groups (RRGs) and purchasing groups (PGs). Although a handful of captive insurers had been established during the medical malpractice crisis of the 1970s, the Act fostered explosive growth in the development of so-called alternative risk financing facilities.

Captives and RRGs are basically small insurance companies owned either by their policyholders or by an association to which their policyholders belong. In contrast, PGs are not risk bearers. Unlike captives and RRGs, they are not required to capitalize to or reinsure the entity, because they are merely groups of insureds who band together to purchase coverage from an insurance company.

### *Captives*

A captive insurer is an entity created to insure the loss exposures of its founding organizations. A well-accepted definition of a "captive" is:

> A closely-held insurer whose business is primarily supplied by and controlled by its owners, and in which the original insureds are the principal beneficiaries.

Nearly all captives writing professional liability coverage are group captives. These entities are owned by multiple, nonrelated organizations (policyholders) and are designed to insure the risks of these different entities.

### *Risk Retention Groups*

Risk retention groups (RRGs) are actually a type or subset of captive insurer. Except for two key differences, they operate in a very similar manner. First, unlike traditional captives, RRGs are not subject to individual state laws which would otherwise prohibit the formation of group captives or make it difficult to form or operate them. Second, once a RRG group is licensed in a single state, licensing in any other state is not required to do business. For these reasons, RRGs have become much more popular vehicles for writing professional liability coverage, compared to traditional captives.

### *Purchasing Groups*

The LRRA also authorized the establishment of purchasing groups (PGs). PGs are groups formed to obtain liability coverage for its members, all of whom must have similar or related exposures. The Act requires a PG to be domiciled in a specific state. In contrast to RRGs, PGs are not risk-bearing entities. Accordingly, they are not required to capitalize or reinsure the entity, as RRGs must. Thus, PGs are easier to form, which is demonstrated by the fact that an RRG may require as long as 18 months to implement. In contrast, PGs can achieve full operation in as little as 60 days.

Most PL/ML PGs purchase coverage in one of the following four categories.

- **Errors and omissions (E&O) risks** (e.g., pension actuaries, real estate appraisers, bankruptcy trustees, court reporters, claims adjusters, computer consultants, executive search firms, travel agents)
- **Specialists within a traditional profession** (e.g., pediatric dentists, radiologists, cosmetic surgeons, intellectual property attorneys, military physicians, structural engineers)
- **Allied health care professionals** (e.g., mental health counselors, pharmacists, nurse anesthetists, acupuncturists, substance abuse professionals, nutritionists)
- **Members of a specific professional organization** (e.g., lawyers who are members of the Defense Research Institute, dentists who are members of the Minnesota Dental Association, real estate agents who are members of the National Association of Realtors, veterinarians who are members of the American Veterinary Medical Association)

A review of these categories indicates the value-added nature of the professional liability coverage provided by PGs. First, they facilitate the development of highly specialized, tailored policy forms ordinarily beyond the scope of what is available in the traditional marketplace. Moreover, the fact that an insurer can deal with an association, rather than individual, allows relatively small insureds to reap the benefits of underwriting and administrative economies of scale, and ultimately, substantial premium reduction for its policyholders.

## Chapter 9 Review Questions

1. Which of the following describes a characteristic of admitted and nonadmitted insurers that might operate in a given state?
   a. Admitted insurers are blacklisted by many states.
   b. Admitted insurers are sometimes called nonstandard insurers
   c. Nonadmitted insurers may be permitted to sell insurance in the state.
   d. Nonadmitted insurers are unwilling to acknowledge that the service they provide qualifies as insurance.
2. Llama of Lebanon Insurance Company (LLIC) is an excess and surplus lines insurer specializing in employment practices liability (EPL) insurance. Which of the following statements is most likely to describe LLIC's products and operations?
   a. LLIC is a nonadmitted insurer.
   b. LLIC's policy forms are highly regulated.
   c. LLIC's premiums are highly regulated.
   d. LLIC uses the same standard policy forms as other insurers.
3. ZMGA is a fairly typical managing general agent (MGA). Which of the following most likely characterizes ZMGA's business?
   a. Unlike a wholesale surplus lines broker, ZMGA handles no claims.
   b. Unlike a wholesale surplus lines broker, ZMGA lacks the authority to bind coverage on behalf of an insurer.
   c. ZMGA accepts applications on behalf of one or more insurers but does no underwriting.
   d. ZMGA works as an intermediary between retail agents whose clients have special insurance needs and insurers that might address those needs.

### *Answers to Chapter 9 Review Questions*

1. c. Nonadmitted insurers are part of the excess and surplus lines insurance market, and many states approve excess and surplus lines insurers to write coverage in their state.
2. a. Nonadmitted insurers are part of the excess and surplus lines market.
3. d. Both MGAs and wholesale surplus lines brokers function as intermediaries.