Wiley Rein LLP

EXECUTIVE SUMMARY

Legal Developments Affecting Professional Liability Insurers | January 2017

Architect's Prior Knowledge Bars Coverage for Professional Liability Claim

A New York federal court has held that an architecture firm is not entitled to coverage under a claims-made professional liability policy because the insured had a reasonable expectation of liability prior to the policy's inception date. *University of Pittsburgh v. Lexington Ins. Co.,* 2016 WL 7174667 (S.D.N.Y. Dec. 8, 2016).

The insured architecture firm held consecutive claims-made professional-liability policies with two different insurers. The architect designed a building and, during the first policy period, construction problems arose. The architect submitted a notice of potential claim to the first insurer stating that a claim was reasonably likely to result against the firm due to the construction delays. The first insurer denied coverage, asserting that the notice did not provide sufficient detail. The architect then provided notice of the same incident to the second insurer, who also denied coverage.

In an earlier decision in the coverage litigation that ensued, the court granted summary judgment to the first insurer, holding that the notice of potential claim did not meet the notice requirements of the first policy. In this subsequent decision, the court also agreed that the second policy did not afford coverage for the claim. Citing a prior knowledge condition in the second policy, the court held that the undisputed facts showed that the architect "had knowledge of any act, error, omission, situation or event that could reasonably be expected to result in a Claim" before the second policy incepted.

The court rejected the insured's contention that the decision "create[s] an unfair forfeiture" because the insured purchased consecutive claims-made policies. According to the court, the insured "did not respond to its knowledge of potential liability with the care and promptness required by the terms of its insurance contracts." The court explained that the insured "was never entitled to unconditional indemnification, even if it purchased two back-to-back policies." To hold otherwise "would effectively hold [the second insurer] to a strict-liability coverage standard for which it did not contract and for which it was not paid." ■

Fifth Circuit Holds that Prior Knowledge Exclusion is Unduly Broad

The United States Court of Appeals for the Fifth Circuit, applying Texas law, has held that the prior knowledge exclusion contained in a lawyers professional liability policy was unduly broad as written and would be construed to apply to wrongful acts reasonably likely to lead to a malpractice claim. *OneBeacon Ins. Co. v. T. Wade Welch & Assocs.,* 2016 WL 6694548 (5th Cir. Nov. 14, 2016). The court also reaffirmed that an insurer may accept a Stowers demand that offers to release fewer than all insureds.

The insured law firm purchased a claims-made malpractice policy from the insurer for the policy period of December 2006 to December 2007. The policy contained a retroactive date of

continued on page 2

ALSO IN THIS ISSUE

Fifth Circuit Holds that Prior Knowledge Exclusion is Unduly Broad *continued from page 2*

January 4, 1995. The policy also contained a prior knowledge exclusion, providing that coverage would be precluded for "any claim arising out of a wrongful act occurring prior to the policy period if … you had a reasonable basis to believe that you had committed a wrongful act, violated a disciplinary rule, or engaged in professional misconduct; [or] you could foresee that a claim would be made against you." The policy defined "wrongful act" as "any actual or alleged act, error, omission, or breach of duty arising out of the rendering or the failure to render professional services." In applying for the policy (and the subsequent renewal policy), the insured law firm represented that it was not aware of any act, error, or omission that would result in a claim.

In 2006, an attorney at the insured law firm failed to respond to discovery requests within the time limit and subsequently failed to properly verify and supplement discovery responses as required by court order. Shortly after the effective date of the policy, the insured law firm was served with a motion seeking sanctions for the discovery failures. The sanctions motion was ultimately granted, and the court awarded sanctions and deemed the claims against the insured law firm's client established as a matter of law. Following the entry of the sanctions order, the insured law firm notified the insurer of a potential malpractice claim. The insurer ultimately rescinded the policy and filed a declaratory judgment action seeking, in relevant part, a declaration that the prior knowledge exclusion barred coverage because the attorney was aware of the discovery misconduct when the policy incepted. The insured law firm prevailed at trial, and the insurer appealed.

On appeal, the Fifth Circuit held that the prior knowledge exclusion was unduly broad as drafted and unenforceable as a matter of law. According to the court, the definition of "wrongful act" in the prior knowledge exclusion was overbroad because "[o]n its face, [it] covers every single thing an attorney does or does not do, wrongful or not," and thus "the exclusion renders the coverage illusory and is facially absurd." The court held that the exclusion "must be directed at a 'wrongful act' reasonably likely to lead to a malpractice claim." In that regard, the court concluded that the attorney (and the insured law firm) did not have knowledge of the potential malpractice claim when the policy incepted, because at that point the misconduct could have been corrected and sanctions could have been avoided.

The court also upheld the district court's ruling that the insurer was negligent in failing to accept a settlement demand for the policy limits that would have released only the insured law firm. In opposition, the insurer argued that its refusal to settle was proper because the attorney, one of its insureds, would still have had exposure. The court rejected this argument, holding that when faced with a Stowers demand with respect to a policy covering multiple insureds, an insurer is free to settle as to one insured even if the potential liability of other coinsureds remains unresolved. ■

Court Finds EEOC Charge and Subsequent Lawsuit to be Two Separate Claims under Claims-Made Policy

The United States District Court for the Northern District of Illinois, applying federal and Illinois law, has found that an employment discrimination lawsuit was "first made" within a professional liability policy's policy period despite the fact that the lawsuit's required precursor, an Equal Employment Opportunity Commission (EEOC) charge, was filed before the policy period. *John Marshall Law Sch. v. Nat'l Union Fire Ins. Co.,* 2016 WL 7429221 (N.D. Ill. Dec. 26, 2016). The court also refused to dismiss an insured's request for a declaratory judgment that would prevent the insurer from raising policy defenses, as well as the insured's claim for vexatious refusal to pay under an Illinois statute.

The insured, a law school, was sued by one of its professors for alleged disability discrimination during the policy period of the insured's claims-made liability insurance policy. Before the policy period, the professor had filed a charge based on the same allegations with the EEOC, as required before he could sue in court. The insurer denied coverage for the lawsuit on the basis that the insured's claim was first made when the EEOC charge was filed, which was outside the policy period. The insured disagreed, arguing that the lawsuit was first made within the policy period, independent of the preexisting EEOC charge. The insurer filed a motion to dismiss.

The Northern District of Illinois denied the insurer's motion to dismiss, finding the policy ambiguous as to when a claim is "first made" when two legal proceedings arise from the same facts. Noting that the policy did not define when a claim is "first made," the court articulated the issue as "whether the EEOC charge and the lawsuit are two separate claims as the policy defines that term, or just one." The court stated that if the two proceedings constituted one claim, then the insurer would be entitled to dismissal because the claim was first made when the EEOC charge was filed against the insurer.

The court found that, construing the policy in the insured's favor, the EEOC charge and lawsuit were two separate claims. Relying on *Lodgenet Entertainment Corp. v. American International Specialty Lines Insurance Co.,* 299 F. Supp. 2d 987 (D.S.D. 2003), the court found that two policy provisions implied that multiple claims could arise from the same facts. First, the policy's notice/claim reporting provision stated, "if written notice of a Claim has been given… then any Claim which is subsequently made… arising out of [the same facts] shall be considered made at the time such notice was given." Second, the policy contained an exclusion stating that "the insurer is not liable to pay for a loss 'in connection with a Claim made against an insured… alleging, arising out of, based upon or attributable to the facts alleged, or to the same or Related Wrongful Act alleged or contained in any Claim' reported under an earlier policy of which the current policy is a renewal." Based on these provisions, as well as the fact that the EEOC charge and lawsuit each fell under the policy's definition of "claim," the court found that the two proceedings could reasonably constitute separate claims, and therefore, the lawsuit was a claim first made within the policy period.

The court also found that the insurer was not entitled to dismissal of the insured's request for declaratory judgment, because the policy contained language sufficient to give rise to a duty to defend. Similarly, the court did not dismiss the insured's claim for vexatious refusal to pay, as the insured sufficiently alleged that the insurer had no bona fide basis to deny coverage. ■

Settlement of Class Actions for Allegedly Withheld Profits Not Disgorgement

Applying New York and Delaware law, the Superior Court of Delaware has held that a retirement benefits provider's settlement of three class actions seeking payment of alleged profits did not constitute disgorgement and was insurable under the provider's professional liability policies. *TIAA-CREF Individual & Institutional Servs. LLC v. Illinois Nat'l Ins. Co.,* 2016 WL 6534271 (Del. Super. Ct. Oct. 20, 2016). The court also held that the two later class action lawsuits "related back" to the first lawsuit, that a commingling exclusion did not apply, and that the insured's decision to self-fund defense costs did not make the costs per se reasonable.

The insured retirement benefits provider purchased primary and excess professional liability insurance policies for the 2007-2008 and 2009-2010 policy years. In October 2007, the insured was sued by claimants alleging that it failed to timely process transfer or withdrawal requests, and that it withheld profits that accrued to accounts during the transfer process. In May 2012, the insured settled the 2007 class action, agreeing to pay each class member who filed an approved claim "an individual amount calculated according to a formula" set in the settlement. Two other class action lawsuits with similar allegations were filed in 2009 and 2012 and likewise were settled.

In the coverage action, the insurers asserted that the settlements of the three class actions constituted uninsurable disgorgement, arguing that they were payment of "ill-gotten gains." The insured contended that the settlement amounts were not disgorgement because it had not been "ordered to return funds." The Superior Court granted the insured's motion for summary judgment, noting that New York cases addressing disgorgement were distinguishable because "all involve[d] conclusive links between the insured's misconduct and the payment of monies." According to the court, such connections were lacking in this case where the insured "settled and expressly denied any liability" and did so following "lengthy litigation," as opposed to situations addressed in the New York cases that involved SEC and/or other governmental investigations.

The court also held that the two later class actions related back to the first suit under the plain language of the policy, explaining that "the allegations in the Underlying Actions arise out of, and are attributable to the same type of conduct—[the insured's] business practice that resulted in failure to pay customers their gains during delays in processing."

Furthermore, the court rejected the insurers' argument that the commingling exclusion, which provided "the policy will not apply to any claim made against the insured arising out of, alleging, or any way involving, directly or indirectly, the commingling of funds or accounts," should apply. The court held that (1) the insured's agreements stated that the profits would be "allocated among other accounts"; (2) "clients could readily calculate the value of their gain"; and (3) the insured "did not mix clients' funds with its own funds, the hallmark of comingling, nor did it use those funds for its own private benefit."

Finally, the court rejected the insured's argument that its defense costs were per se reasonable because they were paid for out-of-pocket. The court noted that Delaware and New York require a multi-factor analysis to determine the reasonableness of defenses costs and self-funding may be one of many factors. ■

No Duty to Defend Claim Seeking Return of Premiums Based on Policy Exclusion

The United States District Court for the Eastern District of Pennsylvania, applying Pennsylvania law, has held that a professional liability insurer has no duty to defend an insured insurance agency against a claim seeking return of premium payments pursuant to an exclusion in the policy barring coverage for any claim to recover premiums. *TRI-ARC Fin. Serv., Inc. v. Evanston Ins. Co.,* 2016 WL 7178419 (E.D. Penn. Dec. 8, 2016).

In the underlying claim, the plaintiff alleged that it had paid premiums to an insurer but had never received actual insurance coverage. The insurer filed a petition requesting that the insurance agency be named as a third-party defendant and assigned a portion of the liability. The insurance agency sought coverage under its professional liability insurance policy, which excluded coverage for any claim "based upon or arising out of . . . any Claim for loss monies received by the Insured . . . for premiums[.]" The insurer denied coverage on the grounds that the claim demanded a return of premium payments, which is excluded under the policy. The insurance agency then filed suit against the insurer, and the insurer filed a motion to dismiss.

In granting the insurer's motion to dismiss, the court held that the relevant exclusion was clear and unambiguous, barring coverage for any type of claim that seeks recovery of premiums. Because the claim against the insurance agency sought only damages in the form of lost premium payments, the court held that it fell within the policy's exclusion, and the insurer had no duty to defend. ■

Lead Underwriter's Document Production Limits Scope of Following Market's Production

Applying New York law, a federal district court in New York has held that market underwriters in a syndicate insurance program need not produce potentially responsive claim materials where such production is burdensome and duplicative of documents already produced by the lead underwriter on the program. *Certain Underwriters of Lloyd's v. National Railroad Passenger Corp.,* 2016 WL 7017356 (E.D.N.Y. Nov. 30, 2016).

In coverage litigation, a policyholder sought discovery from its insurers, lead and following London market underwriters, which wrote policies through syndicates. Under the program, the lead underwriter – *i.e.,* the insurer who had accepted the largest percentage of the risk of the insurance program – typically handled claims and worked with the insured and defense counsel when a claim was submitted. The following market underwriters – *i.e.*, the insurers who issued coverage for the remainder of the program – generally did not actively engage in the claims handling process. In the coverage litigation, the lead underwriter produced its files, but the policyholder sought further production of the following market underwriters' files.

The court analyzed the production request under Federal Rule of Civil Procedure 26, which allows a court to limit potentially responsive discovery if such production would be overly burdensome to the producing party and duplicative of other available discovery. Although the court noted that no blanket prohibition exists on discovery of the files of the following market underwriters, in this case the policyholder had obtained the relevant documents from the lead underwriter. Accordingly, the court held that the policyholder was entitled only to limited additional discovery from the following market underwriters where such production was not duplicative or overly burdensome. ■

SPEECHES & EVENTS

Non-Cumulation and Prior Insurance Clauses: Allocating Liability Among Multiple Policies Triggered by Multi-Year Loss

Stafford Seminars

Mary E. Borja, Speaker

JANUARY 12, 2017 | ONLINE WEBINAR | EVENT

Professional Liability Attorneys

Kimberly A. Ashmore	202.719.7326	kashmore@wileyrein.com
Matthew W. Beato	202.719.7518	mbeato@wileyrein.com
Mary E. Borja	202.719.4252	mborja@wileyrein.com
Edward R. Brown	202.719.7580	erbrown@wileyrein.com
Jason P. Cronic	202.719.7175	jcronic@wileyrein.com
Cara Tseng Duffield	202.719.7407	cduffield@wileyrein.com
Benjamin C. Eggert	202.719.7336	beggert@wileyrein.com
Ashley E. Eiler	202.719.7565	aeiler@wileyrein.com
Jessica N. Gallinaro	202.719.4189	jgallinaro@wileyrein.com
Michael J. Gridley	202.719.7189	mgridley@wileyrein.com
Emily S. Hart	202.719.4190	ehart@wileyrein.com
John E. Howell	202.719.7047	jhowell@wileyrein.com
Leland H. Jones, IV	202.719.7178	lhjones@wileyrein.com
Parker J. Lavin	202.719.7367	plavin@wileyrein.com
Charles C. Lemley	202.719.7354	clemley@wileyrein.com
Jessica C. Lim	202.719.3749	jlim@wileyrein.com
Mary Catherine Martin	202.719.7161	mmartin@wileyrein.com
Kimberly M. Melvin	202.719.7403	kmelvin@wileyrein.com
Laura Lee Miller	202.719.4196	lmiller@wileyrein.com
Jason O'Brien	202.719.7464	jobrien@wileyrein.com
Leslie A. Platt	202.719.3174	lplatt@wileyrein.com
Nicole Audet Richardson	202.719.3746	nrichardson@wileyrein.com
Marc E. Rindner	202.719.7486	mrindner@wileyrein.com
Kenneth E. Ryan	202.719.7028	kryan@wileyrein.com
Gary P. Seligman	202.719.3587	gseligman@wileyrein.com
Richard A. Simpson	202.719.7314	rsimpson@wileyrein.com
William E. Smith	202.719.7350	wsmith@wileyrein.com
Daniel J. Standish	202.719.7130	dstandish@wileyrein.com
Margaret D. Thomas	202.719.4198	mthomas@wileyrein.com
David H. Topol	202.719.7214	dtopol@wileyrein.com
Karen L. Toto	202.719.7152	ktoto@wileyrein.com
Jennifer A. Williams	202.719.7566	jawilliams@wileyrein.com
Bonnie Thompson Wise	202.719.3763	bwise@wileyrein.com