Wiley Rein & Fielding

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The Executive Summary

Developments Affecting Professional Liability Insurers

No Rescission Where Attorneys Unaware of Employee's $2.7 Million Embezzlement Scheme

A Massachusetts appellate court has held that an insurer was not entitled to rescind a legal malpractice policy because the insured attorneys did not make misrepresentations in their insurance applications and because they were not on inquiry notice of an embezzlement scheme when they signed the applications. *Chicago Ins. Co. v. Lappin*, 792 N.E.2d 1018 (Mass. App. Ct. 2003). The court also held that the embezzlement scheme involved multiple claims under the Policy. Finally, the court made a number of rulings concerning coverage for prejudgment interest and attorneys' fees.

The insurer issued a claims-made legal malpractice policy to two solo practitioners who shared office space and often worked together on cases. The policy contained a limit of $1 million per claim, with an aggregate limit of $2 million. In connection with the renewal of the policy, the attorneys each submitted renewal applications on May 4, 1995. The applications asked: "Have any new claims or circumstances which may result in a claim arisen in the past policy period?" Both attorneys answered in the negative. They were issued a policy, which, according to the declarations page, commenced on May 10, 1995 for a one-year policy period. The policy was bound on May 10, 1995, activated on July 20, 1995, and physically delivered on August 8, 1995. The policy obligated the insurer to pay "all sums" the attorneys become "legally obligated to pay as damages." Additionally, the policy contained an endorsement that provided that "[p]rejudgment interest, where payable under this policy, will be in addition to the limits of liability stated in the declarations."

One of the attorneys hired a secretary and administrative assistant who was later found to have embezzled some $2.7 million from the attorney's clients. The trial court found that the attorneys were unaware of the embezzlement scheme at the time it took place and when they signed the renewal application. The attorneys first began to learn of the scheme on July 11, 1995, and they subsequently notified the insurer of the circumstances. After the attorneys were sued in connection with the embezzlement and tendered the complaint to the insurer, the insurer filed suit to rescind the policy, contending that the attorneys had made misrepresentations in answering the question on the application concerning new circumstances or claims that may result in a claim.

The court first rejected the insurer's argument that the attorneys should have disclosed two prior, unrelated matters. The first of these matters was a bar disciplinary proceeding brought by a client who demanded no relief; the second was a letter warning of future action from a client. The court reasoned that those matters did not need to be disclosed because they were not "claims" within the meaning of the question on the application since the policy provided no coverage for such matters. The court explained that no coverage would have been available for the bar disciplinary proceeding because the person complaining to the bar "did not allege any injury and made no present demand for relief, either monetary or otherwise." The court explained that the second matter was "more in the nature of a request that the recipient complete unfinished work rather than a demand as of right." The court also rejected the insurer's argument that the two matters constituted "circumstances which may result in a claim," explaining that the attorneys "did not believe either [matter] could result in a claim because at the time of the application, both matters appeared to have been amicably resolved with only ministerial details yet to be completed."

The court declined to hold that the attorneys were on inquiry notice of the embezzlement scheme and should have detected

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Also in This Issue

Case or Controversy Exists When Insurer Sues Directors Indemnified by Policyholder Company

A federal district court in Kansas denied a motion to dismiss filed by the directors and officers of a company who were insured under a D&O policy issued to the company and were named, along with the company, as defendants in a lawsuit by the insurer concerning coverage for the settlement of an underlying securities lawsuit. *Executive Risk Indem. Inc. v. Sprint Corp. et al.*, 2003 WL 22149637 (D. Kan. Sept. 9, 2003). The court rejected the argument by the directors and officers that there was no case or controversy since the company was indemnifying them.

The insurer issued a D&O policy to the company. Subject to all of its terms and conditions, the policy provided coverage for the directors and officers to the extent they were not indemnified by the company and coverage to the company to the extent that it indemnified the directors and officers. The policy also contained a presumptive indemnification clause stating that the certificate of incorporation, by-laws and all other relevant documentation "will be deemed to have been adopted or amended to provide indemnification to the fullest extent permitted by the law."

Securities litigation was filed against the company and the litigation ultimately settled for $50 million. During the settlement negotiations, the directors and officers were represented by their own counsel. After the settlement was reached, the company, which had agreed to indemnify the directors and officers for the settlement, and the insurer could not agree on the extent of coverage for the underlying litigation, although the insurer advanced a portion of the settlement amount under the terms of an interim funding agreement. The insurer filed suit against both the company and the directors and officers. The directors and officers sought to dismiss the lawsuit on the grounds that there was no case or controversy because any obligation they would have in connection with the settlement would be paid by the company.

The district court denied the motion to dismiss, explaining that "[r]egarding the [presumptive indemnification] clause, whatever effect if might have on the parties' respective burdens and benefits as a matter of insurance law, this Court's jurisdiction is based on actual fact, not on what parties have 'deemed' to exist." The court noted that the fact that the company was "deemed" to have indemnified the directors and officers did not guarantee that it had done so and that the words "to the fullest extent provided by law" created uncertainty about the extent of indemnification. Accordingly, since the parties had not agreed on the resolution of the coverage dispute and "indemnification is not assured, the Individual Defendants remain interested parties with whom [the insurer] has an actual case or controversy." The court also noted that directors and officers had been "insured as directors and officers, separately from [the company]; they were named as defendants in the underlying litigation, separately from [the company]"; and they were represented by separate counsel in the underlying litigation. ✦

Intentional Acts Exclusion Precludes Coverage

A Minnesota intermediate appellate court, applying Texas law, has held that the intentional acts exclusion in a technology E&O policy issued to a computer manufacturer precluded coverage for two class action lawsuits alleging that the manufacturer intentionally sold computers that it knew were defective. *Compaq Computer Corp. v. St. Paul Fire & Marine Ins. Co.*, 2003 WL 22039551 (Minn. Ct. App. Sept. 2, 2003).

The coverage action arose after two class action lawsuits were filed against the policyholder computer manufacturer, alleging that the manufacturer intentionally and knowingly designed and sold computers that contained defective hardware and codes, causing the loss of use, corruption and destruction of data. The insurer provided coverage to the manufacturer under a package policy that contained technology E&O, general liability and umbrella excess liability insuring agreements. The technology E&O insuring agreement provided coverage for loss resulting from "error," which the agreement defined as "any error, omission, or negligent act." The policy excluded coverage for criminal, dishonest, fraudulent or other "intentionally wrongful act[s]." After the insurer disclaimed coverage, litigation ensued.

The court first concluded that Texas law applied because "[t]he primary contacts in this controversy are centered in the state of Texas": the package policy was issued in Texas, the insurer was licensed in Texas and the policyholder's principal place of business was in Texas. Next, the court held that the intentional acts exclusion in the E&O insuring agreement precluded coverage under that agreement for the two class

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Court Addresses Differing Retentions in Separate Coverage Parts

In an unreported decision, a Pennsylvania trial court held that where the allegations in a complaint implicated the D&O coverage part (with zero retention) of a professional liability policy, that coverage part governed coverage for the complaint, even though some of the allegations in the complaint would also have been covered by the Employment Practices Liability (EPL) coverage part, which had a $1 million retention. *Steinberg v. Syndicate 212 at Lloyd's of London, et al.*, 2003 WL 22119866 (Pa. Ct. C.P. Sept. 8, 2003).

The insurer issued a professional liability to a company. The policy contained four coverage parts, including one for D&O liability and one for EPL. The EPL coverage part contained an exclusion for "that portion of Loss which is covered under any other Coverage Section of this Policy." The D&O coverage part had no retention; the EPL coverage part had a $1 million retention. The General Terms and Conditions section of the Policy provided that when two or more coverage parts of the Policy apply, "the total applicable Retention shall not exceed the largest single Retention."

The company and certain of its directors were named in a lawsuit by a former employee who alleged that the company and its directors had breached a shareholders agreement he had entered into with the company, which contained a provision for the buyback of stock at certain predetermined prices if he left the company. The plaintiff filed suit contending that the company breached the agreement by, among other things, failing to inform him of certain plans to merge or sell the company. He alleged violations of various securities laws, breach of contract and fraud. After the directors sought coverage under the policy, the insurer took the position that the $1 million retention of the EPL coverage part applied, and litigation ensued.

The court held in favor of the directors. The court first concluded that all of the allegations were covered under the D&O coverage part. Accordingly, the court reasoned that because the EPL coverage part expressly excluded loss covered under any other coverage part, no coverage was available under that coverage part and the retention in the EPL coverage part could not apply. The court rejected the insurer's argument that the provision in the general terms and conditions section addressing multiple retentions applied, explaining that the provision would be relevant only if coverage were available under multiple coverage parts. The court concluded: "Even though certain claims may also fall under the EPL section, the EPL Exclusion precludes such coverage and, as a result, the applicable retention is that of the D&O Section, zero." ✦

Court Determines That Claim Made Before Bankrupt Law Firm Dissolved

The United States Court of Appeals for the Eighth Circuit, applying Missouri law, has determined that the term "dissolved," as used in a claims-made professional liability policy, was to be interpreted under Missouri partnership law, and based on this interpretation, the policyholder's claim was tendered to the insurer before the policyholder dissolved. *Old Republic Ins. Co. v. Bitting, et al., (In re Popkin & Stern)*, 2003 WL 21998978 (8th Cir. Aug. 25, 2003). The court further determined that a policy issued by a second insurer to the partners of the law firm after the dissolution of the law firm provided excess coverage only and that, as a result, the first insurer was fully liable for the claim.

The first insurer issued a claims-made policy to a law firm. The policy contained a change of status clause, which provided that, if the law firm dissolved, "this Policy shall end on the date the change in status takes place." The policy also contained an "other insurance" clause, which provided that "[t]his Policy applies in excess of any other valid and collectible insurance available to the Insured, unless such other insurance is written only as specific excess insurance over the limit of insurance of this Policy."

As a result of financial troubles, the law firm decided to dissolve. Seven days later, the law firm tendered a claim to the first insurer. The first insurer sought a declaratory judgment that no coverage was available because the claim was filed after the dissolution of the law firm.

The Eighth Circuit first determined that the term "dissolved" should be interpreted under Missouri partnership law, noting that the word "dissolved" is a legal term of art that applies to partnerships. The court therefore reasoned that applying Missouri partnership law to determine when the law firm dissolved "is consistent with the specific factual context of this case and the language of the insurance policy." The court then addressed whether the claim was filed prior to the policyholder's dissolution. The court observed that the policyholder had not followed the procedures for dissolution as outlined in the partnership agreement when it initially

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E&O Policy Affords Coverage to Benefits Company for Acts Involving Its Own Employees

In an unreported decision, the United States Court of Appeals for the Fifth Circuit has held that coverage is available to a benefits management company, insured under an E&O policy, for a claim arising out of alleged wrongful acts in providing benefits to the company's own employees. *Administaff, Inc. v. Am. Int'l Specialty Lines Ins. Co.*, 2003 WL 22080760 (5th Cir. Sept. 9, 2003).

The insurer issued an E&O policy to a company that provided personnel management and human resources services to other companies (benefits management company). The policy provided coverage for "all sums which the Insured shall become legally obligated to pay as Damages resulting from any claim or claims first made against the Insured and reported to the Company during the Policy Period for any Wrongful Act of the Insured." The policy defined "Wrongful Act" as "any actual or alleged breach of duty, neglect, error, misstatement, misleading statement or omission solely in the conduct of the Insured's Profession." "Insured's Profession" was defined as "Soley [sic] in the performance of recruiting and selection, outplacement services, employer liability management and assistance…benefit management, HR consulting…."

The benefits management company filed a lawsuit against a company that was providing health insurance to the benefit management company's employees. The company counterclaimed, alleging that the benefits management company was liable for violations of ERISA, breach of contract and misrepresentations. The benefits management company sought coverage under its E&O policy, and the insurer denied coverage on the grounds that any liability resulting from the counterclaim was for actions the benefits management company took with respect to its own employees, and not for performance of its profession for customers.

The Fifth Circuit rejected the insurer's argument and held that coverage was available, reasoning that the policy provided coverage for wrongful acts in providing benefits management and that the benefits management company was alleged to have committed wrongful acts in providing benefits to its own employees. The court also rejected the insurer's argument that coverage was only available with respect to services provided to consumers, stating that "[n]othing in the policy indicates the policy covers only Wrongful Acts alleged by [the benefits management company's] client-consumers." The court therefore remanded the case to the trial court to consider additional coverage issues, including the application of certain exclusions. ✦

Court Determines That Claim Made Before Bankrupt Law Firm Dissolved

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agreed to dissolve. Based on this conclusion, the court determined that the partnership actually dissolved approximately thirty days after it had initially decided to do so. Accordingly, the court concluded that the law firm's claim, which was made seven days after the policyholder's initial attempt to dissolve, but prior to the dissolution becoming effective under Missouri partnership law, was made during the policy period.

The Eight Circuit also considered the application of two "other insurance" clauses. After the law firm dissolved, the partners were insured under a policy issued by a second insurer. That policy contained an "other insurance" clause stating that "[i]f an Insured has insurance provided by other companies against a Claim covered by this policy, the Company shall not be liable under this policy for a greater proportion of such Damages and Defense Expenses than the applicable Limit of Liability stated…." The clause further provided that "with respect to acts or omissions which occur prior to the inception date of this policy, the insurance hereunder shall apply only as excess insurance over any other valid and collectible insurance…."

The court rejected the first insurer's argument that the "other insurance" clauses in the two policies were "mutually repugnant" and that both policies therefore afforded coverage. Instead, the court concluded that only the first insurer's policy provided coverage for the claim. The court reasoned that the second insurer's policy was "more specific" because of its reference to acts prior to the inception of the policy. The court therefore reasoned that, "[i]n the case of acts or omissions committed before the inception of the [second policy], however, the policy is more like a true excess or umbrella policy than a primary policy." Accordingly, it held that only the first policy provided coverage for the claim. ✦

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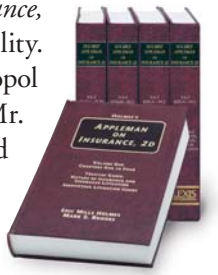
WRF Attorney Authors "Professional Liability Chapter" in *Holmes' Appleman on Insurance*



For the first time, *Holmes' Appleman on Insurance, 2d*, includes a section on professional liability. Wiley Rein & Fielding attorney David H. Topol authored the recently released chapter. Mr. Topol is Of Counsel in the Insurance and Appellate Practices. He represents insurance carriers in connection with a variety of professional liability policies, including banking, mutual fund, investment adviser, directors and officers liability policies.

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Intentional Acts Exclusion Precludes Coverage

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action lawsuits. The court reasoned that "the overwhelming majority of the factual allegations" in one complaint "allege[d] intentional and knowing conduct," and the other complaint "repeatedly referred to [the manufacturer's] knowing conduct." Consequently, even though a paragraph in one of the complaints alleged that the policyholder "should have been aware" of the problems in question, these "few isolated sentences…are insufficient to create a duty to defend."

The court further concluded that the complainants' allegations that the policyholder violated the Computer Fraud and Abuse Act were not covered under the E&O policy because that is a criminal statute and the exclusion precluded coverage for criminal acts. The court also explained that, even if the underlying claimants could have alleged a violation of the same statute without alleging intentional action, the complaint's actual allegations—not what the claimants could have alleged—controlled the analysis. Since the complaints alleged intentional conduct, the E&O agreement's intentional acts exclusion precluded coverage.

Finally, the court held that the policy did not afford coverage for allegations that the policyholder had failed to take adequate steps to prevent the problems. Distinguishing cases cited by the manufacturer to demonstrate that such a failure constituted negligent, rather than intentional, conduct, the court ruled that regardless of what plaintiffs could have alleged, they had alleged that the actions and resulting damages were intentional. ✦

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warning signs concerning the secretary's conduct. Noting that whether notice is sufficient to charge a person with constructive knowledge is a question for the fact-finder, the appellate court declined to overturn the trial court's conclusion that the attorneys were not on notice even though different conclusions could have been drawn concerning the operative facts.

The court also rejected the insurer's argument that the policy's operative date was July 20, 1995, the date on which the policy was activated, and that the attorneys therefore should have updated their application after they learned of the embezzlement scheme on July 11, 1995. The court concluded, finding no policy language to the contrary, that the policy was operative on the date it was bound, May 10, 1995, not the day it was activated or physically delivered.

The court rejected the insurer's argument that the single claim limit of $1 million applied to the embezzlement scheme, accepting the trial court's conclusion that the attorneys had been negligent through multiple and unrelated breaches occurring over a period of many years rather than through a single breach. Accordingly, the $2 million aggregate limit was held to be applicable.

Finally, the court made a number of rulings concerning damages. The court held, relying on the insurer's obligation to pay "all sums," that the insurer was required to pay prejudgment interest and that the interest payments were not subject to the limits of liability under the policy. The court also held that the trial court had acted within its discretion when it awarded attorneys' fees and costs incurred in litigating both the coverage dispute and the underlying litigation to the policyholders. However, the court did hold that the fees incurred in defending the underlying action would come off of the policy limits. The court reasoned that, while the insurer declined to defend, it "at least acquiesced in defence [sic] of the insured by counsel retained by him." Finally, the court rejected an argument by the underlying plaintiffs that they were entitled to attorneys' fees and costs. The court explained that, although it was appropriate to award fees to a party that was supposed to benefit from the duty to defend—the insured—that logic did not hold with respect to the underlying claimants. ✦

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Vehicle Exclusion Inapplicable Where Infant Left in Van

An Illinois intermediate appellate court, applying Illinois law, has held that an automobile exclusion in a policy providing professional liability coverage to a day care center did not bar coverage for a claim arising out of the death of an infant who was left in a van because the death resulted from the day care center's nonvehicular conduct. *Mount Vernon Fire Ins. Co. v. Heaven's Little Hands Day Care*, 2003 WL 21998618 (Ill. App. Ct. Aug. 22, 2003).

The policyholder, a day care center, was sued for the wrongful death of an infant after an employee allegedly left the infant in a van when he was unloading the other children. The policyholder tendered the claim to its insurer under the professional liability coverage part of its general liability policy, which provided coverage for "all sums which [the policyholder] shall become legally obligated to pay as damages because of liability arising out of any negligent act, error or omission in rendering or failure to render professional services." The coverage part contained an exclusion for "liability arising out of the ownership, maintenance, operation, use, loading or unloading of any vehicle, watercraft or aircraft." The insurer filed a declaratory judgment seeking a determination that it had no duty to defend or indemnify the policyholder based on the vehicle exclusion.

The appellate court held that the vehicle exclusion did not bar coverage for the day care center's claim. The court reasoned that the van was the mere "situs" of the accident and that no causal relationship existed between the infant's death and the use, loading or unloading of the van. In so ruling, the court stated that "leaving an infant in an automobile used to transport him to a day-care facility is not a normal or reasonable consequence of the use of the vehicle," and therefore the infant's death "resulted from nonvehicular conduct on the part of [the policyholders] and its employees." ✦

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