Recent Developments and Trends in Professional Liability Coverage Cases

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Because coverage disputes in the professional liability arena are decided on a case-by-case basis by federal and state courts nationwide, and because insurance law varies by state, it is impossible to predict future developments with certainty. Recent decisions regarding some important recurring issues do, however, provide clues as to trends in the law regarding those issues. Below, we describe recent decisions and the trends we think they may suggest for future litigation regarding several important coverage issues, namely: prior knowledge provisions and severability exceptions; coverage for statutory damages; business enterprise and contractual liability exclusions; coverage for data breaches; and the right to independent counsel. We discuss some of these issues in more detail than others.

I. Prior Knowledge Provisions and Severability Exceptions

Professional liability policies are typically written on a claims-made or claims-made-and-reported basis, with coverage provided for claims first made during the policy period, even if those claims are based on wrongful acts committed before the inception date of the policy. This policy structure raises obvious concerns for insurers regarding the availability of coverage for claims arising from circumstances known to the insured before the inception date of the policy. Insurers understandably want to preclude coverage for such known risks.

To address this concern, many professional liability policies include prior knowledge provisions. The specific terms of such provisions vary and must be read closely, but prior knowledge provisions generally preclude coverage where an insured had knowledge of circumstances that might reasonably be expected to be the basis of a claim (or a “potential claim”) before a specified date. Many policies specify that the date for measuring knowledge of a potential claim is the inception date of the current policy, whereas other policies measure knowledge as of the inception date of the first policy issued by the insurer and continuously renewed thereafter. See, e.g., Charles Lemley & Kimberly Ashmore, Irrelevant Innocence: The Interplay Between Innocent Insured Provisions and Prior Knowledge Provisions in Claims Made Policies, 21 Coverage 41 (2011).

Whether a prior knowledge provision applies to bar coverage as a contractual matter is distinct from the question whether the insurer may have grounds for rescinding the policy based on a material misrepresentation in the application for coverage. See, e.g., Ross v. Cont’l Cas. Co., 420 B.R. 43, 56 (Bankr. D.D.C. 2009) (defense based on a prior knowledge provision is “entirely distinct from rescission”), aff’d, 393 F. App’x 726 (D.C. Cir. 2010). Sometimes, where a prior knowledge provision does not apply to bar coverage because the insured gained knowledge of a potential claim after the inception date of the first policy issued by the insurer but before the inception date of the current policy, rescission may be available as a remedy. This is because many renewal applications ask the insured to disclose any known potential claims, and a failure to do so may be a material misrepresentation. An insurer’s right to rescind in such circumstances typically turns on the language of the application, the responses (or lack thereof) set forth therein, the form of representation and warranty, the identity of the signatory to the application, and the timing of the claims or circumstances that support the insurer’s prior knowledge position.

Some policies include prior knowledge provisions in the insuring agreement as a condition precedent to coverage, while other policies include prior knowledge exclusions. The placement of the provision could affect the burden of proof, but the intent in each instance is to protect the insurer from having to cover claims based on circumstances known to an insured before the inception date of the policy (or the inception date of the first policy issued and continuously renewed). See, e.g., Bryan Bros. Inc. v. Cont’l Cas. Co., 660 F.3d
827, 831 (4th Cir. 2011) (explaining that “the prior knowledge provision essentially makes fortuity a condition of coverage” by indicating “in clear and unambiguous language [the insurer’s] unwillingness to cover liability arising from prior acts or omissions that any insured might reasonably be expected to result in a claim”).

Insureds frequently contend that prior knowledge provisions should bar coverage only where an insured subjectively recognizes the potential for a claim, regardless of how unreasonable the insured’s subjective beliefs may be. These arguments – which, if accepted, would make it very difficult for insurers to obtain summary judgment in prior knowledge cases and would effectively reward professionals who put their heads in the sand – have met with very limited success. For example, in rejecting an insured’s argument that it was entitled to coverage because it did not subjectively believe that an employee’s criminal conduct would result in a claim for negligent supervision, the Tenth Circuit observed that, absent the insured’s recognition of an objectively reasonable, “sure and obvious” defense, the insured had a duty to report: “The threat of a claim, even an unfounded one, is relevant to the insurer’s exposure, because defense costs, which can be quite substantial, are covered by the policy even when the claim against the insured proves unsuccessful. The reality of modern American litigation, which is what insurance policies are designed to protect against, is that persons must be prepared to defend against colorable albeit invalid claims.” Cohen-Esrey Real Estate Servs. Inc. v. Twin City Fire Ins. Co., 636 F.3d 1300, 1304-05 (10th Cir. 2011).

The clear trend in decisions applying prior knowledge provisions – which we believe reflects a growing consensus – is that the knowledge of an insured professional must be measured pursuant to a mixed, subjective-objective standard that analyzes: (1) what the insured subjectively knew at the time of the policy’s inception; and (2) whether a reasonable professional with the knowledge actually possessed by the insured would have a basis to believe that the conduct at issue might result in a claim. See, e.g., Koransky, Bouwer & Poracky, P.C. v. Bar Plan Mut. Ins. Co., 712 F.3d 336, 343 (7th Cir. 2013) (looking to whether a “reasonable attorney in [the insured’s] position would realize that his client might bring a malpractice claim against him” based on the facts actually known to the insured); Prof’l Asset Strategies, LLC v. Cont’l Cas. Co., 447 F. App’x 97, 99-100 (11th Cir. 2011) (“the question is whether an objective person in [the insured’s] position should have expected that his acts might form the basis of a claim, [regardless of the insured’s] subjective beliefs”); Colliers Land & Axilbund v. Lloyds of London, 337 F. App’x 195, 199–200 (3d Cir. 2009) (reaffirming the use of a mixed, subjective-objective approach); Ettinger & Assocs., LLC v. Hartford/Twin City Fire Ins. Co., No. 12-cv-3274, 2014 WL 2134599, at *5-6 (E.D. Pa. May 22, 2014) (applying two-stage, subjective-objective test); Chicago Ins. Co. v. Paulson & Nace, PLLC, No. 12-2068, 2014 WL 1392101, at *9 (D.D.C. Apr. 10, 2014) (explaining that “[w]hether the attorney defendants had a ‘reasonable basis to believe’ that a breach of professional duty had occurred is an objective inquiry that asks what a reasonable attorney would have done in the same circumstance”); Schwartz Manes Ruby & Slovin, L.P.A. v. Monitor Liab. Managers, LLC, No. 1:09CV790, 2011 WL 3627287, at *5 (S.D. Ohio Aug. 17, 2011) (“Because [the insured law firm] either knew or could have reasonably foreseen that [its] handling of the [claimant’s] matter might be the basis of a malpractice claim, the . . . Policy excludes from coverage the underlying malpractice suit.”), aff’d, 483 F. App’x 241 (6th Cir. 2012).

This two-tiered, subjective-objective standard appears to be gaining widespread acceptance because it fairly balances the legitimate interests of the insurer and the insured. Where an insured is not aware of existing circumstances that may result in a claim, or where an insured is aware of the circumstances but reasonably does not recognize that a claim may result, prior knowledge provisions should not bar coverage. That is the kind of situation insurance is intended to cover. But where an insured is aware before the policy inception date of circumstances that a reasonable professional would recognize might result in a claim, there should not be coverage for the unreasonable professional who fails to recognize or acknowledge the possibility of a claim, particularly since it is so easy for an insured conveniently to assert that he did not subjectively realize that a
claim might be made. To cite a classic example, prior knowledge provisions do not bar coverage for an attorney who misses a statute of limitations, but does not know that the deadline was missed at the time the policy incepts. By contrast, prior knowledge provisions do bar coverage for an attorney who knows he missed the statute but asserts that he subjectively believed that the client would not make a claim against him or that no harm would result for one reason or another.

Another issue that has been frequently litigated in recent years is whether a prior knowledge provision bars coverage for “innocent” insureds, i.e., whether knowledge of a potential claim by one insured bars coverage for all insureds. The starting point for analysis is, of course, the language of the policy. Some policies contain express severability provisions that prevent the insurer from denying coverage for other insureds based on one insured’s knowledge. See, e.g., Avon State Bank v. BancInsure, Inc., No. 12-2557, 2014 WL 1048503, at *5 (D. Minn. Mar. 18, 2014) (policy provided that “[n]o fact pertaining to or knowledge possessed by any Insured Person shall be imputed to any other Insured Person for the purposes of applying the exclusions”). Other policies limit the class of insureds whose knowledge of a potential claim will bar coverage by, for example, specifying that only knowledge of a management committee member or officer will trigger the prior knowledge provision. E.g., Maher & Williams v. ACE Am. Ins. Co., No. 3-cv-1191, 2010 WL 3546234, at *8 (D. Conn. Sept. 3, 2010) (interpreting a prior knowledge provision that barred coverage based on the knowledge of “the Firm, any Firm partner, or any member of the Firm’s management or executive committee”).

Many prior knowledge provisions, however, focus broadly on whether any insured had knowledge of a potential claim. When a prior knowledge provision is clearly worded to bar coverage for “all insureds” based on the knowledge of “an insured” or “any insured,” courts generally have upheld the provision’s applicability to so-called “innocent” insureds. E.g., Murphy v. Allied World Assurance Co. (U.S.) Inc., 370 F. App’x 193, 194 (2d Cir. 2010) (agreeing that, “[i]n the context of [prior knowledge exclusions], the words ‘any insured’ unambiguously preclude coverage for innocent co-insureds”); Westport Ins. Corp. v. Hanft & Knight, P.C., 523 F. Supp. 2d 444, 460-61 (M.D. Pa. 2007) (prior knowledge exclusion referencing the knowledge of “any” insured barred coverage for innocent co-insureds). In this regard, the clear trend is for courts to reject arguments that “innocent insured” provisions by their language showing they are intended to apply to dishonesty exclusions can somehow “save” coverage that is otherwise barred by a prior knowledge provision, and to reject arguments that public policy mandates coverage for “innocent” insureds. See, e.g., Bryan Bros., 660 F.3d at 831 (the “innocent insureds provision” is “an exception to the bad acts exclusion” that is not implicated where coverage is barred by a prior knowledge provision); Cont’l Cas. Co. v. Marshall Granger & Co., LLP, 921 F. Supp. 2d 111, 122 (S.D.N.Y. 2013) (by its plain language, an “Innocent Insureds” provision in an accountants liability policy applies only if coverage is barred based on the “bad acts” exclusion); Cont’l Cas. Co. v. Battery Wealth, Inc., No. 09-cv-00605, 2011 WL 11439128 (D.S.C. May 5, 2011) (rejecting insured’s argument that “Innocent Insured” provision can save coverage where the policy’s prior knowledge condition precedent has not been satisfied), aff’d, 474 F. App’x 898 (4th Cir. 2012); Cont’l Cas. Co. v. Jones, No. 09-cv-1004, 2011 WL 3880963, at *3, *6 (D.S.C. Sept. 2, 2011) (same); navigators Specialty Ins. Co. v. Scarinci & hollenbeck, LLC, No. 09-cv-4317, 2010 WL 1931239, at *13-14 (D.N.J. May 12, 2010) (innocent insured provision pertains solely to the policy’s dishonesty exclusion and does not apply where coverage is barred by a prior knowledge provision); Cont’l Cas. Co. v. Walker, 741 F. Supp. 2d 987, 991-92 (E.D. Ark. 2008) (innocent insured provision did not apply where insurer was not invoking any policy exclusion relating to criminal, dishonest, fraudulent, or malicious conduct); Davis & Meyer Law, Ltd. v. ProNational Ins. Co., No. 06AP-730, 2007 WL 2009666, at *6 (Ohio Ct. App. July 12, 2007) (“innocent insured” clause is an exception to the fraud exclusion).

In rejecting policyholder attempts to make an end-run around prior knowledge provisions, courts have generally reasoned that policies should be enforced as written and that insureds may purchase poli-
cies with narrower prior knowledge provisions if they desire more expansive coverage. See Bryan Bros. Inc. v. Cont’l Cas. Corp., 704 F. Supp. 2d 537, 542 n.4 (E.D. Va. 2010) (“[N]othing prevented [the insureds] from bargaining for a policy that included a more limited prior knowledge provision or a broader ‘innocent insureds’ provision”), aff’d, 660 F.3d at 832 (4th Cir. 2011) (“[the insured] was free to bargain for additional coverage”); Prof’l Asset Strategies, 447 F. App’x at 100 (explaining that the insurer “had the right to . . . limit its liability” by selling a policy that plainly “negated coverage of a claim if any of a broad group of persons affiliated with [the insured]-including all employees-knew of the basis of a claim on the policy’s effective date”).

II. Statutory and Punitive Damages

Professional liability policies often exclude coverage for various kinds of statutory or punitive damages. Alternatively, professional liability policies may carve out certain types of relief (for example, “fines,” penalties” and “sanctions”) from the definition of “damages” or “loss.” In general, these exclusions and carve-outs are designed to protect the insurer from liabilities that are non-compensatory in nature. Statutorily authorized and punitive recoveries often bear no resemblance to the actual injury inflicted by the policyholder’s conduct, or connote a level of intentional wrongdoing that the insurer does not want to indemnify.

Depending on the wording of the policy, the underlying complaint, and the specific statutory regime at issue, disputes can arise regarding the proper characterization of the monetary award at issue. For example, a Delaware trial court recently grappled with the proper characterization of monetary awards imposed by a Louisiana workmen’s compensation statute. Exec. Risk Specialty Ins. Co. v. First Health Grp. Corp., No. CIV.A. 09C-09-027JOH, 2013 WL 1908664, *3 (Del. Super. Ct. May 7, 2013). The court ultimately determined that the awards were not covered because they were punitive in character: “The amount under the statute more than compensates an injured party for losses sustained for a lack of notice. Additionally, ‘[S]ection 40.2203.1(G) is punitive in nature because its purpose is to punish group purchasers for failure to provide notice of PPO discounts to health care providers.’” Id. (footnotes and citations omitted); see also Indian Harbor Ins. Co. v. Bestcomp, Inc., No. 09-7327, 2010 WL 5471005, at *5 (E.D. La. Nov. 12, 2010) (statutory damages were “not compensatory [and therefore not covered] because the amount of damages bears no correlation” to the actual harm caused by the defendant), aff’d, 452 F. App’x 560 (5th Cir. 2011). By contrast, the Supreme Courts of Illinois and Missouri recently refused to apply exclusions for “statutory damages” to the monetary award authorized by the Telephone Consumer Protection Act – “$500 in damages for each . . . violation,” 47 U.S.C. §227(b)(3)(B) – reasoning that the remedy prescribed by the statute was not entirely punitive in nature. Standard Mut. Ins. Co. v. Lay, 989 N.E.2d 591 (Ill. 2013); Columbia Cas. Co. v. HIAR Holding LLC, 411 S.W.3d 258 (Mo. 2013).

The application of carve-outs and exclusions of this kind is likely to remain a fertile ground for dispute, in part because the sheer number and complexity of the statutory and remedial schemes that can be invoked by claimants is vast. Moreover, the plaintiffs’ bar has a strong incentive to pursue suits under statutes that support the filing of class actions and/or provide for monetary remedies on a “per violation” basis because potential monetary awards (and, perhaps more to the point, potential attorneys’ fees awards) can be very large. Data and privacy protection statutes such as the Federal Stored Communications Act, the Federal Wiretap Act, the Video Privacy Protection Act, the California Invasion of Privacy Act, and consumer protection statutes such as the Fair Credit Reporting Act, the Fair and Accurate Credit Transactions Act, the Truth in Lending Act, the Fair Debt Collections Practices Act, and the Telephone Consumer Protection Act, are commonly relied upon in support of such suits.

In determining whether there is coverage for a claim seeking relief under these statutes, courts often must determine the legislative purpose underlying the monetary awards that the statutes authorize. Resolution of that question can require a detailed analysis of the statute’s legislative history. Courts’ passing charac-
terizations of statutes as authorizing “damages” or “penalties” may not be accurate if the decision in question did not squarely consider the question. The parties may also dispute who has the burden of proof of establishing coverage for a monetary amount awarded pursuant to a statute, regardless of whether the policy limitation is found in the insuring agreement or in an exclusion. And where the proper characterization of a settlement is at issue, there is an ongoing debate whether the proper focus is limited to the allegations in the complaint, see, e.g., Unified W. Grocers, Inc. v. Twin City Fire Ins. Co., 457 F.3d 1106, 1115 (9th Cir. 2006), or whether other evidence such as the terms of the settlement agreement is also relevant, notwithstanding that the terms of a settlement agreement are often largely if not entirely within the control of the settling policyholder that is advocating that the claim is covered. As yet, there are no clear trends that have emerged around these issues, but this will remain an active area of litigation nationwide.

III. Business Enterprise and Contractual Liability Exclusions

Although business enterprise exclusions and contractual liability exclusions are focused differently, they are both designed to narrow the coverage afforded by professional liability policies to protect insurers from liability arising out of the routine business activities of their insureds.

A. Business Enterprise Exclusions

The precise terms of business enterprise exclusions vary, but two kinds predominate: (1) exclusions for claims arising from an insured’s role with respect to a different business entity (e.g., as a manager or director of a separate corporation); and (2) exclusions for claims arising from an insured’s actions with regard to an entity that the insured controls or in which an insured has a significant financial interest. In application, business enterprise exclusions are typically implicated in actions where a professional wears two “hats,” intermingling a professional practice with private business activities. Professionals who so choose to mix their business and professional pursuits are at increased risk of claims, including claims that allege conflicts of interest. See, e.g., Admiral Ins. Co. v. Adges, No. 11 CIV. 8289 JPO, 2012 WL 2426541 (S.D.N.Y June 27, 2012). Insurers rightly do not want to take on this increased risk. As the saying goes, a lawyer who represents himself has a fool for a client.

Many courts have applied business enterprise exclusions in accordance with their broad language – even where there may be isolated allegations of conduct that arguably falls within the insuring agreement. For example, one court rejected an insured attorney’s argument that the business enterprise exclusion did not preclude coverage because he was “wearing his lawyer ‘hat’ at the precise moment” of the alleged malpractice. Coregis Ins. Co. v. LaRocca, 80 F. Supp. 2d 452, 458–59 (E.D. Pa. 1999). The court refused to parse the insured’s actions, explaining that “[d]istinguishing with certainty between the roles [the insured] was playing at different moments in his dealings . . . could prove impossible. The broad, inclusive language of the [business enterprise] exclusions, however, makes the drawing of such distinctions unnecessary.” Id.

Not surprisingly, disputes over the application of business enterprise exclusions typically focus on whether the underlying claim concerns services or actions that are unrelated to the professional’s insured activities. For example, in “mixed actions” that combine legal malpractice allegations with allegations regarding an attorney’s business activities, courts have generally considered whether the attorney’s business activities lie at the heart of the alleged wrongdoing. When the alleged malpractice clearly arises out of or relates to an attorney’s separate business activities, the trend has been to enforce the exclusions to bar coverage. E.g., Gomery v. Cont’l Cas. Co., No. 1:13-CV-947, 2014 WL 4209648 (W.D. Mich. Aug. 25, 2014) (business enterprise exclusion barred coverage where malpractice claims were inextricably tied to and based upon the attorney’s self-dealing as a member of a real estate development company); Christensen v. Darwin Nat’l Assurance Co.,
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2:13-CV-00956-APG, 2014 WL 1628133 (D. Nev. Apr. 14, 2014) (business enterprise exclusion barred coverage); Abrams, Fensterman, Fensterman, Eisman, Greenberg, Formato & Einiger, LLP v. Underwriters at Lloyd’s, London, 918 F. Supp. 2d 114, 120-21 (E.D.N.Y. 2013) (applying business enterprise exclusion, the court refused to consider the malpractice claims in isolation, reasoning that a business enterprise exclusion in a lawyer’s professional liability policy assumes the existence of an attorney-client relationship); Am. Guarantee & Liab. Ins. Co. v. Flangas McMillan Law Grp., Inc., 2:11-CV-188-KJD-RJJ, 2012 WL 628511 (D. Nev. Feb. 24, 2012) (rejecting argument that the exclusion was vague). There are no signs that this trend is eroding. Moreover, the same approach has been taken to cases that involve different types of professionals. E.g., Keown v. Tudor Ins. Co., 293 P.3d 137, 141 (Haw. Ct. App. 2012) (application of business enterprise exclusion in policy issued to real estate agent was not contrary to the policyholder’s reasonable expectations, because the exclusion was a “common clause” and the bar applicable to coverage for “his personal business activities was neither unknowable nor unexpected under the circumstances of this case”).

B. Contractual Liability Exclusions

Contractual liability exclusions typically provide, in substance, that there is no coverage for liabilities that an insured assumes under contract or for the failure to perform under a contract or agreement, unless the insured would have been liable even in the absence of the contract or agreement. These exclusions are designed to limit the professional liability insurer’s exposure to claims that are unrelated to claims for commercial breach. Otherwise, the insurer would effectively be guaranteeing the policyholder’s performance and earnings in the ordinary course of business.

Some recent decisions have applied contractual liability exclusions where the relationship that gave rise to the underlying claim was contractual in nature, even though the claimant also alleged non-contractual theories of liability. Thus, in Town of Monroe v. Discover Property & Casualty Insurance Co., CV126026835S, 2014 WL 2054307 (Conn. Super. Ct. Jan. 21, 2014), the trial court applied a contractual liability exclusion to bar coverage for a dispute arising out of a contract relating to the construction of a communications tower, even though the underlying claimant alleged that the defendant was also liable in tort:

Any representations or statements alleged to have been made could only arise from or be in consequence of the contract claim and could not exist in the absence of the contract claim or its breach. The wrongful act complained of arose out of or had its origin in the breach of contract even though . . . count two alleges the legal theory of negligent misrepresentation. In interpreting the language of the policy and the allegations of the underlying complaint, the wrongful act is not the legal theory of negligent misrepresentation but is the breach of the contract and it falls within the purview of the contract exclusion under the policy.

Id. at *6; see also City of Warren, Mich. v. Int’l Ins. Co. of Hannover, 524 F. App’x 254, 257 (6th Cir. 2013) (applying exclusion where underlying claim arose out of a municipality’s alleged breach of contract); In re Romeo Montessori Sch. Ass’n, Inc., 450 B.R. 667, 672-74 (Bankr. E.D. Mich. 2011) (applying exclusion to claims arising out of failure to provide educational services because “it is obvious to the Court that the claims are squarely grounded in a breach of contract theory”). In enforcing a contractual liability exclusion, a federal district court in Alabama recently explained: “The insurer indemnifies the insured only for errors and omissions in the performance of professional services. Far from being illusory, these contract liability exclusions are essential to prevent the insurer from assuming the insured’s contractual obligations. If a[] . . . [professional liability] insurer were responsible for the insured’s performance of the underlying contract, then the insured would have an incentive to refuse performance and to seek indemnification upon the commencement of a lawsuit.” Scottsdale Ins. Co. v. Ala. Mun. Ins. Corp., 2:11-CV-668-MEF, 2013 WL 5231928, at *9 (M.D. Ala.)
Other decisions, however, have held the insurer to a high bar and have expressed concern that – depending on the circumstances – a broad reading of a contractual liability exclusion might render the coverage afforded by a professional liability policy illusory. Thus, in Idaho Trust Bank v. BanchsSure, Inc., No. 1:12-CV-00032-REB, 2014 WL 1117027 (D. Idaho Mar. 20, 2014), the district court refused to apply a contractual liability exclusion to claims brought against a lender. The court reasoned that the lender’s business was essentially contractual in nature and the contractual liability exclusion created an inherent conflict in the policy that was properly resolved in favor of the policyholder because “[a]n insurer cannot seek to apply policy limitations and exclusions in a way to defeat the precise purpose for which the insurance is purchased.” Id. at *12. In another banking case, even though the parties’ relationship was based on an account agreement, the court held that the insurer had failed to establish that the contractual liability exclusion unequivocally barred coverage because the agreement had not been made a part of the record and the underlying claimant had asserted claims based on the UCC that were potentially independent of any claim based on the agreement. Lombardi, Walsh, Wakeman, Harrison, Amodeo & Davenport, P.C. v. Am. Guarantee & Liab. Ins. Co., 85 A.D.3d 1291, 1295-96, 924 N.Y.S.2d 201, 205 (2011).

As the foregoing authorities demonstrate, courts will likely scrutinize proposed applications of contractual liability exclusions carefully. Although courts have recognized limitations on their enforcement in certain circumstances, they have generally applied the exclusions consistent with their plain meaning when the policyholder is seeking coverage for a contractual obligation that a reasonable insured would not expect to be covered. We expect that, increasingly, this common-sense approach will continue to be adopted in this context.

IV. Coverage for Data Breaches

Computer hackers and data breaches threaten insured professionals, as well as corporate directors and officers, with enormous potential liability. Courts have only recently begun exploring the availability of insurance coverage for claims resulting from data security lapses. Early decisions indicate that courts are unlikely to interpret general commercial liability policies as affording coverage for these claims. E.g., Recall Total Info. Mgmt., Inc. v Fed. Ins. Co., 147 Conn. App. 450, 463-64 (Conn. App. Ct. 2014) (loss of data tapes containing personal identifying information without resulting publication did not trigger coverage under a CGL policy’s personal injury coverage), cert. granted in part, 311 Conn. 925 (2014); Zurich Am. Ins. Co. v. Sony Corp. of Am., Case No. 651982/2011 (N.Y. Sup. Ct. Feb. 21, 2014) (acts by third-party hackers do not constitute “oral or written publication in any manner of the material that violates a person’s right of privacy” within a CGL policy’s personal and advertising injury coverage). CGL insurers are also increasingly adding endorsements and exclusions that specifically bar coverage for data security claims. See, e.g., R. Anderson, Coming to a CGL Policy Near You: Data Breach Exclusions (Apr. 23, 2014), available at http://www.law360.com/articles/529464/coming-to-a-cgl-policy-near-you-data-breach-exclusions.

Although there are few cases addressing professional liability coverage for data security claims, coverage generally may be triggered only when there is a direct link between the insured’s acts and omissions giving rise to the liability and the specific type of “professional services” covered by the policy. See, e.g., Eyeblaster, Inc. v. Fed. Ins. Co., 613 F.3d 797, 803 (8th Cir. 2010) (an “Information and Network Technology” E&O policy issued to an online marketing company potentially afforded coverage for a suit alleging that the company wrongfully used online advertising software scripts). Although some D&O and E&O insurers have added
limited coverage to their policies for such risks through the addition of data breach endorsements, many are joining CGL carriers in adding specific exclusions for claims arising out of data breaches. Similar to coverage disputes concerning the application of contractual liability exclusions, however, and depending on all of the applicable policy language, data breach exclusions can invite arguments that the insurer is impermissibly taking coverage away with one hand that it has extended with another. Thus, in First Bank of Delaware, Inc. v. Fid.
& Deposit Co. of Maryland, CA No. N11-08-221, 2013 WL 5858794 (Del. Super. Ct. Oct. 30, 2013), reargument denied, 2013 WL 6407603 (Del. Super. Dec. 4, 2013), the Delaware trial court refused to enforce an unambiguous data breach exclusion in a D&O policy on the ground that it rendered a coverage grant in the policy illusory. In particular, the court refused to enforce the exclusion because the policy elsewhere granted the policyholder coverage for “any unauthorized use of, or unauthorized access to electronic data … with a computer system.” Id. Although we disagree with the court’s conclusion, we expect that the result would have been different absent the very specific grant of coverage that the exclusion then appeared to negate.

V. The Right to Independent Counsel

There is a growing body of law nationwide regarding whether and, if so, in what circumstances, an insured has a right to independent defense counsel, notwithstanding that the policy gives the insurer the right and duty to defend, which typically includes the right to appoint defense counsel. Typically, an insurer may select defense counsel from a panel of attorneys who the insurer regularly retains to defend its insureds. In an independent counsel situation, the insured typically demands to use other defense counsel, usually of its own choice.

States vary widely regarding their rules about the right to independent counsel. A survey of independent counsel law could be a book by itself, but below are examples of the major general approaches.

First, the largest number of states follow in substance the rule adopted by California in its “cumis statute,” which specifies that an insured may select independent counsel where the insurer reserves rights on a ground that creates an actual conflict between the insurer and the insured regarding how the case is defended. See Cal. Civ. Code §2860; Nat’l Cas. Co. v Forge Indus. Staffing, Inc., 567 F.3d 871, 874 (7th Cir. 2009) (Illinois law) (“If there is an actual conflict of interest between the insurer and insured, the insured has the right to obtain independent counsel at the insurer’s expense.”); Roussos v. Allstate Ins. Co., 655 A.2d 40, 43 (Md. 1995) (Maryland law) (holding that, when a conflict of interest arises, “the insurer must either provide an independent attorney to represent the insured or pay for the cost of defense incurred by the insured hiring an attorney of his or her choice”); Mut. Serv. Cas. Ins. Co. v. Luettmer, 474 N.W.2d 365, 368 (Minn. Ct. App. 1991) (Minnesota law) (stating that “before an insured will be entitled to counsel of its own choice, an actual conflict of interest, rather than an appearance of a conflict of interest, must be established”).

The classic example of an “actual” conflict of interest is a claim asserting both a fraud count and a negligence count based on the same facts. If the insured is to be held liable, it is in the insurer’s interest for the conduct to be determined to have been fraudulent because indemnity coverage therefore would be precluded. By contrast, it is, of course, in the insured’s interest for any liability to be based on a negligence finding only, because negligent conduct is covered. Because defense counsel could steer the case one way or the other, there is a conflict of interest, and the California statute (as well as a large number of states) give the insured the right to select independent counsel.

Second, some states, with Massachusetts appearing to be an example, permit the insured to select independent counsel whenever the insurer reserves the right to deny coverage. Herbert A. Sullivan, Inc. v. Utica Mut. Ins. Co., 788 N.E.2d 522, 539 (Mass. 2003) (Massachusetts law) (“When an insurer seeks to defend
its insured under a reservation of rights, and the insured is unwilling that the insurer do so, the insured may require the insurer either to relinquish its reservation of rights or relinquish its defense of the insured and reimburse the insurer for its defense costs.”).

Third, some states, like Florida by statute, give the insured the right to independent counsel whenever the insurer reserves rights but require the insured and the insurer to agree on mutually acceptable independent counsel. Fla. Stat. §627.426(2)(b)(3).

Finally, some states hold that the insurer retains the right to select defense counsel notwithstanding any reservations of rights, even one that creates a conflict, relying on the ethical integrity of attorneys to protect the insured from being adversely affected by any conflict of interest between the insurer and the insured as to how the case is defended. These states sometimes also impose an enhanced duty of good faith on the insurer regarding its conduct of the defense in such circumstances See, e.g., Finley v. Home Ins. Co., 975 P.2d 1145, 1154 (Haw. 1998) (Hawaii law) (holding that any potential conflict of interest is resolved by reliance on the integrity of the retained defense counsel); Norman v. Ins. Co. of N. Am., 239 S.E.2d 902 (Va. 1978) (Virginia law) (finding that an attorney employed by insurer to defend insured “is bound by the same high standards which govern all attorneys, and owes the insured the same duty as if he were privately retained by the insured”); Ferguson v. Birmingham Fire Insurance Co., 460 P.2d 342 (Or. 1969) (Oregon law) (holding that even where a clear conflict of interest exists, the insurer had no duty to provide independent counsel, and the insured had no right to retain one at the insurer's expense because the insurer is unlikely to relax its defense of its insured due to the likelihood of the jury being sympathetic to the insured in subsequent coverage litigation).

One trend we see is that courts are increasingly willing to scrutinize whether a particular reservation of rights truly creates a conflict of interest between the insurer and the insured regarding how a case is defended. And, to protect their right to select counsel or control the defense, insurers are sometimes intentionally waiving a reservation of rights that they could otherwise assert in order to avoid triggering a right to independent counsel. Where insureds assert the right to select independent counsel merely because the insurer reserved rights on some grounds, courts generally recognize that the insurer's right to retain defense counsel is an important contractual right that should not lightly be set aside. An insured who wants the right to select defense counsel for all claims should pay the higher premium required to purchase a policy giving the insured that right. Otherwise, under a typical duty to defend policy, the insurer's right and duty to select defense counsel should be honored.

The recent decision in Coats, Rose, Yale, Ryman & Lee, P.C. v. Navigators Specialty Ins. Co., 830 F. Supp. 2d 216, 220-21 (N.D. Tex. 2011), aff’d, 489 F. App’x 769 (5th Cir. 2012), provides a good example of a case in which an insurer successfully insisted on its right to select defense counsel, notwithstanding several significant reservations of rights. That case also provides an example of an insurer choosing not to reserve rights on a ground (specifically, the policy’s dishonesty exclusion) that would trigger a right to independent counsel, even where there were grounds for such a reservation.

The Coats Rose court rejected the policyholder's assertion of the right to independent counsel on several grounds. With regard to the policyholder's argument that the insurer was conflicted because the complaint sought recovery on different legal theories (legal malpractice and breach of fiduciary duty), the court held that there was no conflict because the policy afforded coverage under either theory. As to the policyholder's argument that there was a conflict because the complaint sought both compensatory damages (which were covered) and a return of fees (which were not covered), the court held that there was no conflict because the competing measures of damages were neither mutually exclusive nor substitutes for one another, and there was no showing that defense counsel would have any reason not to contest the policyholder’s liability across-the-board because the claims for relief were based on a common set of factual allegations. For similar
reasons, the court rejected the policyholder’s argument that there was a conflict because the underlying complaint contained a non-covered count for declaratory relief, because as a practical matter the grounds alleged for declaratory relief were inseparable from the grounds alleged in support of damages.

Other key points to examine in connection with the right to independent counsel include the following: (1) if there is a right to independent counsel, who selects that independent counsel; (2) if the insured has the right to select independent counsel, are there limitations on the choice, such as experience or qualification requirements; (3) what rates must the insurer pay for independent counsel; and (4) what reporting and other obligations does independent counsel have to the insurer. The California statute provides clear guidance on all of these points. See Cal. Civ. Code §2860(c) (“When the insured has selected independent counsel to represent him or her, the insurer may exercise its right to require that the counsel selected by the insured possess certain minimum qualifications . . . . The insurer’s obligation to pay fees to the independent counsel selected by the insured is limited to the rates which are actually paid by the insurer to attorneys retained by it in the ordinary course of business in the defense of similar actions in the community where the claim arose or is being defended.”); id. §2860(d) (“When independent counsel has been selected by the insured, it shall be the duty of that counsel and the insured to disclose to the insurer all information concerning the action except privileged materials relevant to coverage disputes, and timely to inform and consult with the insurer on all matters relating to the action . . . .”); id. §2860(f) (“Where the insured selects independent counsel pursuant to the provisions of this section, both the counsel provided by the insurer and independent counsel selected by the insured shall be allowed to participate in all aspects of the litigation. Counsel shall cooperate fully in the exchange of information that is consistent with each counsel’s ethical and legal obligation to the insured.”). As a side note, although the statute presumes that the insurer will appoint its own counsel to participate with independent counsel in the defense of the claim, typically the independent counsel acts as the only defense counsel.

Another important issue to consider when an insured’s right to independent counsel has been triggered is whether the insurer has an obligation to inform the policyholder affirmatively of its right to retain independent counsel (and what the consequences might be if the insurer fails to do so). Thus, in Executive Risk Indemnity Inc. v. Icon Title Agency, LLC, 739 F. Supp. 2d 446, 450-51 (S.D.N.Y. 2010), the district court held that the policyholder had a right to independent counsel because the insurer had taken the position that there was no coverage for fraud, but the underlying complaint alleged fraud in the alternative. The court ultimately did not reach the policyholder’s assertion that the insurer was liable for committing an unfair or deceptive act or practice because the insurer had failed to inform the policyholder of its right to independent counsel; however, the court did note that courts in New York were divided on that issue. Id. (comparing Sumo Container Station, Inc. v. Evans, Orr, Pacelli, Norton & Laffan, P.C., 278 A.D.2d 169, 719 N.Y.S.2d 223 (2000) (no affirmative duty to inform insured of right to select counsel) with Elacqua v. Physician’s Reciprocal Insurers, 800 N.Y.S.2d 469, 473 (App. Div. 2005) (“If defendant was obligated to defend plaintiffs in the underlying action and . . . provide them independent counsel of their own choosing, it follows that defendant was required to advise them of that right. To hold otherwise would seriously erode the protection afforded.”)).

In some jurisdictions, an insurer’s failure to inform its policyholder of a conflict of interest or to apprise the policyholder of its right to independent counsel may be invoked in support of arguments that the insurer is estopped from denying coverage or confronts other, extra-contractual liability. See, e.g., Stoneridge Dev. Co. v. Essex Ins. Co., 382 Ill. App. 3d 731, 742 (2008) (“If, however, the insurer goes ahead and defends its insured without disclosing the conflict of interest in its reservation of rights, the insurer will be estopped from raising coverage defenses.”). At this point, it appears that cases concluding that an insurer has an affirmative duty to advise the insured of the right to independent counsel even where no request has been made are outliers, but the issue bears watching.
VI. Conclusion

It is difficult to predict how courts will rule on professional liability coverage issues. We believe that there are some trends regarding the key recurring coverage issues discussed above. These trends are more fully developed as to some issues than others. Nonetheless, the starting point for analysis must always be the exact language of the applicable policy, as even seemingly small differences in policy language can result in different outcomes. No matter how strongly the law may seem to be trending regarding a particular issue, each case requires a careful analysis of the precise policy language at issue and consideration of the applicable state’s law regarding insurance coverage and professional liability.