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## VIEWPOINTS

# Does Your Error-and-Omission Insurance Need a Tune-Up?

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Investment banks face a tsunami of litigation, which could mean personal liability for their employees.



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In such a climate, investment bankers must pay close attention to their professional liability insurance policies, also known as errors and omissions (“E&O”) policies. Standard E&O policies — and the E&O claims process — are honeycombed with exclusions, Catch-22s, and creative defenses against coverage.

### THE INSURING AGREEMENT

The insuring agreement of a professional liability policy sold to investment bankers typically contains a promise by the insurer: to pay for all loss that the policyholder becomes legally obligated to pay as a result of claims made against the policyholder arising out of any actual or alleged negligent act, error, or omission in the policyholder’s performance of professional services.

**Claims made.** E&O policies are typically written on a “claims made” basis, which means that, to obtain coverage, a “claim” must be first made against the

policyholder during the policy period. In addition, some forms of E&O policies require that the claim also be reported to the insurer during that period.

A “claim” is typically defined to include a complaint filed in a lawsuit or alternative dispute resolution. It can also be defined to include “any demand for money or services.” In any case, the relevant date is not when the negligent act, error, or omission is alleged to have occurred but when the claim is made.

An interesting issue occurs where a dispute arises in one policy period but the claim appears in another period with a different company. The first insurer will typically take the position that no coverage is afforded during its policy period. The second insurer will typically argue either that the claim arose in the first period or that the policyholder knew of circumstances that would result in a claim but that were not disclosed on the application.

Faced with this scenario, the policyholder should notify the first insurer when the dispute arises and should notify the second when filling out the application and at the time the claim is made. This will ensure a recovery from one of

the insurance companies; which one will depend on the court’s resolution of when a “claim” arose.

Another “claims made” issue arises when a policyholder changes employers or sells a business. Suppose the policyholder commits a negligent act, error, or omission while with one employer but the claim is made when the policyholder is with another.

The latter’s insurer will deny coverage, claiming that it did not insure the risk of the employee’s prior professional negligence. This argument has significant support in case law. Coverage under the prior employer’s E&O policy will depend on whether it purchases an optional extended reporting period, which is often outside the professional’s control.

**Negligent act, error, or omission in the performance of professional services during the policy period** (or earlier, if prior-acts coverage is provided). This next issue is whether the claim is one of professional negligence, which insurers often challenge. If the complaint is unclear in this regard, the investment banker will be entitled to coverage under the universally accepted principle that, unless the claim is clearly not covered, coverage must be afforded.

Often the issue is whether the negligence allegedly occurred in the policyholder's rendition of "professional services."

The phrase is usually defined in the declaration page or application for the policy. If it is not defined in great detail, a policyholder may be able to rely on the extensive case law, in which the consensus construction is "services related to the performance of duties within the person's area of expertise."

A safer way to ensure coverage, however, is a broad delineation in the policy of the services the professional performs. For example, investment bankers should accurately delineate the range of services, including any clerical duties, they perform daily.

**Loss.** Whether there has been one is the next issue. Policies generally define "loss" to include all damages and judgments rendered against or settlements entered into by the policyholder. Most policies also include all costs of the policyholder's defense.

Some E&O policies are like other types of liability policies in containing a duty to defend, which is equivalent to a promise to hire and pay counsel to defend the policyholder. In most E&O policies, however, defense costs are normally charged against limits.

Investment bankers should pay close attention to this distinction. In this new era of accountability, losses will likely be greater than ever before. As losses rise, judgments and settlements will increase proportionately. As settlements and judgments rise, investment bankers or their insurance companies will have more economic incentive to litigate. As a result, the bankers are likely to use up more of their insurance limits on defense costs, leaving less for settlements and judgments.

**The hammer clause.** Though loss may include a settlement, E&O policies generally

contain a "hammer clause" that appears to protect a professional's reputation rights.

Under other liability policies, an insurer can settle cases, within limits, at its own discretion. In contrast, professional policyholders generally have veto rights on settlements to protect their professional reputation.

However, when such rights are asserted, insurers attempt to limit their liability in E&O policies to the amount for which they could have settled if the professional had not rejected the settlement.

The insurer may attempt to limit its liability early if it knows the policyholder does not want to settle under any circumstances. To make the case go away, it may propose making a very low settlement offer. If the policyholder asserts veto rights, the insurer may later argue that it should be liable only for the amount that it had initially proposed to settle the matter.

To protect themselves, policyholders must document the low offer and confirm in writing that the plaintiff would not settle for it.

### EXCLUSIONS

Even if coverage is initially triggered, there are exclusions that can operate to bar coverage under E&O policies.

**Known prior acts.** Claims arising from circumstances known by the policyholder before the policy period as likely to lead to a claim are often excluded.

**Dishonest, fraudulent, intentional, or criminal acts.** These are generally excluded. An issue arises where a claimant sues the policyholder for a number of tortious acts, ranging from negligence to recklessness to intentional misconduct. Most cases hold that the claim is covered.

The issue becomes how much is covered. The majority view is that if any claims are

potentially covered, a policyholder is entitled to reimbursement of defense costs for the entire action. A minority holds that the policyholder is entitled only to reimbursement of defense costs associated with potentially covered claims.

Another concern is whether an investment banker who did not commit a fraudulent or criminal act is denied coverage because an associate or partner did. Resolution depends on whether there is a "severability clause" or an "antiseverability clause" in the policy. These state whether each policyholder is treated separately for purposes of this exclusion.

### WHAT TO DO

To protect their interests, the bankers should, at a minimum, do the following in connection with their E&O policies:

- Purchase insurance from a company with good claims-paying experience.
- Review the terms with a highly qualified professional.
- Notify the insurer of all circumstances that could lead to a claim.
- Purchase an optional extended reporting period.
- Select an appropriate retroactive date for prior-acts coverage.
- When applying for the policy, carefully describe all services performed, to ensure a broadly worded definition of "professional services."
- Ensure that the limits are adequate.
- Make sure that the policy contains a severability provision.
- Properly document all settlement offers and responses by the claimant.

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