

Enforce

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Must Every Service Company Have Both E&O and D&O Programs?

By Raymond C. Dion and David E. Wood

In the post-World War II period, America was the land of manufacturing, where the giants of commerce owned heavy industry: foundries, utilities and factories making everything from baby clothes to bombers. Today, the manufacturing sector is being supplanted by service-driven companies generating intangible rather than tangible products. These companies have different needs than manufacturers. Protecting the means of production in a manufacturing economy from litigation requires insurance for products liability. Guarding a service company against liability exposure calls for policies covering services rather than products. In the 21st century, American business needs less insurance for manufacturers, and more insurance for makers of intangible products and providers of services.

All publicly owned corporations, new economy or old, have securities-related exposures arising from alleged failures of corporate governance. For these liabilities, the insurance industry designed directors and officers (D&O) liability policies to protect the individuals and the entity

from shareholder and derivative litigation. Manufacturers and heavy industry buy general liability coverage for their products and premises liabilities, but these policies often don't fit service companies very well. To meet new economy demand, the insurance industry offers errors and omissions (E&O) policies covering what the service company does for a living: render services.

But what if a senior officer of a service sector company is sued for making misrepresentations to a customer allegedly affecting the company's stock price? Is the ensuing litigation covered by D&O, E&O, both or neither? If crafted correctly, these policies can fit together like puzzle pieces within a corporate risk management strategy. If not, they can leave the policyholder with a lot of retained risk it didn't know it had. Service companies need insurance for mistakes made in rendering, or failing to render, services to their customers. But, they also need insurance for their directors' and officers' management blunders, essentially breaching duties of service to the corporation for which they act.

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Where Coverage Begins

Too often, insurance companies assume that D&O policies apply to mismanagement claims alone, and not to those involving both failures of corporate governance and customer relationships. Underwriters urge service companies to buy E&O insurance to protect their D&O program against erosion when claims having anything to do with customers and service issues come along. But, do allegations of service failures against a service company automatically rule out D&O coverage?

E&O policies cover loss from a claim as a result of a wrongful act taking place before or during the policy period “in the rendering or failure to render professional services.” E&O policies often define the term “professional services” as whatever the insured company does to drive revenue. Every service provider needs E&O insurance tailored to the services it renders to others. Under this kind of policy, professional services means whatever the policyholder does to make money.

Now, suppose the health care conglomerate, accounting firm or investment bank faces liability exposure for the way it manages itself. That’s what D&O insurance is for. In a perfect world, allegations against service companies for mistakes or misrepresentations made while rendering services to others are easy to distinguish from allegations of securities-related liability or other mistakes made while serving a corporation. But, think back to the senior officer sued for misrepresenting the scope of service work to be done for a customer, where the resulting adverse financial impact on the company drives down its share price. What if the customer, which owns a large stake in the insured company, doesn’t sue the company for the allegedly substandard services, but instead sues the company and its directors and officers on behalf of a class for concealing the failed engagement from shareholders? Where does E&O coverage end and D&O coverage begin?

When insuring a service company, underwriters try to express the dividing line between E&O and D&O coverage by a Professional Liability Exclusion (PLE) in the D&O policy. A PLE typically excludes any claim having to do with the company’s rendering or failing to render professional services. For reasons known only to themselves, underwriters often don’t define professional services in a PLE appended to a D&O policy. This is a recipe for coverage disputes, especially when the service company doesn’t buy an E&O policy designed to plug the gap created by the PLE under D&O coverage.

In the above example, where the customer’s primary complaint is about the insured company’s reporting of its financial condition, and not about the quality of its services, the D&O policy should cover the claim and the PLE should not apply. But, D&O policies often contain allocation provisions allowing the insurance company to escape coverage for a portion of the insured company’s defense costs, and part of the ultimate settlement or judgment. What if the insurance company construes the tangential involvement of professional services in an otherwise-covered securities claim as a partial defense to coverage, justifying allocation? Must any lawsuit mentioning professional services brought by a customer be perceived as an E&O loss justifying partial denial of D&O insurance coverage?

Can You Define That?

Most judicial decisions describe the undefined term “professional services” as services that arise out of a vocation, calling, occupation or employment involving specialized knowledge, labor or skill, and the labor or skill involved is predominantly mental or intellectual, rather than physical or manual. Some of these opinions define the term professional services in a PLE used in D&O policies. Others address what the term means in the coverage grant of E&O

policies, while still others deal with the term as used in the PLE to a general liability policy.

One of the decisions cited most often is *Marx v. Hartford Accident & Indemnity Co.*, 157 N.W. 2d 870, 871-2 (Neb. 1968). Hartford wrote a policy covering a doctor for errors and omissions in rendering professional services, without defining the term. The insured company's employee sterilized instruments incorrectly, using benzene instead of water, and the building burned down. The Nebraska Supreme Court held that the malpractice insurer had no duty to cover the loss because the employee was unskilled, and had been performing a manual rather than an intellectual task. For a generation, Marx was the case most cited for what professional services means in all insurance policies using the term. If the service rendered was intellectual and not manual, it was professional.

Courts now acknowledge that sometimes, the distinction between professional and non-professional services does not apply easily to service companies. In *Harad v. Aetna Casualty & Surety Company*, 839 F. 2d 979 (3d Cir. 1988), a lawyer bought a commercial general liability policy that excluded bodily injury arising out of the rendering of undefined professional services. A client sued him for malicious prosecution after the attorney verified an answer and counterclaim. The Third Circuit held that this was a professional service because the lawyer made a strategic decision that filing a verified complaint would be to Hanover's benefit, eliminating commercial general liability. The act was "professional" because it arose out of a vocation involving specialized skill that was predominantly mental or intellectual. The act was "not professional" because "[t]he commercial aspect of running a law firm involves the setting up and running of a business, i.e, securing office space, hiring staff, paying bills and collecting accounts receivable, etc."

The Unclear Legal Landscape

Next, courts began to acknowledge there is a no-man's land between D&O and E&O policies that the PLE often does not clearly map out. In *Great American Insurance Company v. GeoStar Corp.*, 2010 Westlaw 845953 (E.D. Mich. 2010), GeoStar was in the business of selling tax shelters to investors. The tax shelters, involving the lease of racehorses, were overturned by the IRS and the proceeds diverted to unapproved uses. The court held that the underlying plaintiffs' claims that GeoStar misrepresented the value of the tax shelters concerned a professional service excluded under its D&O policy, while claims that GeoStar had sold more leases than there were horses were not. The court rejected the D&O carriers' assertion that, in effect, everything GeoStar did in relation to its tax shelter business was excluded by the PLE.

In a case such as *Great American Insurance*, in which the distinction between operating services rendered to customers and management services rendered to the insured company itself is blurred, rejection of a PLE – especially one that doesn't define the term *professional services* – seems easy to justify. But, where services rendered to customers can fairly be segregated from services rendered to the insured company itself, the PLE may be applied more appropriately.

These decisions, and cases like them, suggest a trend toward a more uniform and fair interpretation of the PLE – and away from the assumption that a service company must have an E&O program to protect against big gaps in its D&O coverage. The definition of professional services emphasizing intellectual rather than manual work is all but obsolete. The distinction between intellectual and manual services never migrated well into D&O programs, particularly those purchased by service companies with overlapping shareholder and customer exposures. In the

example of the unfortunate company sued for customer misrepresentations resulting in securities-related liability, this definition would wipe out insurance coverage for all misrepresentation-based losses. How the insured company generated service revenue would be irrelevant. Even though D&O

insurance is designed specifically with securities-related exposures in mind, any claim based in part on a customer relationship would be vulnerable. This is an unfair result for service companies that purchase D&O coverage but not an E&O program.

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