

2003

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Recommended Citation

Susan Saab Fortney, *Legal Malpractice Insurance: Surviving the Perfect Storm*, 28 J. Legal Prof. 41 (2003)

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LEGAL MALPRACTICE INSURANCE: SURVIVING THE PERFECT STORM

*Susan Saab Fortney**

I. NEW MARKET CONDITIONS

Any lawyer who has recently shopped for insurance knows that the market has changed. No longer do lawyers find the soft market conditions of the late 1990s. Rather, various forces have converged to create a “perfect storm.”¹

During the 1990s, insurers sold legal malpractice at low rates because premiums could be invested in a booming stock market.² Beginning in 2000, investment income was dramatically down because of poor performing markets. At the same time, insurers began to experience increased losses. Following the September 11 tragedy, insurers and reinsurers paid out the largest property and casualty loss in the history of the insurance industry, a loss approaching 70 billion dollars.³ As a result, some insurers and reinsurers left the market.⁴ Other insurers were declared insolvent.⁵ Those insurers who continued to write legal malpractice insurance expect an increase in both the frequency and severity of claims.⁶ Historically, following tough economic times, more litigants sue lawyers.⁷ Another concern is that

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1. According to Anthony K. Greene, Director at Jamison Insurance Group in West Orange, the “sagging economy, ten years of devil-may-care underwriting by insurers, and huge claims from corporate scandals” have created the “perfect storm” for lawyers purchasing professional liability coverage.” Earl Ainsworth, *Ouch! Legal Mal Rates Zooming Sky-High*, N.J. LAW., Jan. 6, 2003, at 1.

2. Anthony Lin, *Paying a Premium for Law Firm Malpractice Insurance*, RECORDER, Mar. 21, 2003, at 2 (noting that insurers were “more than happy” to sell professional liability insurance to law firms at low rates because the premium could be plowed into lucrative investments for long periods before any claims might arise).

3. RONALD E. MALLIN ET AL., LEGAL MALPRACTICE: THE LAW OFFICE GUIDE TO PURCHASING LEGAL MALPRACTICE INSURANCE § 1.1 (Ronald E. Mallin ed., 2002).

4. *Id.* (discussing the reduction in reinsurance capacity in errors and omissions markets and the destabilization of primary insurers).

5. Tom Shean, *Tennessee Says Three Malpractice Insurers Unable to Pay Claims*, VIRGINIAN PILOT, Feb. 6, 2003, available at 2003 WL 1516587.

6. *Managing Risk: What Law Firms Must Do to Control Liability Insurance Costs*, L. OFF. MGMT. AND ADMIN. REP. (Inst. of Mgmt. & Admin., New York, N.Y.), May 1, 2003, available at 2003 WL 2068161 [hereinafter *Managing Risk*] (referring to The Profile of Legal Malpractice Claims: 1996-1999, a study conducted by the ABA Standing Committee on Lawyers' Professional Liability).

7. *Why Professional Liability Insurance is Again a Major Cost & Concern for Partners*, PARTNERS REP. FOR L. FIRM OWNERS (Inst. of Mgmt. & Admin., New York, N.Y.), Apr. 1, 2003, available at 2003 WL 2213164 [hereinafter *Cost & Concern*] (showing historically that “clients are more likely to sue when they aren't making money, whether or not their law firms have made a mistake”).

more claims will result from corporate scandals, much like what occurred during the savings and loan crisis.⁸

All of these factors have contributed to fewer insurers writing legal malpractice insurance, limited coverage offered by those insurers who remain in the market, and dramatic premium increases for those policies that are available. For example, in New Jersey the number of insurers writing legal malpractice insurance dropped from eighteen to eight or eleven, depending on whether one counts insurers who are very selective in turning down more lawyers than they insure.⁹

Solo practitioners and firm lawyers alike must deal with new limitations on coverage coupled with premium increases. Lawyers practicing in large firms appear to be the hardest hit with rates increasing from 35% to as much as 75%.¹⁰ Smaller firms will probably face somewhat lower increases of between 25% and 30%, reflecting the lower litigation risk.¹¹ Some high risk practice areas with the potential for large malpractice awards are seeing 100% to 300% premium increases.¹² While most firms can expect an increase of 25% to 40%, firms with claims histories and high risk practice areas, such as plaintiffs personal injury work, can expect increases of more than 100%.¹³

In addition to being subject to higher premiums, lawyers who practice in certain high risk areas also are encountering limited coverage. For some practice areas, insurers are attempting to limit their exposure by restricting the limits of liability or requiring higher deductibles. Other insurers are now declining to write lawyers who practice in certain practice areas. For example, two of the nation's largest malpractice insurers, AIG and CNA, now refuse to write malpractice insurance for intellectual property lawyers.¹⁴ At least one major insurer has excluded work related to insureds handling mass tort cases.¹⁵

Given these hard market conditions, lawyers in all practice areas must be diligent in shopping for insurance. Instead of allowing the purchase decision to be driven by the lowest premium quotation, lawyers should carefully study policy terms and insurers so that the lawyers will have coverage in the unfortunate event of suit.

8. Lin, *supra* note 2, at 2.

9. Ainsworth, *supra* note 1, at 1.

10. Anthony Lin, *Firms Pay Heed To Insurance Hikes, Patent Prosecutions, Opinion Letters Deemed High-Risk Areas*, CONN. L. TRIB., Mar. 31, 2003, at 7.

11. *Managing Risks*, *supra* note 6 (quoting the New York Law Journal).

12. Earl Ainsworth, *Malpractice Insurance: A High Priced Headache for Lawyers*, N.J. LAW., Mar. 10, 2003, at A2.

13. *Cost & Concern*, *supra* note 7 (citing a San Diego insurance broker).

14. Earl Ainsworth, *Paying the Price for IP Practice Insurance*, N.J. LAW., June 30, 2003, at A5 (using an actual case to illustrate how intellectual property lawyers risk being "wiped out" because of inadequate coverage).

15. See Jett Hanna, *FAQs About Lawyers' Professional Liability Insurance*, TLIE LEGAL MALPRACTICE ADVISORY (Tex. L. Ins. Exchange, Austin, TX), at <http://www.tlie.org/newslet/adv0103/art1.htm> (updated Apr. 14, 2003) (noting that some companies are excluding or limiting coverage for mass tort and class action litigation).

As a first step to becoming informed consumers, lawyers should realize that policy coverage and insurers vary widely. This Article is intended to first help lawyers understand the type of insurance offered and the main features of legal malpractice insurance. Second, the Article reviews the application process, identifying factors that lawyers should consider in purchasing insurance. Finally, the Article provides suggestions for handling legal malpractice claims.

II. WHAT COVERAGE IS AVAILABLE?

In the past, professionals could purchase occurrence policies. Under such policies, coverage was triggered by an "occurrence" during the policy period. Over the years, insurers abandoned the occurrence form, largely because of the unpredictability associated with predicting claims and losses that would be paid under occurrence policies.¹⁶ To obtain more underwriting certainty and to control their losses, insurers moved to a claims-made form. Now virtually all lawyer malpractice policies use the claims-made form.¹⁷

Some claims-made policies require that the claim be both made and reported within the policy period. Because such policies provide no "grace period" to report claims, lawyers who are insured under such policies must diligently report claims made or risk jeopardizing their coverage.¹⁸ A more restrictive policy form requires that the act, error, or omission, as well as the claim, be made within the policy period. Coverage under such policies is more "illusory" than real because, in professional law practice, a claim seldom occurs in the same year that the act, error, or omission occurs.¹⁹

A typical claims-made policy provides coverage for claims asserted during the policy, regardless of when the incident giving rise to the claim actually occurred.²⁰ Under a claims-made policy, coverage is determined by the date of the claim. Some claims-made policies define "claim," while others do not. If the term "claim" is not defined, the term should be understood according to its common meaning, applying rules of construction. A claim is commonly defined as an adequate demand or assertion of a right.²¹

An important feature in a claims-made policy is prior acts coverage. Prior acts coverage provides protection for acts or omissions that occurred prior to the inception date of the policy, provided that the insured had no prior knowledge of any situation or occurrence that would give rise to the

16. MALLEN ET AL., *supra* note 3, § 2.32 (discussing the evolution of the claim-made policy form).

17. *Id.* § 2.31 (noting that occurrence policies are difficult to find, if at all and more expensive than claims made policies).

18. *Id.* § 2.33.

19. *Id.* § 2.34.

20. STANDING COMM. ON LAWYERS' PROF'L LIABILITY, AM. BAR ASS'N, THE LAWYER'S DESK GUIDE TO LEGAL MALPRACTICE 172 (1992).

21. See RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE § 34.14 (5th ed. 2000) (discussing the definition of a claim).

claim or suit. Professional liability insurance applications ask if any lawyer with the firm is aware of an incident that may give rise to a claim. The policy itself will also specifically exclude claims related to those incidents.

In general terms, the legal malpractice policy has four principal parts: the declarations page, the insuring agreements, the exclusions, and the conditions. The declarations page identifies specific information applying to the named insured. The declarations page is followed by a standard form policy that sets forth the terms of coverage.

A. What Are the Specific Policy Terms for the Named Insured?

THE DECLARATIONS PAGE

The declarations page serves as the face sheet to the policy. It identifies the named insured, the policy period, the policy limits of liability on a per claim and an aggregate basis, and the deductible on a per claim or annual basis. If the policy provides for limited prior acts coverage, the effective date of the prior acts coverage may be stated on the declarations page as a retroactive date. If a retroactive date is specified, coverage is provided for acts or omissions occurring after the stated retroactive date. If no retroactive date is specified in a policy with prior acts coverage, the insured has unlimited prior acts coverage, again, provided that the insured did not know at the inception of the policy that the act or omission would give rise to a claim.

The declarations page will also identify any additions or deletions to the insurer's standard form. These deletions or additions are handled through endorsements to the policy, which are attached to and included as part of the policy. Endorsements tailor the standard declarations and policy form to the needs of the insured. For example, an endorsement to a policy can extend coverage to mediation and arbitration services provided by a licensed lawyer.

Finally, the declarations page may incorporate statements made in the application for insurance. In the application, the applicant answers questions related to the applicant's law practice, business interests, disciplinary history, knowledge of potential claims, and matters that indicate underwriting risks. When the application representations are incorporated into the policy, the application representations are treated as conditions to coverage. An insurer who becomes aware of misrepresentations in the policy application may seek to rescind the policy, asserting policy fraud.

*B. What Do Policies Cover?**INSURING AGREEMENTS*

No coverage exists unless the matter falls within the general language of the insuring agreements.²² Basically, the insuring agreements describe the risk.

Beyond the named insured identified on the declarations page, the insuring agreements may identify the classes of other insured persons such as lawyers, employees, former partners, and predecessor firms. The classes of insured persons may also be defined in the policy's definition section or conditions. Only persons who fall into one of the named classes of insureds will be provided coverage.²³ Therefore, in shopping for insurance, you should make sure that you are comfortable with the description of additional or other insureds. For example, a named insured firm may prefer that new lawyers who join the firm are only treated as insured for work done on behalf of the named insured firm. Similarly, in order to limit claims under its policy, an insured firm may prefer a definition of insured that only covers former firm lawyers for work they did on behalf of the insured firm.

You should also determine how the insuring agreements or definitions treat employees such as secretaries and paralegals. Some insurers only insure such persons if the named insured makes a special request to do so.²⁴

Although firm principals should be covered for vicarious liability claims associated with the work of a contract lawyer, the contract lawyer will not qualify as an insured under the policy reference to "employees." Contract lawyers and their agencies should purchase their own policies, rather than assuming that they will be protected under the policy of the firm that retained the contract services.

Under the insuring agreements, the insurer commonly agrees to pay all sums the insured becomes legally obligated to pay as money damages. An insurer may assert that claims seeking equitable relief are not covered because such claims are not "claims for money damages." On that basis, insurers may maintain that injunctive and disciplinary actions are not covered under the insuring agreement, which limits claims to those seeking money damages. Therefore, you should purchase a policy that expressly provides coverage for disciplinary matters if you want the malpractice insurer to pay the costs of defending disciplinary complaints.²⁵

22. MALLIN ET AL., *supra* note 3, § 2.10.

23. See DUKE NORDLINGER STERN & JO ANN FELIX-RETZKE, A PRACTICAL GUIDE TO PREVENTING LEGAL MALPRACTICE § 9:26 (1983) (discussing the various classes of insured persons that might be covered).

24. MALLIN ET AL., *supra* note 3, § 2.21.

25. See Elizabeth A. Alston, *Coverage for a Rainy Day: Many Malpractice Policies Will Help Pay the Costs of Defending Disciplinary Complaints*, A.B.A. J., Aug. 2003, at 29, 29 (providing guidance on making or seeking coverage for a disciplinary complaint).

On the same basis, an insurer may take the position that the policy does not cover fee disputes and sanction awards. In an opinion from the U.S. Court of Appeals for the Fourth Circuit, the court agreed with the insurer, concluding that the legal malpractice policy did not cover a court-ordered refund of excessive lawyers' fees because the fee forfeiture did not qualify as "damages" under the ordinary meaning of the word.²⁶ To avoid such a coverage dispute, an insurer may include a policy definition of "damages," expressly stating that sanctions and disgorgement of attorneys' fees are not covered.

Typically, the claim seeking money damages must be first made during the policy period. The point in time when the "claim" is first made operates as a "coverage trigger." Some policies may require a "double trigger" if the insuring clause requires two events during the policy period: (1) the making of the claims against the insured, and (2) the giving of notice to the insurer.²⁷ When the insuring clause does require claims to be both made and reported during the policy period, a lawyer should not let a policy expire without reporting, in writing, all possible claims to the insurer.

Depending on the circumstances, the policy may provide for an extended reporting period. An extended reporting period is called "tail" coverage because it allows an insured to report the claim for a specified tail period following the policy expiration date. For example, an insurance policy may allow an insured lawyer who is retiring from law practice to pay an additional premium to obtain coverage for a specified "tail" period. Provided that the claim relates to the insured's acts and omissions in rendering legal services before the insured's retirement, the claim will be covered as long as the insured reports the claim during the extended reporting period.

The policy may also require that the claim seeking money damages arise out of an act, error, or omission of the insured in rendering or failing to render professional services for others in the insured's capacity as a lawyer. If the insuring agreement specifies that the services must be rendered "to others," claims will not be covered if they arise out of rendering services to an enterprise or venture controlled by the insured lawyer. This section may also clarify that the policy is intended to cover only the insured acting in the capacity of a lawyer engaged in the legal profession. Therefore, a lawyer acting in another capacity, such as that of a broker or realtor, would not be covered under the insuring agreements. At the same time, lawyers may render investment advice and perform other services, so certain services may be considered professional services absent some limitation or exclusion in the policy.

26. *Friend v. Attorney Liab. Prot. Soc'y*, No. 96-2862, 1997 WL 746761, at *2 (4th Cir. Dec. 4, 1997) (unpublished opinion).

27. John Haley, *Lawyers Professional Liability Insurance: A New York Overview*, in AVOIDING LEGAL MALPRACTICE 1998, at 390 (PLI Lit. & Admin. Practice Course, Handbook Series No. H0-000B, 1998), available at 580 PLI/Lit 387.

Lawyers who perform nonlegal services should recognize that insurers may dispute coverage for claims arising out of such services.²⁸ In resolving coverage disputes, some courts make the coverage determination on the basis of whether the retention of the insured was principally for legal services. If so, the legal malpractice policy arguably applies even if the lawyer provides incidental nonlegal services.²⁹

If a law office provides notary services, the insured should determine if the insuring agreements provide coverage for claims related to notary work. If not, the insured should seek an endorsement that adds such coverage.

Similarly, lawyers who provide services as fiduciaries should carefully examine policy provisions. Some policies provide protection for legal work performed by lawyers who serve as fiduciaries, but not other work such as investment and management services performed by the lawyer-fiduciary. If lawyers in a firm regularly serve as fiduciaries, the firm should obtain a special errors and omissions policy to insure those risks.

If the policy includes a duty to defend, the duty will be set forth in the insuring agreements. Under the insuring agreements, the insurer should agree to pay all attorneys' fees and other costs associated with the defense of a claim or suit under the policy. To determine if it has a duty to defend, the insurer should study the allegations in the complaint filed against the lawyer. An insurer must defend the suit if "the complaint states claims which, if proved, would make the insured liable to pay damages for the loss within coverage."³⁰

Beyond this general test for determining whether the insurer must defend a particular claim, judicial decisions split when applying rules on the extent of the duty to defend. One approach applies the "eight corners rule."³¹ Applying this rule, the complaint triggers the duty to defend by alleging at least one claim covered by the policy.³² Once such an allegation is made, the insurer has a duty to defend the entire lawsuit if a claim has been asserted that is potentially covered by the policy.³³ Rather than using the "eight corners rule," some courts apply the "potentiality rule," focusing on whether the complaint raises a "potential for coverage."³⁴ Under the potentiality rule, the insurer "must look beyond the effect of the pleadings

28. MALLIN ET AL., *supra* note 3, § 2.22 (explaining the possibility of a coverage dispute, notwithstanding the fact that courts have been liberal in interpreting "professional service" as a lawyer).

29. *Id.*

30. ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW 861 (3d ed. 2002).

31. *Id.* (explaining that "eight corners" refers to the four corners of the complaint being measured against the four corners of the insurance policy). Some courts refer to this rule as the "four corners rule," referring to the four corners of the complaint. *Id.* Other courts use the term "complaint allegation rule." *St. Paul Guardian Ins. Co. v. Centrum GS Ltd.*, 283 F.3d 709, 713 (5th Cir. 2002) (noting that the "rule requires the trier of fact to examine only the allegations in the [underlying] complaint and the insurance policy in determining whether a duty to defend exists").

32. *King v. Dallas Fire Ins. Co.*, 85 S.W.3d 185, 187 (Tex. 2002) (explaining that the pleading and policy language determine the duty to defend).

33. *See Heyden Newport Chem. Corp. v. S. Gen. Ins. Co.*, 387 S.W.2d 22, 26 (Tex. 1965) (noting that any doubt must be resolved in favor of the insured).

34. JERRY, *supra* note 30, at 862.

and must consider any facts brought to its attention or any facts which it could reasonably discover in determining whether it has a duty to defend.”³⁵ Therefore, a court’s evaluation of the duty to defend will largely turn on whether the jurisdiction applies the “eight corners rule” or the “potentiality rule.”³⁶

In addition to describing the general duty to defend, the insuring agreements may specifically address the selection of defense counsel in the event that a claim is made under the policy. If the policy is silent on the issue, the insurer is likely to take the position that it will have the right to select defense counsel. If the insured wants to have a voice in the selection process, the insured should look for a policy that provides for insured input, or the insured might seek an endorsement that would at least allow the insured to make recommendations on defense counsel.

The insuring agreements will discuss the limits of liability, the amount of which is set forth on the declarations page. The limits set forth are stated on a per claim and an aggregate basis. The per claim limit is the maximum legal obligation for a single claim.³⁷ This per claim limit is different from the aggregate limit of liability, which is the maximum amount that the insurer pays under the entire policy for all claims during the policy year.

The limits of liability provisions may also state whether defense costs are to be deducted from the limits of liability available to pay settlements and judgments. This feature is referred to as “Expenses within Limits” (EWL). Beginning in the 1980s, insurers added this EWL feature in an attempt to cap their total exposure under a particular policy. Recognizing that most professional liability policies now require defense costs to be subtracted from the limits of liability, you should seek limits of liability sufficient to pay both defense costs and the maximum exposure for damages in the event of a suit. Otherwise, defense costs may exhaust policy limits.

In determining the amount of limits of liability to seek, you should also study the policy to determine if it provides for an additional “claims expense allowance.” With such an allowance, defense costs are not subtracted from limits of liability until the insurer has paid defense costs up to the amount of the allowance. By increasing the amount available to pay de-

35. *Id.* (citing *Spivey v. Safeco Ins. Co.*, 865 P.2d 182, 188 (Kan. 1993)).

36. The handling of extrinsic evidence illustrates the key difference between the “eight corners rule” and the “potentiality rule.” If a court applies the “eight corners rule,” it should disregard evidence extrinsic to the complaint. For example, if an insured makes an admission that destroys coverage, such extrinsic evidence should not be considered by the court, provided that the complaint alleges a claim covered by the policy. In applying the “potentiality rule,” a court would consider such evidence. *See, e.g., Senger v. Minn. Lawyers Mut. Ins. Co.*, 415 N.W.2d 364, 369 (Minn. Ct. App. 1987) (recognizing that admissions made by the insured in correspondence to the insurer took the claim outside of coverage of the policy).

37. One approach to selecting a per claim limit would be to determine all or most of the firm’s liability for a claim arising out of a “typical” engagement, assuming that the firm were found to be 100% responsible. State Bar of California, *Purchasing Guide: Frequently-Asked Questions About Buying Professional Liability Insurance*, at <http://www.kvi-calbar.com/guide.html> (last modified Nov. 18, 2003).

fense costs, the claims expense allowance effectively increases the limits of liability for defense costs.

Finally, you should determine if the policy provides coverage for personal injury claims based on torts, such as defamation.³⁸ Unless the legal malpractice policy provides coverage for personal injury claims, you must obtain an endorsement adding personal injury coverage to the firm's comprehensive general liability (CGL) policy.

In a 1998 opinion, the Texas Court of Appeals held that the alleged defamation in a lawyer's solicitation letter to a prospective client was an "advertising injury" under the terms of the law firm's CGL policy.³⁹ According to the court, the solicitation letter did not constitute a "professional service" that would be excluded under the "professional service" exclusion in the CGL policy.⁴⁰ Understanding this opinion, lawyers should appreciate the importance of avoiding coverage gaps for personal injury claims. Such claims should either be covered under the firm's CGL policy or the firm's professional liability policy.

Those professional liability policies that provide personal injury protection vary greatly in their treatment of malicious prosecution and abuse of process claims.⁴¹ If you learn that the standard form policy provides limited or no coverage for malicious prosecution and abuse of process claims, request an endorsement to the policy to cover such claims.⁴² Otherwise, a policy's intentional torts exclusion may eliminate coverage for such claims.

C. What Policies Don't Cover—Exclusions

While the insuring agreements generally describe the risks covered under the policy, the exclusions limit the coverage by specifically identifying certain claims or activities that are not covered. Although exclusions vary depending on the policy form, exclusions generally fall into three categories: (1) those eliminating coverage not intended to be provided in a legal malpractice policy; (2) those relating to extraordinary risks; and (3) those relating to "moral" or illegal risks.

1. Exclusions Eliminating Coverage Not Intended to be Provided Under a Legal Malpractice Policy

As discussed above, the insuring agreements are written to limit coverage to claims arising out of lawyers' activities in rendering legal services.

38. For example, an American Home/National Union Fire Insurance Company Specimen Policy (1/85) defines "personal injury" to mean false arrest, detention or imprisonment; wrongful entry or eviction; or other invasion of the right of private occupancy, or malicious prosecution.

39. *Atl. Lloyd's Ins. Co. v. Susman Godfrey, L.L.P.*, 982 S.W.2d 472, 476 (Tex. App. 1998).

40. *Id.* at 477.

41. Linda S. Bauerschmidt & Darilyn D. David, *Gaps and Overlaps in Coverage*, 1997 A.B.A. LAW. PROF. LIAB. UPDATE 7.

42. *Id.*

In order to clarify types of claims and risks that are not covered, insurers also include specific policy exclusions. For example, the policy may exclude claims arising out of bodily injury or property damages. Such an exclusion eliminates overlapping with CGL coverage.⁴³

The policy may also specifically exclude liability when a lawyer is acting in some capacity other than legal counsel. For example, many policies exclude claims relating to a lawyer's role as an officer or director. Insurers have added such a directors' and officers' (D & O) exclusion because they have found that the more costly claims involve lawyers "wearing two hats"—serving as legal counsel and as director or officer of a business enterprise. Generally the D & O exclusion in a professional liability policy eliminates coverage for the entire firm as well as the lawyer-director.⁴⁴ Therefore, commentators recommend that if you and other firm partners serve in dual capacities, your firm should obtain directors' and officers' liability insurance, as well as legal malpractice insurance.⁴⁵

Some policies also exclude claims arising out of the insured's activities or capacity as a fiduciary under the Employee Retirement Income Security Act of 1974 ("ERISA"). An exclusion may be limited to claims arising out of any insured's activities or capacity as a fiduciary under ERISA, or both. Because other ERISA exclusions may apply to legal work done in connection with an ERISA plan, you must compare policies if you do any ERISA work.

In order to clarify that the legal malpractice policy will not insure lawyers' entrepreneurial ventures, malpractice insurance policies contain some form of business pursuits exclusion. The wording of the business pursuits exclusion varies from policy to policy. Some exclusions appear to be limited to claims arising out of the conduct of the business. A New Jersey opinion considered such a limited exclusion, which applied to claims "in connection with any business enterprise . . . which is owned by any insured or . . . which is directly or indirectly controlled, operated, or managed by any insured in a non-fiduciary capacity."⁴⁶ The court concluded that this provision did not exclude claims related to the insured lawyers' activities as owners of a mortgage company because some of the acts complained of involved legal services performed by the insured lawyers.⁴⁷ All of the claims may have been excluded under a broader exclusion written to extend to any claim arising out of professional services rendered in connection with business ventures with a client or former client, whether or not the activities involved the rendition of legal services.

43. Haley, *supra* note 27, at 403.

44. Mary McCutcheon, *Professional Liability Insurance Issues for Lawyers Sitting on Corporate Boards*, BRIEF, Winter 1998, at 8.

45. E.g., MALLEN ET AL., *supra* note 3, § 2.52.

46. Greenberg & Covitz v. Nat'l Union Fire Ins. Co., 711 A.2d 909, 913 (N.J. Super. Ct. App. Div. 1998).

47. *Id.* at 913.

In 1994, a Texas federal district court held that a business pursuits exclusion precluded coverage for claims arising from a loan transaction involving a savings and loan association owned by the insured lawyers. The court noted that the exclusion would apply even if the insured lawyers performed legal services for the claimant.⁴⁸ The applicable insurance policy contained three business pursuits exclusions. One exclusion eliminated coverage for:

[A]ny claim based upon or arising out of work performed by the Insured, with or without compensation, with respect to any . . . business enterprise or other venture, be it charitable or otherwise, or any kind of nature in which any Insured has any pecuniary or beneficial interest, irrespective of whether or not any attorney-client relationship exists, unless such entity is named in the Declarations.⁴⁹

Such an exclusion creates an obstacle for a legal malpractice lawyer who will try to “plead around” policy business exclusions by focusing on the legal work the lawyer-defendant performed.

Lawyers should recognize that entrepreneurial activities with clients may leave them and their clients with no insurance coverage. While it is generally imprudent to do business with a client, it is positively foolhardy to do so if the policy’s business pursuits exclusion eliminates coverage for all claims relating to the business enterprise.

2. Exclusions Relating to Extraordinary Risks

Insurers associate degrees of risk with different areas of practice. Some insurers decline to write policies for lawyers who practice in areas viewed as particularly risky, such as entertainment law. Other insurers seek to avoid the risk by excluding coverage for particular types of claims.

Securities Exclusions.

Some legal malpractice insurers have sought to limit their liability for securities-related claims through exclusions eliminating coverage for any claims arising under the federal or state securities laws.⁵⁰ Because corporate and partnership work has securities aspects, you should avoid policies with securities exclusions if you are a corporate lawyer. For an extra premium, you may be able to negotiate an endorsement to delete the securities exclusion.

48. Home Ins. Co. of Ind. v. Walsh, 854 F. Supp. 458, 461 (S.D. Tex. 1994).

49. *Id.* at 460.

50. MALLEN ET AL., *supra* note 3, § 2.48 (noting that language of exclusions varies substantially from insurer to insurer).

Regulatory Exclusions.

Following the explosion of multi-million dollar claims brought by government regulators in connection with the savings and loan bailout, insurers were reluctant to insure lawyers who represent financial institutions ("banking lawyers"). Insurers who are still concerned about the exposure of banking lawyers may refuse to underwrite banking lawyers, while other insurers may rely on "regulatory exclusions" to exclude claims brought by the Federal Deposit Insurance Corporation and other banking regulators.⁵¹ Like securities lawyers, banking lawyers must either negotiate such exclusions out of the policy or forego coverage under the legal malpractice policy.⁵²

3. Exclusions Relating to Moral or Illegal Risks

Some policies are written to exclude conduct that is considered illegal or unethical. For example, policies may exclude discrimination or sexual harassment claims. Other policies exclude claims arising out of conversion, misappropriation, or improper commingling of client funds.

All policies have some form of exclusion for dishonest, malicious, or fraudulent acts (the "fraud exclusion"). The typical fraud exclusion states that the policy does not apply "to any dishonest, fraudulent, criminal, or malicious act or omission." You must study the fraud exclusion to determine if it excludes only active and deliberate fraud or dishonesty, committed with actual or fraudulent intent. Such a limited exclusion is preferable to the more general fraud exclusion which arguably applies to unintentional or constructive fraud. In *Brooks, Tarlton, Gilbert, Douglas & Kressler v. U.S. Fire Insurance Co.*, the Fifth Circuit concluded that constructive fraud did not clearly fall within the language of the fraud exclusion in the subject policy.⁵³ Based on the *Brooks* opinion and other case authority, two authors have suggested that lawyers can feel safe in relying upon an insurance policy to at least provide a defense for constructive fraud claims.⁵⁴ Legal malpractice experts, Ronald Mallen and Jeffrey Smith, go a step further in opining that the fraud exclusion should not eliminate coverage for constructive fraud claims or claims based on acts or omissions that are deemed fraudulent only because they are breach of the fiduciary obligations.⁵⁵

51. Linda Himelstein, *Insurers Dodge S & L Claims Against Lawyers*, LEGAL TIMES, Apr. 29, 1991, at 1 (referring to a nationwide campaign of malpractice insurers to eliminate exposure for claims brought against banking lawyers).

52. See Susan Saab Fortney, *Attorney's Malpractice Policies: Regulatory Exclusions and Public Policy*, 109 BANKING L.J. 116 (1992), for a discussion of the enforceability of regulatory exclusions.

53. *Brooks, Tarlton, Gilbert, Douglas, & Kressler v. U.S. Fire Ins. Co.*, 832 F.2d 1358, 1370 (5th Cir. 1987); cf. *Perl v. St. Paul Fire & Marine Ins. Co.*, 345 N.W.2d 209, 213 (Minn. 1984) (holding that the fraud exclusion does not encompass constructive fraud for breach of a fiduciary duty).

54. Andrew S. Hanen & Jett Hanna, *Legal Malpractice Insurance: Exclusions, Selected Coverage and Consumer Issues*, 33 S. TEX. L. REV. 75, 88-89 (1992).

55. MALLEN & SMITH, *supra* note 21, § 34.23 (noting that several courts have held that the "innocent breach of fiduciary duty, which is constructive fraud, is not actual").

A standard fraud exclusion may eliminate coverage for racketeering claims. In *Purcigliotti v. Planet Insurance Co.*, the New York trial court concluded that the policy provided no coverage for racketeering claims because the insurance policy excluded "any dishonest, fraudulent, criminal, or malicious act or omission" of the insured.⁵⁶

Under the policy terms, the fraud exclusion may be waived for any insured that neither personally participated in any fraudulent, criminal, or dishonest conduct nor remained passive after having personal knowledge of any such act or omission. This waiver is often referred to as "innocent partner" coverage and is particularly important in states where lawyers in partnerships and professional corporations share joint and several liability with the other equity holders in the firm.⁵⁷

In addition to a standard fraud exclusion, policies may specifically exclude punitive or exemplary damages. Rather than generally excluding all punitive and exemplary damages, virtually all policies exclude certain specific causes of action that can lead to the imposition of punitive damages. For example, policies commonly exclude coverage for malicious, intentional, and criminal acts. Because the incidence of punitive and multiple damages awards has risen appreciably in recent years, you should seriously consider obtaining a policy with the more limited exclusionary language, rather than a policy with the more encompassing provision that excludes all "punitive and exemplary damages."

Some policies contain specific exclusions covering sanctions, fines, and penalties. Even in the absence of a specific exclusion, an insurer might still argue that sanctions are not covered under the insuring agreement of the policy, which limits coverage to claims for "money damages." Such an argument will not prevail if the court concludes that the policy language is ambiguous and interprets the language against the insurer. To avoid any ambiguity, an insurer may expressly exclude court-ordered sanctions. Therefore, if you are a litigator, you should examine the policy to determine if it specifically excludes court-imposed sanctions.

D. What Typical Conditions Affect Coverage

Every policy includes provisions that act as conditions precedent to coverage. Two such conditions impose duties on the insured, requiring you to give notice and to cooperate in the event of a claim.

First, a notice condition requires the insured to promptly notify the insurer of a claim. This notice requirement may not be limited to notice of actual claims. Rather, the notice condition may require that you give notice

56. Cerisse Anderson, *Firm Denied Insurance Coverage in Fraud Suit, Judge Decides Claims Fall Outside Insurance Indemnification*, N.Y. L.J., Sept. 6, 1994, at 1.

57. See *Aragona v. St. Paul Fire & Marine Ins. Co.*, 378 A.2d 1346, 1350 (Md. 1977) (holding that a policy without innocent partner protection did not afford coverage where the insured's partner misappropriated escrow funds).

of acts, omissions, or circumstances that you reasonably expect to give rise to a claim or suit.⁵⁸

Commonly, the notice provision requires that notice be given "as soon as practicable." This prompt notice allows the insurer to investigate the claim, to gather information for the defense, to attempt to avoid or mitigate a loss, and to establish the scope of coverage. Conversely, late notice may harm or prejudice an insurer.⁵⁹ To avoid coverage disputes, lawyers should protect their coverage by promptly complying with the terms of the notice condition.

Second, you must comply with the policy condition that imposes a duty to cooperate. The typical cooperation provision requires that you assist the insurer and defense counsel in preparing and presenting a defense. Failure to do so can jeopardize coverage.⁶⁰ In order to rely on the breach of cooperation clause, many jurisdictions require that the insurer show that the insurer was prejudiced.⁶¹

You should also examine any policy conditions or other policy provisions that relate to the defense and settlement of claims. While almost all legal malpractice policies give the insurer the right to select defense counsel, the policies differ on the insured's role in settlement of claims. A few policies give you exclusive control of settlement by requiring that the insurer obtain your consent before settling a claim. The preferred wording prohibits the insurer from settling any claims without the consent of the insured, without limitation or exception.⁶² By contrast, if you refuse to consent to a settlement offer recommended by the insurer, the insurer is not liable under some policies for any amount greater than that for which the claim could have been settled if you had agreed to the settlement offer. For example, a policy may include the following consent provision:

"[W]e won't agree to the final settlement of any such claim without your written consent. But if you refuse to give us your consent, we

58. MALLEN ET AL., *supra* note 3, § 9.10 ("Most current claims-made professional liability policies not only cover claims arising out of errors or omissions committed during the current policy period, but also claims made during the current policy period which arise out of acts, errors, or omissions which occurred prior to the inception of coverage."); MARC I. STEINBERG, CORPORATE AND SECURITIES MALPRACTICE 402 (1992).

59. MALLEN ET AL., *supra* note 3, § 9.34 (stating that a "slight majority requires that the insurer seeking to avoid coverage show that it suffered actual prejudice as a result of an insured's delay in notification."). *But see* Hirsch v. Tex. Lawyers' Ins. Exch., 808 S.W.2d 561, 565 (Tex. App. 1991) (recognizing that the requirement to show "prejudice" would rewrite the policy and interfere with the public's right to contract).

60. See JERRY, *supra* note 30, § 87 (providing an overview of what constitutes noncooperation and when noncooperation gives the insurer a valid defense).

61. MALLEN & SMITH, *supra* note 21, § 34.19. For example, Texas courts have adopted the view that the breach of the duty to cooperate may operate to discharge the insurer's obligations under the policy if the insurer is actually prejudiced or deprived of a valid defense by the actions of the insured. *McGuire v. Commercial Union Ins. Co. of N.Y.*, 431 S.W.2d 347, 352-53 (Tex. 1968) (recognizing that an insured cannot make an agreement imposing liability upon the insurer or depriving the insurer of the use of a valid defense).

62. STERN & FELIX-RETZKE, *supra* note 23, § 9:22.

won't pay more than we would have paid had you consented to the proposed settlement."⁶³

This policy provision may not trouble you if you are anxious to settle and put the matter behind you. On the other hand, you may want to control the settlement because your reputation and deductible may be at stake. If you want to control the settlement, you should avoid policies that do not require the insured's consent to settlement.

III. RECOGNIZE HOW FIRM CHANGES AFFECT COVERAGE

Various changes relating to your law firm's structure and composition may impact insurance coverage. These changes can trigger the termination of the insurance policy or limit the coverage provided.⁶⁴

To evaluate how coverage will be affected, a firm manager should first study the insurance policy, looking for a "material change" provision. The policy provision should define what constitutes a "material change" and the consequences of a material change. A material change resulting from merger, acquisition, or an exodus of lawyers can cause the policy to be terminated. The material change provision may require notice to the insurer and may allow the named insured to purchase tail coverage.⁶⁵

Reorganization of a firm may also trigger application of the material change provision. For example, conversion of a law partnership to a limited liability company or professional corporation could cause the policy to be terminated. To avoid termination or coverage questions, a firm manager should notify the insurer before the reorganization occurs and request a policy endorsement to address any change in the structure of the named insured.

Coverage questions also arise with respect to lateral lawyers who join a firm. The standard policy form or an endorsement to the policy may exclude prior acts coverage for claims that relate to work at the former firm. This elimination of prior acts coverage for lateral hires actually protects the new firm's insurance policy from being tapped to pay for claims related to another firm. By avoiding possible claims being made under its policy, the new firm can also avoid future premium surcharges.⁶⁶ If prior acts coverage is provided to a lateral hire, the new firm can protect itself by (1) obtaining

63. St. Paul Fire & Marine Insurance Company, Specimen Policy (1995)

64. See Susan Saab Fortney, *Insurance Issues Related to Lateral Hire Musical Chairs*, 2000 PROF. LAW. 65 (analyzing the underwriting, coverage, and claims handling issues related to lawyers moving between private law firms).

65. See Bruce A. Campbell, . . . *Of Greener Grass, Bigger Bucks and Open Septic Tanks . . . Law Firm Break-ups, Spin-offs and Other Changes*, 61 TEX. B.J. 322, 326-27 (1998), for a discussion of different approaches to obtaining tail coverage following a material firm change.

66. A. Craig Fleishman, *Potential Perils of the Professional Liability Insurance Policy*, COLO. LAW., Feb. 1995, at 229. See Jett Hanna, *Legal Malpractice Insurance and Limited Liability Entities: An Analysis of Malpractice Risk and Underwriting Responses*, 39 S. TEX. L. REV. 641, 643-44 (1998), for suggestions on how lateral hires can protect themselves when prior acts coverage is not provided.

documentation of the insurance coverage maintained by the former firm and (2) by asking the lateral hire to report any potential claims to the former firm's insurer before changing firms.⁶⁷

IV. WHAT TO CONSIDER IN PURCHASING INSURANCE?

Unless a lawyer practices in Oregon, legal malpractice insurance is not required. As a condition to limited liability, some states require that the firm maintain a certain level of insurance.⁶⁸ For example, limited liability firms in Texas must obtain insurance with limits of at least \$100,000 or establish other financial responsibility.⁶⁹ Commentators have expressed different views regarding the advisability of law firms relying on the limited liability shield and reducing their insurance coverage.⁷⁰ Regardless of the efficacy of the limited liability structure as a vicarious liability shield, firms should purchase adequate levels of insurance because the firm and individual tortfeasors remain liable.⁷¹

When purchasing insurance the most important considerations are the actual cost of purchasing the policy and the coverage provided. Beware of a premium quote which is unusually low because it may mean that the coverage provided is very limited or the insurer may be "unable to live up to its obligations once it experiences claim activity."⁷² In addition to comparing costs and the coverage provided, you should also evaluate the insurer's status, financial stability, longevity, and reputation.

With regard to status, some insurers are admitted to do business in a state, while others are non-admitted. "Admitted" means that the company has met the minimum requirements established by state statute authorizing the particular company to underwrite insurance. Generally, admitted companies are subject to more regulation than non-admitted companies. In ad-

67. Ann E. Thar, *Don't Be Sued for Another Attorney's Malpractice*, ILL. B.J., Apr. 1995, at 199, 200.

68. See ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS, THE REVISED UNIFORM PARTNERSHIP ACT, AND THE UNIFORM LIMITED PARTNERSHIP ACT § 2.05 (2001), for a description of state provisions requiring insurance for limited liability firms.

69. See TEX. REV. CIV. STAT. ANN. art. 6132b-3.08(d) (Vernon 2003) (providing that the insurance cover the kinds of errors, omissions, negligence, incompetence, or malfeasance for which liability is limited).

70. Compare Susan Saab Fortney, *Seeking Shelter in the Minefield of Unintended Consequences—The Traps of Limited Liability Law Firms*, 54 WASH. & LEE L. REV. 717, 741-745 (1997) (discussing the adverse insurance effects of reorganizing as a limited liability firm), with Hanna, *supra* note 66, at 645-654 (down-playing the insurance implications of firms converting to limited liability structures).

71. Thomas P. McGarry, *Limited Liability Entities: Can You Reduce Your Insurance*, in LEGAL MALPRACTICE: THE LAW OFFICE GUIDE TO PURCHASING LEGAL MALPRACTICE INSURANCE § 16.18 (Ronald E. Mallen ed., 2002) (explaining that limited liability law firms and individual partners will continue to face malpractice exposure). As noted by one author, a "common misperception is that conversion to an LLC or registration as an LLP will diminish the need for professional liability insurance. Kirsten L. Christophe, *Continuing Protection—Converting to a Limited Liability Structure Raises Key Insurance Issues*, A.B.A. J., Sept., 1995, at 92.

72. *New IOMA Data Rate Firms' Professional Liability Insurers*, 98-1 LAW OFF. MGMT. & ADMIN. REP. 6.

dition, in some states only admitted insurers participate in the state fund which provides compensation to insureds if the insurer becomes insolvent and unable to pay claims.

You should also consider an insurer's financial stability and solvency. In evaluating an insurer's finances, you can compare ratings that companies receive from insurance ratings bureaus. The most well-known insurance rating bureau is A.M. Best Company, which publishes a rating guide to liability insurance companies. Based on a company's underwriting, finances, and operations, Best assigns each company an overall rating.

In considering the stability of a company, consider the longevity of its legal malpractice program. Longevity refers to how long the company has been writing legal malpractice insurance in the state and the likelihood that the company will continue writing legal malpractice insurance when the market tightens due to changes in conditions and claims. Referring to the number of new insurers that entered the legal malpractice market in the late 1990s, one commentator warned:

The savvy insurance buyer will be aware, however, that the rush of new insurers brings some who are not committed to the class of business. Inevitably claims will be made on these policies, and there will be some insurers who will be in a better position than others to effectively deal with and pay for these claims, due to their financial strength and long-term commitment.⁷³

Five years after this warning, insurers are abandoning the market, leaving insureds to find new insurers. The trick is to purchase insurance from an insurer that will be there in "good times and bad times." A lawyer can benefit from continuity of coverage when an insurer has longevity and continues to write insurance when the market changes.

Finally, in evaluating companies, you should investigate an insurer's procedures and reputation relating to claims service and claims prevention. First, obtain information from the insurer on its claims handling procedures and claims prevention programs. For example, before you actually have a claim, you should clarify how the company selects defense counsel. Then investigate the insurer's reputation by asking other lawyers about their experiences with the insurer.

V. HOW TO APPLY FOR INSURANCE

In applying for insurance, an agent who specializes in legal malpractice insurance can provide valuable guidance. The agent assists in the application process by understanding the underwriting guidelines of the insurers,

73. Rian D. Jorgenson, *Lawyers' Professional Liability: Overview and Current Issues*, in INSURANCE LAW 89, 100 (PLI Lit. & Admin. Practice Course, Handbook Series No. H4-5259, 1997), available at 563 PLI/Lit 89.

enabling the applicant to obtain the best coverage for the most reasonable premium.

In order to select an agent, obtain recommendations from other lawyers in your community. After reviewing resumes from recommended agents, interview those agents who appear to have expertise in legal malpractice insurance. Based on the interviews and recommendations, select an agent who is willing to devote time to comparing coverage.

The person who is responsible for completing the insurance application must gather a great deal of information related to the firm, its practices, procedures, and lawyers. A memorandum to all firm lawyers documents the steps taken to obtain accurate information. The memorandum could ask each firm lawyer to respond to certain questions included on the policy application. For example, the memorandum could ask each firm lawyer to indicate whether he or she has any knowledge of potential malpractice claims. If some firm lawyer identifies a potential claim, that matter should be reported to the current malpractice insurer and disclosed on the insurance application. On the other hand, if a firm lawyer fails to disclose a potential claim, the firm managers can show that they acted diligently in making an inquiry and had no knowledge that a claim would be filed. This may enable firm managers and other firm lawyers to rely on the innocent partner protection provided that they did not have notice of the particular matter.

Experts recommend that applicants be diligent in supplying information to prospective insurers.⁷⁴ Although the underwriting criteria for insurers vary, insurers commonly use the following considerations:

1. the number of claims or incidents per firm lawyer, per year;
2. the anticipated expense of these claims including the defense and indemnity costs;
3. the nature and quality of the claim;
4. the degree of fault;
5. another insurer's rejection or refusal to renew;
6. state bar disciplinary proceedings;
7. the firm's predisposition to suing clients for fees;
8. a significant increase in the limits sought;
9. a significant decrease in the deductible sought;

74. *Managing Risk*, *supra* note 6.

10. the nature of practice of firm lawyers; and

11. Martindale-Hubbell rating.⁷⁵

In completing applications, polish all answers, recognizing that underwriters will be influenced by both their form and content. Because the application representations are commonly incorporated in the policy, be thorough and truthful in answering all application questions. You must remember that material misrepresentations or omissions by the applicant can result in rescission of the policy on the basis of policy fraud.⁷⁶

In describing potential and past claims, try to avoid alarming the underwriter. If appropriate, describe the unique circumstances of the claim, so that the underwriter will not assume that similar claims will follow. Try to show the underwriter that you have carefully taken measures to avoid malpractice claims. For example, you should describe in detail your malpractice avoidance measures, such as conflicts of interest control and docket control systems. In short, try to communicate to the underwriter that you are a good risk.

During the application process, you should learn what credits or debits will affect the premium quote. For example, premium savings may be obtained for attending malpractice avoidance seminars. At the same time, be aware of areas that may create a charge or debit. For example, underwriters might surcharge or refuse to write certain areas of practice such as securities or intellectual property law.

The application will ask you to designate the limits of liability and deductible that you seek. Deductibles may be on a per-claim basis, with or without an aggregate for two or more claims. Limits of liability also will be stated on a per-claim and an aggregate basis.

Various factors including the limits of liability, the deductible, the length of time in practice, claims history of the insurance, and areas of practice will affect the premium charged. Because a higher deductible reduces the premium, while higher limits increase the premium, you should ask for quotations for different amounts of limits and deductibles.

Based on the quotations, you then decide on the amounts for the limits of liability and the deductible. In electing a deductible amount, you must decide what deductible amount the firm is willing and able to pay in exchange for a reduction in a premium. If you prefer to pay the annual premium on an installment basis, ask about the insurer's premium payment plan.

In deciding on the policy limits, be sure to consider whether or not the proposed limits will cover the maximum likely financial exposure for a sin-

75. *Id.*

76. *See, e.g.,* Mt. Airy Ins. Co. v. Thomas, 954 F. Supp. 1073, 1079 (W.D. Pa. 1997) (applying an objective standard to the evaluation of whether the insured had a reasonable belief that a claim might be filed).

gle claim and the aggregate liability for multiple claims. This evaluation will largely depend on the nature of the firm's practice, the amount of likely damages that could result from lawyer malpractice, and the complexity of defending possible claims.⁷⁷ If the limits of liability include defense costs, you should evaluate whether the proposed limits will adequately cover potential liability as well as defense costs.

Finally, in choosing a policy, devote time to diligently studying coverage provided under different policies. Through this comparison exercise, you will find that policy terms vary significantly and that the purchase of comprehensive policy will protect both you and your clients.

VI. WHAT TO DO IN THE EVENT OF A CLAIM?

A. *Give the Insurer Prompt Notice*

While most lawyers value having legal malpractice insurance, most do not want to be in the position of having to file a claim under their policy. Some lawyers postpone filing a claim because they believe that they can resolve the matter without involving the insurance company. However, if you do so, you may jeopardize your coverage. As noted in the above discussion of policy conditions, all policies require that insureds report claims under the policy. A policy may merely require that you give the company written notice of any claims against you as soon as practicable. In interpreting the phrase "as soon as practicable," many courts have concluded that the phrase means notice that "is prompt and reasonable under the circumstances."⁷⁸

The policy may specifically define what constitutes a "claim." For example, the policy may define "claim" to include a judicial proceeding against an insured, a demand for money damages or professional services, and a request received by an insured for an agreement tolling the statute of limitations. Any of these events would require written notice to the insurer.

Other policies require the insured to give the insurer written notice as soon as you first become "aware that a wrongful act has been committed." Any time that you are unsure whether or not to notify the insurer, you should study the policy to determine if it requires notice only of actual claims or if it requires notice any time you know of circumstances that are likely to give rise to a claim. If you have any doubts, give prompt notice to the insurer. In recommending that insureds err on the side of caution, one commentator explains, "[i]t is unquestionably wiser to report all 'circum-

77. See Michael Bourgeois, *Know Your Limits*, A.B.A.J., Sept. 1998, at 74 (suggesting a "formula" for arriving at a safe level of malpractice insurance).

78. MALLEN ET AL., *supra* note 3, § 9.33. In one legal malpractice insurance case, a Texas court explained that the insured failed to comply with the notice condition that required notice "as soon as practicable," because the lawyer-insured waited more than six months after service of process to give the insurer notice of the suit. *Matthews v. Home Ins. Co.*, 916 S.W.2d 666, 669 (Tex. App. 1996).

stances' rather than risk a decline of coverage based upon late notice, prior knowledge or a material misrepresentation in your policy application."⁷⁹ Another commentator echoes this advice in stating the "only surefire way to avoid sleepless nights and readjustment of one's retirement portfolio" is to report everything to the carrier."⁸⁰

To avoid questions, you should notify the insurer in writing even if the policy does not require written notice. In your initial notice letter to the insurer and in other correspondence with the insurer, avoid any statements that could be interpreted as an admission of liability or any statements that might adversely affect your insurance coverage.

B. Understand Coverage Issues

Once notified, the insurer will assess the problem and appoint defense counsel if necessary. When an insurer first receives notice of a claim or suit against an insured, the insurer must promptly take one of the following actions: (i) acknowledge receipt of the notice and advise the insured that it will provide coverage; (ii) advise the insured that it will defend the insured, subject to a reservation of its right to deny coverage on one or more specified grounds; (iii) deny coverage on the grounds either that the claim is not covered under the policy or that the insured has breached a policy condition; or (iv) rescind the policy if it appears that the policy was procured through fraud, mutual mistake of fact, or the insured's misrepresentation or concealment of material facts in the application.⁸¹

If the insurer does not see any coverage problems, the insurer should provide an unqualified defense. When the insurer does identify some coverage problem indicating that a claim may not be covered under the terms of the policy, the insurer may agree to provide defense under a nonwaiver agreement or a reservation-of-rights letter.

The reservation-of-rights letter or non-waiver agreement notifies the insured of all possible coverage defenses and reserves the insurer's right to later deny coverage based on the coverage defenses. Both non-waiver agreements and reservation-of-rights letters enable the insurer to provide a defense without waiving any coverage defenses. The non-waiver agreement is signed by the insurer and the insured, while the reservation-of-rights letter is sent by the insurer to the insured. If you are asked to sign a non-waiver agreement or you are sent a reservation-of-rights letter, you should consider

79. Paul Calamari, *The "Not Me" Syndrome and What Happens When it is You*, in AVOIDING LEGAL MALPRACTICE 1998, at 431, 434 (PLI/NY Lit. & Admin. Practice Course, Handbook Series NO. F0-000L, 1998), available at 14 PLI/NY 431.

80. Richard D. Hoffman, *Tell-All Policy*, A.B.A. J., Mar. 2003, at 57 (recommending that lawyers seek guidance from a colleague who can provide an "impartial read").

81. See *Am. Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 861 (Tex. 1994) (Hightower, J., dissenting) (quoting BARRY R. OSTRAGER & THOMAS R. NEWMAN, *HANDBOOK ON INSURANCE COVERAGE DISPUTES* § 2.01 (6th ed. 1993)).

hiring independent counsel for advice on coverage matters.⁸² An insured should also retain experienced coverage counsel if the insurer files a declaratory judgment action seeking a court declaration as to the parties' rights and obligations under the insurance contract.

C. Do Not Write Internal Memoranda

After you report a claim to the insurer, you should not write internal memoranda about the matter. Such internal firm memoranda describing and evaluating an alleged or potential malpractice problem may not be privileged. Although some courts in other states have referred to a "self-evaluative" privilege, you should not rely on such a privilege until it is widely recognized.⁸³ Depending on the facts and circumstances, other privileges including the lawyer-client privilege and investigative privileges may apply. Don't assume that these privileges apply without consulting your lawyer.

D. Assist and Monitor Your Defense Counsel

You should cooperate with defense counsel and the insurer's claims representative. First, the policy requires such cooperation. Second, the problem is more likely to be resolved if the insurer and insured work in partnership. Such cooperation may help minimize both the insurer's and your own expenditure of time and money.

While cooperating with the defense lawyer, the insured should monitor developments in the case, ask questions, and raise concerns about how the case is being handled. In a controversial opinion, the Texas Supreme Court held that an insurer is not vicariously liable for the malpractice of an independent lawyer it selects to defend an insured.⁸⁴ Notwithstanding the fact that the liability insurer selects and compensates insurance defense counsel, the majority of the court refused to hold the insurer vicariously liable for the injury caused by the defense lawyer's malpractice.⁸⁵ Understanding this, an insured should monitor the case to make sure that the insurance defense lawyer is protecting the insured's interests. If your defense lawyer fails to provide you copies of filings and correspondence in the case, request copies. To evaluate the time defense counsel devotes to the case, study billing statements. Question your defense lawyer if you suspect that the defense

82. See Kirk A. Pasich, *Disappearing Coverage*, A.B.A. J., June 1994, at 68, for recommendations on dealing with insurers on coverage disputes.

83. See Susan Saab Fortney, *Are Law Firm Partners Islands Unto Themselves? An Empirical Study of Law Firm Peer Review and Culture*, 10 GEO. J. LEGAL ETHICS 271, 296-305 (1997), for a discussion of the cases and discovery problems related to internal law firm evaluations.

84. *State Farm Mut. Auto. Ins. Co. v. Traver*, 980 S.W.2d 625, 628 (Tex. 1998).

85. *Id.* at 632 (citing *Employers Cas. Co. v. Tilley*, 496 S.W. 2d 552, 558 (Tex. 1973) for the proposition that the defense lawyer "owes the insured the same type of unqualified loyalty as if he had been originally employed by the insured").

lawyer may be cutting corners or otherwise putting the insurer's interests before yours.

Beginning in the 1990s, insurers imposed strict cost containment measures to address rising defense costs paid under the terms of insurance policies. These cost containment measures included closely monitoring the work performed by insurance defense counsel and auditing the bills submitted by defense counsel. Such cost containment measures create conflicts for insurance defense lawyers who feel pressure to comply with the guidelines while remaining loyal to the insured. To give insurance defense lawyers some guidance in handling such conflicts, a number of ethics committees have issued advisory ethics opinions.⁸⁶ Most notably, the ABA Standing Committee on Ethics and Professional Responsibility issued an opinion in 2001, concluding that "lawyers representing insured clients must not permit the client's insurance company to require compliance with litigation management guidelines the lawyer reasonably believes will compromise materially the lawyer's professional judgment or result in her inability to provide competent representation to the insured."⁸⁷ Some commentators and lawyers believe that the practical effect of such ethics opinions is that insurers become less aggressive in micro managing litigation.⁸⁸

Depending on the circumstances, it may be wise to hire personal counsel if your concerns are not addressed. For example, assume that the plaintiff's counsel has made a demand to settle the case within policy limits. If the defense lawyer does not recommend settlement, you may need personal counsel to apply pressure on the insurer. From the outset understand all the consequences of not settling the claim.

VII. CONCLUSION

After lawyers are sued, they learn a great deal about their professional liability coverage and their insurer. While some lawyers learn that they have comprehensive coverage, others experience disappointment when they eventually see their policy's limitations. This shock can be avoided if you compare policies and insurers so that you can make an informed decision in

86. For example, the Texas Ethics Committee issued two opinions that underscore the duties of insurance defense counsel to protect the insured's interests. In Opinion 533 the Texas Professional Ethics Committee concluded that the Texas ethics rules prohibit lawyers from agreeing with the insurer on restrictions that interfere with the lawyer's exercise of independent professional judgment in representing the insured. Tex. Prof'l Ethics Comm., Op. 533 (2000), available at 2000 WL 987293. Because fee statements contain confidential information, Opinion 532 explains that the ethics rules require client informed consent before a lawyer provides the fee statements to an outside auditor working for the insurer. Tex. Prof'l Ethics Comm., Op. 532 (2000), available at 2000 WL 987291; see also Mary Alice Robbins, *Ethics Committee Disapproves of Insurers' Limitations on Counsel*, TEX. LAW., July 10, 2000, at 1; Jay Old, *Walking the Ethical Tightrope*, TEX B. J., Jan. 2001, at 61.

87. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 01-421 (2001).

88. See, e.g., John Council & Brenda Sapino Jeffreys, *Winning the Battle and the War—Future Looks Brighter for Firms Doing Insurance Defense Work*, TEX. LAW., Feb. 25, 2002, at 37 (quoting an insurance defense counsel who notes that insurers "back down" when he provides copies of the ethics opinions).

purchasing legal malpractice insurance. In making an informed decision and purchasing adequate coverage, lawyers protect themselves and demonstrate professional responsibility in protecting persons injured by malpractice.