Understanding Professional Liability Insurance

Part 2

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Part one of this article discussed general concepts related to professional liability coverage, including the insurer's duty to indemnify (October 2012, STRUCTURE®). To indemnify means to compensate or protect from a loss. Under a professional liability policy, the insurer has a duty to indemnify the insured for covered losses, up to the limits of the policy. This second part looks at the insurer's duty to defend, as well as common exclusions to coverage.

Claim Expenses

Expenses incurred in defending against a claim, referred to as either claim expenses or defense expenses, include the reasonable and necessary fees charged by an attorney. Many policies give the insurer the right to designate the attorney; some policies allow the insured to select the attorney, subject to the insurer's approval. Claim expenses also include the other fees and expenses that result from the investigation, defense and appeal of a claim, if incurred by the insurer, or by the insured with the prior written consent of the insurer.

Most types of liability insurance, including CGL policies, do not apply claim expenses to the policy limits. In contrast, professional liability policies are typically "wasting policies" which means that claim expenses are deducted from the policy limits. Both the insurer's duty to defend and its duty to indemnify terminate when the applicable policy limit is exhausted, whether or not the claim has been resolved.

Duty to Defend

The insurer must defend any claim covered by the policy, even if the claim results from groundless or fraudulent allegations. The insured must provide the insurer with all information, assistance, and cooperation that the insurer reasonably requests. In addition, the insured cannot do anything that prejudices the insurer's position or its rights of recovery. In particular, the insured cannot settle a claim or admit liability without the insurer's consent. The insurer is not liable for any settlement, assumed obligation, or admission to which it has not consented.

Settlement

Likewise, the insurer cannot settle a claim without the insured's consent. However, if the insured refuses a settlement that is acceptable to both the claimant and the insurer, the policy may limit the insurer's liability to the amount for which the claim could have been settled, plus the claim expenses incurred until the date of the refusal.

Likewise, if the insured requires the insurer to appeal a judgment that the insurer would not otherwise have appealed, the policy may limit the insurer's liability to the lesser of the damages awarded in the judgment or the appeal. The insured is responsible for any increase in damages (including interest, attorney fees and costs).

Insurers will often provide an incentive to encourage the use of mediation to settle claims. As an example, the policy may state that if the insured settles a reported claim though mediation, the insurer will reduce the deductible for that claim. The fact that defense costs are applied toward coverage limits is another incentive to settle a claim rather than allow it to go to litigation or arbitration.

Subrogation

As is typical with insurance policies, professional liability policies will usually state that the insurer is subrogated to the insured's right of recovery for any payment made under the policy. Subrogation means that the insurer "steps into the shoes" of the insured and acquires any rights the insured has with respect to the payment. For example, if the A/E's insurer was required to pay an adjacent land owner for damage caused in part by the owner, the insurer could sue the owner for reimbursement. The insured must do whatever is necessary to secure and preserve the insurer's rights, including signing any documents needed for the insurer to effectively sue in the name of the insured.

It has become common for participants on a construction project to waive their right of subrogation against other participants, however. As a result, most E&O policies state that the insurer waives its rights of subrogation against clients of the insured, but only to the extent required by a written contract. A/Es should ask their insurance brokers to review their standard client contracts to ensure that the subrogation requirement in their policy does not conflict with any provision in their contracts.

Exclusion for Fraudulent and Intentional Acts

E&O policies only cover claims for negligence, where negligence is defined as failure to comply with the standard of care applicable to the insured's professional services. Policies do not cover claims arising out of intentional acts, whether committed by the insured, at the insured's direction, or with the insured's prior knowledge. In addition, they do not cover claims arising out of fraudulent, malicious, or criminal acts.

Notwithstanding these exclusions, the insurer will generally pay expenses for such claims, as long as they arise out of the provision of professional services, unless there is finding that the insured's act or omission was fraudulent, malicious, criminal, or intentional. If there is such a finding, the insurer's liability for claim expenses ceases and the insured must generally reimburse the insurer for any claim expenses it has paid. A finding is deemed to occur upon a criminal conviction for the acts or omissions forming the basis of the claim, or a judgment in a trial court against the insured.

Other Exclusions

Professional liability policies typically exclude coverage for claims that are more properly covered by other types of insurance. Thus they exclude coverage for liability arising out of the insured's ownership, operation, or use of property or any kind of vehicle. They also exclude coverage for liability arising out of the sale or distribution of any product developed by the insured.

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Likewise, policies typically exclude claims arising out of any type of alleged discrimination, as well as liability arising out employment-related practices, including refusal to employ any person or termination of any person's employment. Claims for workers' compensation under any workers' compensation, unemployment compensation, or disability benefits law are also excluded.

An E&O policy will cover claims alleging that the insured's professional services are not in conformity with the applicable standard of care, as this is the definition of negligence. It will not cover any other express warranties with respect to the insured's services, however. For example, it would not cover a claim based on the insured's failure to complete work by the agreed-upon date, because that would be a breach of contract, not negligence.

Supplementary Payments

Many E&O policies reimburse the insured for legal fees and expenses if a regulatory or administrative action is brought against the insured based on its performance of professional services. Such actions are usually brought under the Americans with Disabilities Act (ADA), the Federal Fair Housing Act (FFHA), or the Occupational Safety and Health Act (OSHA). Some policies also reimburse reasonable legal fees and expenses if a disciplinary proceeding is brought against the insured. A disciplinary proceeding means a proceeding by a regulatory agency to investigate charges of professional misconduct in the performance of professional services.

Although these reimbursements generally do not have a deductible and do not count against the coverage limits of the policy, the maximum amount reimbursed is typically much lower than the coverage limits. In addition, the insurer will not pay any damages, fines, or penalties pursuant to an administrative action or disciplinary proceeding.

Most policies will reimburse the insured for loss of earnings and travel expenses if the insured has to take time off from work to attend mediation meetings, arbitration hearings, depositions, or trials relative to a claim. The insured is typically not compensated for any other time spent in assisting in the defense and investigation of a claim.

Other Insurance

Professional liability policies are usually written such that coverage is in excess of any other valid insurance available to the insured, including any project-specific insurance. This includes policies carried by parties other than the insured. Coverage does not start until the limits of any other policy have been exceeded.

Additional Insureds

Owners often ask to be included as additional insureds on an A/E's CGL policy, as this provides them with coverage for claims by third parties, such as tenants, that arise from the A/E's work. However, most professional liability policies exclude coverage for claims by another insured ("insured versus insured claims"). Thus, it does not make sense for an owner to be named as an additional insured on a professional liability policy, since the policy would not cover the owner's claims for design defects.

Conclusion

An insurance policy is a contract between the insured and the insurer. Most professional liability policies contain an integration clause that limits the contract to the application and the policy. Typical wording for such a clause is:

> The Insured agrees that this Policy, including the Application and any endorsements, constitutes the entire agreement between the Insured and the Insurer.

It is important that an A/E read its policy documents carefully so that it understands its rights and obligations. When deciding whether to purchase professional liability insurance, an A/E should compare the policies offered by several different insurers, to see which policy best fits its needs.▪

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