Vol. 8, #10 May 20, 2003

Commentary

Not All Settlements Of Claims Are Covered 'Losses' Under D&O or E&O Policies

By
Karen A. Reardon
Scott O. Reed

[Editor's Note: Karen A. Reardon and Scott O. Reed are partners in the Chicago law firm of Reardon Golinkin & Reed. Their practice centers upon representing and counseling clients on a wide variety of insurance coverage issues, primarily involving professional liability matters. Copyright 2003 by the authors. Replies to this commentary are welcome.]

Most forms of professional liability policies, including Directors and Officers liability policies and many forms of errors and omissions insurance, protect insureds against "Claims" arising from "Wrongful Acts" or "Professional Services." The first type of protection given against "Claims" is for the professional liability policy to afford a defense — either under a duty to defend policy or under an indemnity policy. The second — and often much more costly — protection is the obligation to pay "Loss" or "Damages" associated with settlements.

One might assume that where the professional liability insurer accepts its obligation to furnish or fund a defense for a particular suit, it also agrees to fund the settlement of that suit as "Loss" or "Damages" resulting from a covered — or non-excluded — "Claim." But this assumption reads the average professional liability insuring agreement far too broadly. Just because the insurer defends or pays for the defense of a claim does not mean that it is obligated to pay for the full funding of any settlement which is reached as covered "Loss" or "Damages." As shorthand, we refer to this issue as the "loss causation issue."

"Loss" or "Damages" must be *caused* by a defined "Wrongful Act" or by defined "Professional Services." It is not something which merely accompanies those acts or services. Therefore, if an insured is forced, through litigation, to do something which it is already obligated to do – be it under a contract, by statute or regulation or otherwise — that should not be covered "Loss" or "Damages" which the insurer must pay for. Nor should an insurer be forced to pay, as part of a settlement of a claim, for a benefit which the insured received. This is a somewhat elusive concept, but one which becomes more clear with an analysis of specific policy language and concrete claims examples.[1]

I. Policy Language

The terms which are relevant to whether a settlement of a claim is covered under a professional liability policy are found primarily in three provisions: the insuring agreement, the definition of "Wrongful Act" or "Professional Services" and the definition of "Loss" or "Damages." While forms used by different carriers differ somewhat, the basics of these provisions are often relatively similar.

- ***Insuring Agreements***

Some examples of the insuring agreements in recent use among D&O and E&O insurers are as follows:

© Copyright 2003 LexisNexis, Division of Reed Elsevier Inc., King of Prussia, PA • www.mealeys.com

> This policy shall pay the Loss of any Insured Person arising from a Claim made against such Insured Person for any Wrongful Act of such Insured Person, except when and to the extent that an Organization has indemnified such Insured Person.[2]

The following example is from a public officials errors and omissions policy:

> We will pay those sums that the Insured becomes legally obligated to pay as damages resulting from "claims" to which this insurance applies, against the Insured by reason of "wrongful act(s)" rendered in discharging duties on behalf of the public entity named in the Declarations.[3]

The following example is from a lawyers' professional liability policy:

> The Company will pay on behalf of the Insured all Damages that the Insured becomes legally obligated to pay as a result of any Claim first made against the Insured during the Policy Period and reported to the Company during the Policy Period or within 60 days thereafter . . . for any actual or alleged act, error or omission, or Personal Injury resulting from the performance of Professional Services. . . .[4]

The last example is from an insurance agents' errors and omissions policy:

> The Company will pay on behalf of the Insured all damages that the Insured becomes legally obligated to pay because of claims made against the Insured for wrongful acts arising out of the performance of professional services for others.[5]

A common element of these insuring agreements is that the insurer's obligation to pay loss or damages is triggered by a causation element. The loss or damages must "result from" or "arise from" or be "because of" the claim. Some insuring agreements use causation language twice in the insuring agreement, such as the second example above, where the claim itself must be "by reason of" wrongful acts, or the last two examples, where the act or omission must be "resulting from" or "arising out of" the performance of professional services.[6]

In other words, under standard professional liability insuring agreements, an insurer is not obligated to pay all loss or damage which is merely *associated with* a claim. It must instead be *caused by* the "Wrongful Act" or "Professional Services" rendered.

- ***Definitions Of 'Wrongful Act' Or 'Professional Services'***

The following is a typical definition of "Wrongful Act" in a D&O policy:

> Wrongful Act(s) means:
>
> 1. Any error, misstatement, misleading statement, act, omission, neglect, or breach of duty actually or allegedly committed or attempted by:
>
>   (a) any Insured Individual in their capacity as such; . . . [or]
>
> 2. Any matter claimed against any Insured Individual solely by reason of their serving in such capacity. . . .[7]

Other definitions of "wrongful act" can include the modifier "negligent" before the word "error." This modification has been viewed by some courts as potentially having some effect on whether a settlement or judgment in a particular claim is covered "Loss" or "Damages."

Errors and omissions policies typically tailor the definition of "Wrongful Act" or "Professional Services" to the risk insured. The following example is from a public officials liability policy:

> "Wrongful Act(s)" means alleged or actual breach of duty, or violation of any federal, state or civil rights, by an insured while acting within the scope of his or her duties as a public official for the public entity named in the Declarations.[8]

The following example is from a fiduciary liability policy:

> (2) as respects an Administrator, any act, error or omission solely in the performance of one or more of the following administrative duties or activities, but only with respect to a Plan . . . [provision references counseling, Plan interpretation, records handling and enrollment and termination] . . .
>
> or any matter claimed against an Insured solely by reason of his, her or its status as an Administrator, the Plan or the Sponsor Organization, but only with respect to a covered Plan; . . .[9]

The final example is a definition of "Professional Services" from an insurance agents' errors and omissions policy:

> "Professional services" means services performed for others in the Insured's capacity as an insurance agent, insurance broker, insurance general agent . . . [other insurance claims and consulting activities referenced]. . . .[10]

These representative definitions of "Wrongful Act" or "Professional Services" do *not* contain language which bears expressly upon issues of loss causation.

- ***Definitions Of 'Loss' Or 'Damages'***

Typical definitions of "Loss" or "Damages" in professional liability policies contain a description of what *is* included within that definition, and what is *not* included.[11] Examples of those portions of the definition which describe what is included are as follows:

> Loss means the amount(s) which the Insureds become legally obligated to pay on account of a Claim, including damages, judgments, any award of pre-judgment or post-judgment interest, settlement amounts, costs and fees awarded pursuant to judgments, and Defense Costs. . . .[12]

* * *

> "Loss" means damages, judgments, settlements and Defense Costs . . .[13]

* * *

> Damages are monetary judgments, awards and settlements, provided any settlement is negotiated by or with our assistance and approval. Damages also include pre-judgment or post-judgment interest awarded against you on such judgments or awards. . . .[14]

* * *

> Damages means a monetary judgment, monetary award or monetary settlement which you are legally obligated to pay, but does not include punitive or exem-

© Copyright 2003 LexisNexis, Division of Reed Elsevier Inc., King of Prussia, PA • www.mealeys.com

plary damages, fines, penalties, court imposed monetary sanctions, or return or restitution of legal fees, costs and expenses.[15]

Like the definitions of "Wrongful Act" or "Professional Services," the typical definitions of "Loss" and "Damages" do not contain words which are associated with a causation analysis. Thus, the "heavy lifting" on that subject is left to the professional liability insuring agreement.

II. The Loss Causation Problem: The Insured Wants The Insurer To Pay All Of A Settlement, Even Though The Settlement Would Discharge The Insured's Independent Obligations Or Confer A Benefit On The Insured

Assume that an insured under a professional liability policy is sued for failing to comply with obligations it owes the claimant under contract, or under statute or regulations. Assume also that the insured would have had those obligations to the claimant *whether or not* it committed any "wrongful act" or "error or omission," although a claimant does allege that the insured committed a "wrongful act." Nevertheless, the insured asks the insurer to settle the suit and pay for the full amount of the settlement.

The insured reasons as follows: (1) the lawsuit is a "claim" against it; (2) the lawsuit accuses the insured of committing "wrongful acts"; and (3) the definition of "loss" or "damages" includes "settlements." Therefore, any settlement of the suit is fully the responsibility of the insurer, even if it discharges other responsibilities of the insured or confers a benefit on it.

What should the insurer's response be to this argument? Fortunately, a body of largely consistent case law from a variety of jurisdictions has developed which provides the answer by explaining the "loss causation requirement" which is implicit in the causation language of the professional liability insuring agreement.

III. An Illustration: A Public Utility Wants Its E&O Carrier To Pay For Asbestos Removal

To place the "loss causation" problem into context, the facts in a recent professional liability coverage dispute warrant examination. In Lansing Board of Water & Light v. Deerfield Ins. Co.,[16] a publicly-owned utility, the Lansing Board of Water & Light ("BWL") was insured under a public officials errors and omissions policy.[17] It wanted to renovate an outdated power plant, which required it to remove all asbestos. BWL submitted the renovation job for bid and obtained a fixed-price renovation contract with a fixed-price asbestos abatement subcontract. BWL attached certain plant drawings and schematics to the bid proposal, and invited the bidders to inspect all other documents available at the plant prior to submitting their bids.

After the contract was awarded, the asbestos abatement subcontractor found additional "hidden" asbestos in various areas of the plant, specifically a second layer of asbestos insulation in the plant's aged boilers which was not apparent from the drawings the subcontractor had reviewed. During the renovation project, additional drawings were found (including some behind a desk and others mounted in a frame on a wall) which showed the second layer of asbestos in the boilers.[18] The subcontractor sought a change order to compensate it for the unanticipated work, but BWL denied the request.

The subcontractor then sued BWL for breach of contract and various other causes of action, including failure to disclose information based on superior knowledge, *quantum meruit*, breach of express warranty and promissory estoppel. The subcontractor's theory was that either 1) BWL violated its duty under Michigan law when it failed to affirmatively provide it with all of the drawings (rather than simply let the bidders hunt for them) or 2) even if BWL did not violate that duty, it received a benefit — the removal of the unanticipated asbestos — for which it should

© Copyright 2003 LexisNexis, Division of Reed Elsevier Inc., King of Prussia, PA • www.mealeys.com

pay under the theory of *quantum meruit*. BWL contended that it had a fixed-price contract and the abatement subcontractor assumed the risk of undisclosed conditions.

The public officials insurer defended the suit by the subcontractor ("Underlying Litigation") under a reservation of rights. BWL sued its insurer for a declaration of full defense and indemnity coverage. The Underlying Litigation settled. BWL offered to contribute a *de minimis* amount of the settlement only, in exchange for resolution of all coverage issues. Finding the proposed contribution insufficient to warrant resolution of the coverage dispute, the insurer paid the full settlement amount and agreed to litigate responsibility for it in the coverage litigation. It filed a counterclaim for reimbursement to BWL's declaratory complaint.

BWL moved to dismiss the counterclaim. It argued that because "loss" included "settlements" and because the subcontractor's suit alleged a "wrongful act" (*i.e.*, the non-disclosure of certain drawings), the settlement therefore was covered *in its entirety*. The District Court agreed with BWL that non-disclosure was a "Wrongful Act" under the policy as a matter of law, but rejected BWL's suggestion that the presence of a "Wrongful Act" warranted a finding of coverage in its favor.

The Lansing Board court held that, to the extent BWL accepted labor and materials that the abatement subcontractor did not contemplate providing, those allegations did not involve any "Wrongful Acts" and the insurer was entitled to reimbursement for that amount. As the court put it, "[i]n theory, this amount could be the entire amount of the settlement, if the value of the additional work was the entire amount of the settlement. In the alternative, this amount could be none of the settlement or only part of it."[19] The court declined to dismiss the insurer's cause of action against the insured for *quantum meruit* "because, *as a matter of law*, the Court has found that any amount of the settlement which constitutes the actual value of the asbestos removal work which [BWL] would have agreed to pay is not covered 'Loss' because no 'Wrongful Act' by [BWL] would be present."[20] In other words, the Lansing Board opinion set the stage for an allocation trial on what part of the settlement was caused by the "Wrongful Act" and what part was the amount which BWL would have had to pay to remove the asbestos if all parties were operating with full knowledge during the bid process.

The allocation trial in Lansing Board never took place because the matter settled when BWL agreed to reimburse the insurer nearly fifty percent of the $1.8 million paid in settlement. The insurer and insured filed cross-motions for summary judgment on their respective allocation theories, and both were denied. In accepting the magistrate's report recommending denial of both motions, the District Court dispatched the insured's contention that because the settlement amount was less than the subcontractor's damage claim, the settlement was all for a "wrongful act." It commented that:

> As the Court understands [BWL], the only logical conclusion is that the settlement amount must then only be for [BWL]'s "wrongful act." The absurdity of this is palpable. Just because the settlement amount is less than the claimed damage amount related to [BWL]'s "wrongful act" does not necessarily mean that is all the settlement covers.[21]

In this opinion, the Court also reiterated its ruling that the subcontractor's *quantum meruit* claims "are not themselves allegations of a wrongful act and do not encompass any wrongful act. Damages on a *quantum meruit* claim are separate and apart from damages for a wrongful act."[22]

The Lansing Board opinions demonstrate that in analyzing the issue of coverage for settlements under a professional liability policy, the inquiry does not end with the question of whether the litigation *alleges* a wrongful act. If that were the case, then the duty to defend would end up being identical to the duty to indemnify, which is clearly not true in any American jurisdiction under any type of insurance policy. Instead, the "loss causation issue" must be addressed and a

close analysis must be undertaken of the relationship between the wrongful acts (or professional services), the causes of action which they support, and the ultimate settlement.

IV. Application Of The 'Loss Causation Issue' In Various Contexts

The Lansing Board coverage dispute is one example of the "loss causation issue" in professional liability settlements. But this problem cuts across professional liability lines of business and manifests itself in a wide variety of disputes which have resulted in published opinions.

For analytical purposes, the cases which have addressed this problem can largely be divided into two categories. The first category is where the proposed settlement requires the insurer to pay to resolve the insured's obligations which exist independently of any "wrongful act" or "error or omission." We describe these cases as the "deliberate business decisions" cases. The second category is where the proposed settlement would require the insurer to, in effect, pay for a benefit the insured received, but did not pay for. We describe these cases as the "benefit to the insured" cases.

There is a certain amount of overlap among these decisions, in that an insured may have received a benefit as a result of a deliberate business decision (as in the Lansing Board case, or in the Oktibbeha County case discussed below). Nevertheless, the "bright line" used below can assist in giving order to this factually disparate body of law.

A. Settlements Of Claims Caused By Deliberate Business Decisions Are Not Covered Loss Or Damages

Professional liability policies are referred to as errors and omissions policies for a reason. They are not designed to ensure that when an insured makes a deliberate business decision to engage in a particular course of conduct — and then is sued for it — any settlement of that suit is fully covered. Of course, on the other hand, one can argue that errors are intentional or deliberate too, and that this principle is overly broad. Perhaps the best way to respond to that argument is by example.

- ***Failure To Honor Contractual Obligations***

In American Cas. Co. v. Hotel & Restaurant Employees and Bartenders Int'l. Union Welfare Fund,[23] the alleged "wrongful act" was an insured's failure to indemnify an affiliate organization for its legal fees. In Hotel & Restaurant Employees, the international trustees of a labor union entered into a merger agreement with a union local. The merger agreement required the international trustees to indemnify the local trustees for any losses, damages or claims brought against them. Suit was later brought against the local trustees, but the international trustees refused to defend the local trustees, contending that the suit charged them with violating ERISA. In fact, the basis for the refusal was wrong because the merger agreement precluded indemnity of the local trustees only if they were *adjudicated* to have violated ERISA.

The local trustees sued the international trustees for breach of the merger agreement. Judgment was entered in favor of the local trustees for their defense costs in the underlying suit (where they prevailed); the matter was settled post-judgment. The international trustees then sought coverage for the settlement from their fiduciary liability insurance policy. That policy covered claims arising from wrongful acts, defined as "any actual or alleged error or misstatement or misleading statement or act or omission or neglect or breach of duty by the Insureds in the discharge of their duties, individually or collectively, on behalf of the Trust." The international trustees contended that the settlement was "loss" resulting from their "wrongful act" — their erroneous interpretation of their contractual obligations to indemnify the local trustees.

The Hotel & Restaurant Employees court rejected the insured's position. While it agreed that loss was defined "very broadly," the issue was whether the loss resulted from any "wrongful act" — the failure to defend the local trustees. But according to that court, the only loss occasioned by that particular failure was the international trustees' costs in defending the local's action against them. It explained that "[t]he failure to defend did not result in the local trustees' costs in defending the third party action against them, because the costs involved in defending the third party suit would have been incurred whether or not the international trustees had committed the wrongful act of failing to defend the local trustees."[24] That was because if the international trustees had elected to defend the local trustees, they "would not have been in a position to pass their legal obligation on to their insurance carrier."[25]

The rationale underlying the Hotel & Restaurant Employees result was stated briefly as follows:

> The international trustees were required to pay their contractual obligation. This contractual obligation did not result from their wrongful act of refusing to satisfy it. To hold otherwise would allow an insured to turn all of its legal liabilities into insured events by the intentional act of refusing to pay them.[26]

This result has been reached in a number of other cases arising out of an insured's contractual obligations to others. In Baylor Heating & Air Conditioning, Inc. v. Federated Mut'l. Ins. Co.,[27] a union pension fund sued an employer for failing to make pension contributions as required by a collective bargaining agreement. The employer contended that it was "mistaken" about the extent of those obligations, but judgment nevertheless was entered against the employer in the amount of the past due obligations. The employer sought reimbursement of the judgment from its insurer, which provided a multi-cover endorsement under which it agreed to "pay on your behalf all sums which you become legally obligated to pay as damages arising out of any claim made . . . for injury or damage caused by any negligent act, error or omission in the 'administration' of your 'employee benefit programs.'"

The Baylor Heating court did not believe that the insured's conceded "negligence" in determining its contractual obligations — or even its reliance on allegedly erroneous advice from its attorney in doing so — made the judgment a covered matter under the endorsement. It stated that to accept that reasoning would mean that "any default arising from a mistaken assumption regarding one's contractual liability could be transformed into an insured event."[28] As an example, the court stated that reliance on an attorney's mistaken advice likewise would convert a contractual obligation into damage arising from an insured event. The court cautioned that "[w]e dare not imagine the creative legal theories treading just short of malpractice and frivolity that could seek to transform contract obligations into insured events."[29]

This line of cases makes sense, and does not depend on whether the definition of "wrongful acts" incorporates the term "negligence," as it did in Baylor Heating (and on cases on which it relied and, in certain instances, which followed it).[30] Where the duty alleged to have been breached is a contractual one, an insured or claimant should not be permitted to expand the scope of professional liability coverage by describing the breach as a "negligent" one. The incongruity of that position was pointed out in Baylor Heating. Indeed, in one of the cases on which that court relied, the insured's attorney actually argued that if the insured were neglectful in paying its bills, a claim which resulted would be covered under an E&O policy.[31]

- ***Deliberate Business Decisions***

The line of cases discussed above should not be limited to strict "breach of contract" scenarios.[32] They actually rest on the broader principle that an insured's deliberate business decisions are not covered under errors and omissions policies, with resulting judgments and settlements not being covered "loss" or "damages." An illustration of this broader principle is Crum & Forster Managers Corp. v. Basin Elec. Power Cooperative.[33]

© Copyright 2003 LexisNexis, Division of Reed Elsevier Inc., King of Prussia, PA • www.mealeys.com

The insured in Basin was a public utility which invested in a second party in exchange for a letter of credit which could be drawn upon in the event of the second party's bankruptcy. When the second party's bill paying habits raised concerns, Basin filed an involuntary bankruptcy petition against that party. That filing ultimately was determined to have been made in bad faith (in part because other creditors were not persuaded to join it, and in part because it was motivated by the goal of drawing upon the letter of credit), and the bank which issued the letter of credit sued Basin. Basin settled with the bank and sought to recover the amount from its nonprofit organization liability policy, which obligated the insurer to pay "all Loss which the Insureds shall be legally obligated to pay for any civil claim or claims first made against them because of a Wrongful Act." The policy defined Wrongful Act in part as "any actual or alleged error or misstatement or misleading statement or act or omission or neglect or breach of duty," *i.e.*, it did not use the term "negligence."

The Eighth Circuit did not accept the insured's characterization of its settlement as a covered loss. It did not believe that the decision to file the involuntary bankruptcy petition was either a "negligent" or a "wrongful" act. Rather, it viewed the act as "merely a difficult business decision that did not reap the corporation a contingent benefit and not a 'wrongful act' as encompassed by the policy."[34] That the filing was improperly motivated did *not* mean that the decision to do what appeared to be the only act which could protect the insured's security interest, although ultimately unsuccessful, was a "wrongful act."

An errors and omissions policy is *not* designed to guarantee the success or value of any procurement, purchasing, contractual or outright business strategy decisions an insured makes. This line of cases recognizes that the fundamental purpose of professional liability insurance, independent of any exclusionary terms or public policy reasons, is to protect against fortuitous events arising from wrongful acts or omissions, *not* to act as a guarantee that business decisions always will be fruitful ones.

B. Settlements Of Claims Which Result In Paying For Or Disgorging A Benefit Received By The Insured

The plain meaning of the terms "loss" or "damages" implies that something of value is lost or impaired. In an insurance context, they suggest that the insured has either caused or suffered some form of impairment to a tangible or intangible item, and that the insurer is responsible for making up that impairment. The terms do not fit within the context of an insured *receiving* something of value, and a number of cases within professional liability policies confirm that result.

Thus, in lawyers' professional liability policies, it has been held that restitution of legal fees is not "damages," even where a policy's definition of damages does not expressly exclude restitution from that term. In Republic Western Ins. Co. v. Spierer, Woodward, Willens, Denis & Furstman,[35] the court held that restitution of an attorney's fees was not "damages" under a professional liability policy which defined that term as a "monetary judgment, award or settlement." The Spierer, Woodward court cited Bank of the West v. Superior Court[36] for the proposition "that insurable damages do not include costs incurred in disgorging money that has been wrongfully acquired." In other words, even if an act is "wrongful," that does not mean that an errors and omissions insurer needs to pay for returning what the insured obtained through that act.

This principle has been applied in a number of settings within the professional liability lines. In Local 705 Int'l. Brotherhood of Teamsters Health & Welfare Fund v. Five Star Managers, L.L.C.,[37] a union health and welfare fund received contributions from the union's pension fund for certain employees who were not eligible for health and welfare fund benefits. The pension fund sued the health and welfare fund for violations of ERISA, seeking recovery of the improperly transferred benefits plus interest. The suit was settled, with the health and welfare fund agreeing to repay the improperly transferred money to the pension fund, with interest. The pension fund then sought to recover the value of the repayment from its fiduciary liability insurer.

© Copyright 2003 LexisNexis, Division of Reed Elsevier Inc., King of Prussia, PA • www.mealeys.com

The Local 705 court noted that loss is defined as "the act or fact of losing: failure to keep possession."[38] It held that the settlement of the ERISA suit was not "loss" under the errors and omissions policy because:

> there is no question that the sole basis upon which [the health and welfare fund] paid out the settlement amount was the Pension Fund's claim that [the health and welfare fund] was required to return those monies which it had no right to possess in the first place. Such a payment can hardly be termed a loss. Nor can such payment create a deprivation any more so than any borrower can be said to suffer a deprivation from being required to repay an indebtedness.[39]

Whether or not the formal cause of action seeks "restitution" of the insured's gains, a settlement of a claim that the insured has received a benefit should not be deemed "loss" or "damages."

In the directors and officers field, a widely-discussed Seventh Circuit case, Level 3 Communications, Inc., v. Federal Ins. Co.,[40] held that an insured does not incur "loss" within the meaning of a directors and officers liability policy where it settles a claim asserting that the corporation improperly received a benefit as the result of a wrongful act.

In Level 3, the claimants had sold shares in their corporation to the insured. They contended that the insured had made fraudulent representations to induce them to do so. They sought to rescind the transaction and recover the value of the shares because their corporation could not be reconstituted. The court described the nature of the claim for relief as the difference between the value of the stock at the time of trial and the price they received for it from the insured.

Judge Posner, in a decision rendered technically under Nebraska law, but using general principles of insurance policy construction, stated that "[a]n insured incurs no loss within the meaning of the insurance contract by being compelled to return property that it had stolen, even if a more polite word than 'stolen' is used to characterize the claim for the property's return."[41] Because the relief requested effectively sought to compel the insured to return the value of that property, the settlement was therefore not "loss."[42] Judge Posner theorized situations in which a policy would respond to "loss," such as where misstatements are made and the company receives no benefit from them, or where a corporate agent stole property for the company's benefit, but the company incurred substantial legal expenses in defending against its return.

Closing the circle to previous analysis in this article, Judge Posner rejected an argument which was strikingly similar to an argument made in the Lansing Board case — that because the policy covers "settlements," the settlement with the claimants was covered (even though a judgment based on fraud would clearly be excluded). Recognizing the fallacy of the Lansing Board-type syllogism, Judge Posner stated simply, "[t]hat can't be right."[43]

Finally, in a nod to a possible "exception" which threatens to breed coverage litigation in certain circumstances, Judge Posner mused about the implications of an argument by the insured that it did not in fact receive ill-gotten gains which it needed to disgorge, but settled the underlying claim anyway. He asked whether that meant that if the insured showed that the improper gain theory was untrue, would the settlement be "loss"? He properly declined to decide, noting that "prudence is definitely the better part of valor here, since we can find no guidance on the point from cases or other materials."[44]

The Level 3 analysis contains the potential to be a powerful analytical tool in an analysis of coverage for settlements of directors and officers claims. Recently, in Conseco, Inc. v. National Union Fire Ins. Co.,[45] an Indiana state trial judge followed Level 3's reasoning to hold that the portion of a $120 million securities settlement which related to claims under Section 11 of the Securities Act of 1933 was not "Loss" under various directors and officers policies. The Conseco court noted that these Section 11 claimants (whose claims constituted $81.84 million of a $120

million settlement) had asserted that the insured had raised over $2.3 billion through various misleading public offerings during the class period, and had sought damages based on the return of the value the insured received through those offerings, as the statute provides. The court viewed Level 3 as consistent with those cases (some of which are discussed in this article) holding that "insurance cannot be used to pay an insured for amounts an insured wrongfully acquires and is forced to return, or to pay the corporate obligations of an insured."[46]

A variation on the "benefit to the insured" theme was presented in Oktibbeha County School Dist. v. Coregis Ins. Co., 173 F.Supp. 2d 541 (N.D. Miss. 2001), where the benefit to the insured was the value of labor it received without paying for it. Two employees sued the insured school district, alleging that they had been improperly classified as "exempt" workers under the Fair Labor Standards Act and thereby were ineligible to receive overtime pay. The suit was settled by consent decree, with the district agreeing to re-classify the aggrieved employees as non-exempt. The district sought indemnification from its educators legal liability policy, which provided coverage for "Loss as a result of civil Claims made against the Insureds by reason of a Wrongful Act." "Wrongful Acts" were defined as "any act, error or omission of an Insured constituting a breach of a duty imposed by law or a breach of an Employment Contract."

The District Court held that the insurer had no obligation to indemnify the district. It held that the district had a pre-existing obligation to pay its employees overtime, and that obligation did not arise because of any wrongful act by the district. Thus, the district suffered no "loss" by paying for what it had a duty to pay for in the first place.[47]

The Oktibbeha court's reasoning is a straight-forward and succinct application of the "loss causation issue." The court traced the source of the insured's obligation to make a payment to the claimants. Because that obligation existed before — and independent of — any arguable wrongful act (*i.e.*, the improper classification of employees as exempt), then the "wrongful act" could not have been the cause of any "loss."

Much of the litigation relating to the receipt of a "benefit" as "loss" or "damages" has arisen under policies such as directors and officers, fiduciary liability or public officials liability policies, because policies covering fee-for-service professionals such as lawyers and accountants typically contain exclusions for the return or restitution of professional fees. But occasionally, the question of whether the return of a benefit is covered loss under a fee-for-service professional liability policy insuring agreement has been presented. An example is Coregis Ins. Co. v. Salmanson & Falcao, 2002 WL 1018947 (E.D.Pa., May 10, 2002), where the insured law firm was sued for breach of contract, unjust enrichment and *quantum meruit* to obtain its share of fees in a contingent-fee recovery. One of the principals of the insured had worked on the matter at a prior firm, and took it with him when he formed a new firm with another attorney. The prior firm sued the new firm for its share of the fees recovered by the new firm which were attributable to the attorney's work at the prior firm.

The insured law firm's legal malpractice insurer furnished a defense. A judgment was entered against the insured solely on *quantum meruit* grounds, and the insurer declined to appoint appellate counsel, contending that the judgment did not constitute "loss" resulting from a "wrongful act," and therefore its duty to defend was extinguished. The Salmanson court agreed with the insurer. It explained that *quantum meruit* was simply a theory under which the courts imply a contract in law under the theory of unjust enrichment. If the client terminates an attorney-client relationship, the attorney has an equitable cause of action for those unpaid fees. The court noted that this theory did not require proof of any wrongful act, and the insured firm did not commit any wrongful act when it accepted the patronage of the client when the new firm was formed.

The insured sought to counter this result by contending that the division of the fees was awarded on a *pro rata* basis, and thus the attorney who was at the prior firm committed some "wrongful act" in not fully documenting the hours to enable the court to make a division of fees based on

© Copyright 2003 LexisNexis, Division of Reed Elsevier Inc., King of Prussia, PA • www.mealeys.com

time worked. The District Court rejected this argument, noting that the *pro rata* division was actually disapproved by the reviewing court during the pendency of the coverage litigation, and the case was remanded to the trial court to enter judgment based on a comparison of hours worked at both firms.

V. Some Practical And Procedural Issues

If an insured and an insurer disagree about whether a proposed settlement is "loss" or "damages" under a professional liability policy, what should they do? Should the settlement demand be accepted and, if so, who should pay it? The answer is not always obvious and depends on a wide variety of practical and procedural issues. The outcome of many of these issues will often turn on the peculiarities of local law on certain matters. Nevertheless, there are some generalizations which can be made.

Has The Insurer Defended? If the insurer has accepted a defense, the decision to settle must take into account the avoidance of future defense costs as well as the realistic possibility of a judgment which could be higher than the settlement. Further, both sides must consider whether there is a possibility that the litigation later could be limited to a cause of action or theory of recovery which clearly is not covered, as in Salmanson.

Also, the parties must review the reasons for the declination, and whether the particular jurisdiction's bad faith remedies play any part in the decision. In that regard, the recent case of Platinum Technology, Inc. v. Federal Ins. Co.[48] should be of benefit to insurers. That case held that even where the insurer had waived its coverage defenses by not defending its insured, it still was entitled to show that the portion of a settlement which had been made by the insured actually constituted the purchase of a trademark and was not covered loss. Platinum Technology is consistent with the "black letter" rule in insurance coverage litigation that coverage cannot be expanded by waiver, and while exclusions and conditions can be waived, the scope of an insuring agreement (which is where the "loss causation" issue lies) cannot.

Can The Insurer Pay First And Litigate Later? The answer to this question depends on the jurisdiction, although the emerging majority rule appears to be "yes." Cases in California have led the way, and held that where the insurer gives adequate notice to the insured of its intent to seek reimbursement for a settlement and meets other conditions, it can do so.[49] A recent Sixth Circuit case, United Nat'l. Ins. Co. v. SST Fitness Corp.,[50] described as the majority rule that when an insurer timely and explicitly reserves its rights to seek reimbursement (there, of defense costs), provides specific and adequate notice of the possibility of reimbursement, and it is found that there is no duty to defend, then "a reservation of rights is enforceable even absent an express agreement by the insured."[51] The SST Fitness court also found that an implied contract agreeing to the insurer's reimbursement reservation was created by the insured's acceptance of the defense costs, *i.e.*, "the condition becomes part of an implied in fact contract when the insured accepts payment."[52] Arguably, this implied contract exists when the insured accepts the benefit of a settlement funded by the insurer.

The leading case to the contrary is Texas Association of Counties County Government Risk Management Pool v. Matagorda County.[53] In Matagorda County, the court held that an insurer was not entitled to recover the cost of settling an uncovered claim when reimbursement provisions were not found in the initial insurance contract. The underlying litigation was a lawsuit filed by inmates alleging county prison liability for an assault against them. The county's insurance policy contained an exclusion for any claims "arising out of jail." The insurer defended on a reservation of rights. The insurer's second reservation of rights letter asked the insured to contribute to any settlement and stated that the insurer would seek reimbursement for any settlement expenses if a declaratory judgment action found that the claim was not covered under the policy. The insured did not respond to this letter, and neither agreed to the settlement nor to the reimbursement. The insurer, as was its contractual right, settled on its own for $300,000. After a court ruled that

© Copyright 2003 LexisNexis, Division of Reed Elsevier Inc., King of Prussia, PA • www.mealeys.com

the claim was excluded under the jail exclusion, the insurer sought to have the $300,000 reimbursed by the insured. The insured had admitted that the settlement amount was reasonable, but denied any requirement that it reimburse the insurer.

The Matagorda County court found that there was no implied-in-fact contract between the insured and the insurer requiring such a reimbursement, declining to view the insured's silence in response to the second reservation of rights letter as acceptance. The court also refused to recognize a claim for equitable reimbursement or unjust enrichment. It noted that "[r]equiring the insurer rather than the insured to choose the course of action is appropriate because the insurer is in the business of allocating risks and is in the best position to assess the viability of its coverage dispute."[54] Rather, the court urged insurers to seek a prompt declaratory judgment.

Whether an insurer is in a jurisdiction which follows SST Fitness and the California rule or one which follows Matagorda County will determine if the insurer can settle first then litigate coverage later.

Is There A Hammer Clause? If the settlement is favorable, the insurer may wish to recommend it to the insured to take advantage of the "hammer" clause, which normally limits the insurer's liability to the amount by which a case could have been settled plus incurred defense expenses to date, if the insured declines to consent. These types of clauses were generally designed to address the situation where the insured does not believe it is liable to the claimant, but they can also be useful where the insured does not want to consent to a proposed settlement because it disagrees with the insurer's position about who is responsible to pay for it.[55]

Are Other Risk-Shifting Devices Available To The Funding Party? There may be other court rules which could reward the funding party for fronting the settlement money, or may provide an incentive for the non-funding party to be reasonable in negotiating the coverage issues rather than engaging in protracted coverage litigation. A pre-judgment interest rate which is higher than market rates can make the risk of funding the settlement somewhat less. State laws or court rules which shift the costs or attorney fees in a declaratory action may add some incentive to settle rather than litigate. And a strong local "offer of judgment" statute could encourage the funding party to make an early demand of the other party, potentially narrowing the monetary range of the dispute.

All of these issues present a range of options for the insurer and insured, but the complexity of these factors is such that neither party would be well served by proceeding without the advice of competent coverage counsel.

VI. Conclusion

The case law discussed in this article presents a largely consistent front: that settlements which are not caused by a wrongful act (or defined professional services) are not loss (or damages) under a professional liability policy. This result flows both from the causation language contained in all professional liability insuring agreements and from the fortuity requirement inherent in insurance. Because this case law, while limited, is relatively uniform, there is no need to introduce policy modifications to bring any greater clarity to this issue.

Notwithstanding the noted legal clarifications, the "loss causation" problem is one which is likely to continue to present difficulties for insurers and insureds for the very reason that it is a broad overarching concept which is embedded within the professional liability policy. Unlike certain exclusions or other policy terms, the "loss causation" problem cannot often be resolved by pointing to discrete — and limited — policy terms which are created to address narrow situations. This issue is one which is best put to use in resolving a dispute when it is illustrated by example.

© Copyright 2003 LexisNexis, Division of Reed Elsevier Inc., King of Prussia, PA • www.mealeys.com

It is hoped that the collection of authorities discussed in this article will further the analysis of this concept and continue the recognition of "loss causation" principles through tying together a body of case law which has developed through somewhat disparate fact patterns across the various professional liability lines.

ENDNOTES

1. There are a number of other reasons — independent of policy exclusions — that an insurer may not have an obligation to fund all of a settlement of a non-excluded claim. These include the allocation issues associated with the presence of non-covered parties and causes of action within a claim. These allocation issues have been thoroughly addressed elsewhere and are beyond the scope of this article.

2. American International Companies, Executive and Organization Liability Insurance, 75011 (2/00), quoted in International Risk Mgmt. Institute, Inc., Professional Liability Insurance, Directors & Officers at X.E.2. (Sept. 2001).

3. Royal Insurance Company, Public Officials Liability Coverage Form 91247 (10/96), quoted in International Risk Mgmt. Institute, Inc., Professional Liability Insurance, Governmental & Non-profit at XI.C.29. (May 1999).

4. Professional Coverage Managers, Lawyers Professional Liability Policy, 1999, quoted in International Risk Mgmt. Institute, Inc., Professional Liability Insurance, Lawyers at XIV.C.52. (Dec. 2000).

5. Safeco Insurance Company, Insurance Professionals Errors and Omissions Liability Insurance Policy, SR 7043, quoted in International Risk Mgmt. Institute, Inc., Professional Liability Insurance, Insurance at XV.E.3. (Jan. 1997).

6. Another example of this causation language is contained in an insuring agreement which obligates the insurer "[t]o pay on behalf of the Insured all Loss in excess of the deductible which the Insured shall become legally obligated to pay as a result of Claims first made against the Insured during the Policy Period or Extended Reporting Period, if purchased, *because of* any Wrongful Act committed by the Insured." First Reinsurance Co. of Hartford, Public Officials Liability Policy, FRH-POL-CO2 (11/96) (emphasis added).

7. Kemper Insurance Company, Directors, Officers and Corporate Liability Insurance Policy, quoted in International Risk Mgmt. Institute, Inc., Professional Liability Insurance, Directors & Officers at X.E.8. (Sept. 2001).

8. Royal Insurance Company, Public Officials Liability Coverage Form 91247 (10/96), quoted in International Risk Mgmt. Institute, Inc., Professional Liability Insurance, Government & Non-profit at XI.C.29. (May 1999).

9. American International Companies, Employee Benefit Plan Fiduciary Liability Insurance, quoted in International Risk Mgmt. Institute, Inc., Professional Liability Insurance, Fiduciary at XII.F.107. (March 2002). Again, as with D&O policies, the modifier "negligent" sometimes precedes "act, error or omission" in fiduciary liability policies.

10. Safeco Insurance Company, Insurance Professionals Errors and Omissions Liability Insurance Policy, SR 7043 (2/96), quoted in International Risk Mgmt. Institute, Inc., Professional Liability Insurance, Insurance at XV.E.3. (Jan. 1997).

11. Excluded matters are typically fines, penalties, punitive damages and/or matters uninsurable by law.

© Copyright 2003 LexisNexis, Division of Reed Elsevier Inc., King of Prussia, PA • www.mealeys.com

12. Kemper Insurance Company, Directors, Officers and Corporate Liability Insurance Policy, quoted in International Risk Mgmt. Institute, Inc., Professional Liability Insurance, Directors & Officers at X.E.19. (Sept. 2001).

13. American International Companies, Employee Benefit Plan Fiduciary Liability Insurance, quoted in International Risk Mgmt. Institute, Inc., Professional Liability Insurance, Fiduciary at XII.F.104. (Mar. 2002).

14. CNA Pro, Accountants Professional Liability Policy G-127136-A (6/97), quoted in International Risk Mgmt. Institute, Inc., Professional Liability Insurance, Accountants at XIII.E.11. (Mar. 2001).

15. Great American Insurance Company, Legal Professional Liability, Claims-Made Form CG 80 42 (ed. 03/97) XS, quoted in International Risk Mgmt. Institute, Inc., Professional Liability Insurance, Lawyers at XIV.E.11. (June 2002).

16. 183 F. Supp. 2d 979 (W.D. Mich. 2002).

17. The authors represented the insurer.

18. Representatives of BWL and the subcontractor gave conflicting testimony about whether the subcontractor expressly asked for insulation drawings. See Performance Abatement Services, Inc. v. Lansing Board of Water & Light, 168 F. Supp. 2d 720 (W.D. Mich. 2001)

19. 183 F. Supp. 2d at 990.

20. Id. (emphasis added).

21. Lansing Board of Water & Light v. Deerfield Ins. Co., Case No. 5:00-CV-131 (Jan. 10, 2003 opinion) (Enslen, J.), at 5.

22. Id., citing 183 F. Supp. 2d at 990.

23 113 Nev. 764, 942 P.2d 172 (1997).

24. 942 P.2d at 176.

25. Id.

26. Id.

27. 987 F.2d 415 (7th Cir. 1993).

28. 987 F.2d at 420.

29. Id.

30. Cincinnati Ins. Co. v. Metropolitan Properties, 806 F.2d 1541 (11th Cir. 1986) (suit against insured developer for breach of contract, fraud for failing to use "best efforts" to acquire properties); First Southern Ins. Co. v. Jim Lynch Ent., Inc., 932 F.2d 717 (8th Cir. 1991) (suit against employer by terminated employee for failure to re-purchase employee's stock under purchase agreement). Baylor Heating was followed in two separate unpublished matters involving claims by former employees who alleged that the companies deprived them of the value of stock, stock options and/or bonuses. New Hampshire Ins. Co. v. Westlake Hardware, Inc., 201 F.3d 448, 1999 WL 1066836 (10th Cir. 1999); Bendis v. Hartford Acc. & Indem. Co., 1993 WL 463617 (D.Kan., Sept. 16, 1993) (employee benefits liability policies).

31. Cincinnati Ins. Co. v. Metropolitan Properties, 806 F.2d 1541 (11th Cir. 1986).

© Copyright 2003 LexisNexis, Division of Reed Elsevier Inc., King of Prussia, PA • www.mealeys.com

32. Another issue in a breach of contract claim is whether the professional liability policy's breach of contract exclusion — if it has one — would apply. The case law interpreting such exclusions in professional liability policies is widely varied. Some cases apply those exclusions broadly to bar coverage for claims for various types of tortious conduct arising out of a contractual relationship. Phico v. Presbyterian Med. Servs., 444 Pa. Super. 221, 229-30, 663 A.2d 753, 757-58 (1995) (contract exclusion extended to wilful misconduct and negligence claims); CIM Ins. Corp. v. Masamitsu, 74 F. Supp. 2d 975 (D. Haw. 1999) (exclusion extended to fraud, misrepresentation and promissory estoppel claims); American Nat'l. Prop. and Cas. Co. v. Blocker, 165 F. Supp. 2d 1288, 1299 (S.D.Ala. 2001) (exclusion applied to breach of implied warranty and misrepresentation claims). Other courts interpret the exclusions narrowly, and ask whether the duties alleged to have been breached in the tort claims existed independent of the contractual relationship. Admiral Ins. Co. v. Rio Grande Heart Specialists of S. Tex., Inc., 64 S.W.3d 497, 502-03 (Tex. App. 2001); Home Ins. Co. v. Waycrosse, Inc., 990 F. Supp. 720 (D. Minn. 1996). Other authorities apply more of a "bright line" rule, and exclude coverage for claims or counts denominated as breach of contract, but not other claims. E.g., Safeco Ins. Co. of Am. v. Andrews, 915 F.2d 500 (9th Cir. 1990). Also, a breach of contract exclusion with an adjudication requirement would not be applicable if the claim were settled.

33. 911 F.2d 155, 160 (8th Cir. 1990).

34. 911 F.2d at 160.

35. 68 F.3d 347 (9th Cir. 1995).

36. 2 Cal.4th 1254, 10 Cal.Rptr.2d 538, 833 P.2d 545 (1992).

37. 316 Ill. App. 3d 391, 735 N.E.2d 679 (2000).

38. 735 N.E.2d at 683, quoting Webster's Third New International Dictionary 1338 (1993).

39. 735 N.E.2d at 683. The Local 705 court also stated that the insured's repayment of money to which it was not legally entitled "can well be included among" "matters uninsurable under the law pursuant to which this Coverage Form is construed." Id., at 684.

40. 272 F.3d 908 (7th Cir. 2001).

41. 272 F.2d at 911.

42. Curiously, the court noted in passing that the term "damages" was broader than the term "loss." While this comment suggests that the Level 3 result could be different under a different type of professional liability policy, it is respectfully submitted that a more accurate basis for the Level 3 result is the "loss causation" analysis, which is grounded in the insuring agreement rather than the definitions of "loss," "damages" or "wrongful acts."

43. 272 F.2d at 911.

44. 272 F.2d at 912.

45. 2002 WL 31961447 (Ind.Cir.Ct., Marion Co.).

46. 2002 WL 31961447 at * 6. The Conseco court also cited an Indiana case decided under a public officials errors and omissions policy (Town of Orland v. Nat'l Fire & Cas. Co., 726 N.E.2d 364, 371 (Ind. Ct. App. 2000)), for the proposition that such a policy is not a "performance bond" which is available to pay an insured's corporate contractual obligations. Id., at * 7. In Town of Orland, a town (following citizen inquiries and a change in the make-up of its board) suspended activities on a wastewater and drinking water project, and the contractor brought a declaratory judgment and *quantum meruit* action against the town. The court held, under a local government errors and omissions policy defining wrongful acts as "negligent" acts, errors or omis-

© Copyright 2003 LexisNexis, Division of Reed Elsevier Inc., King of Prussia, PA • www.mealeys.com

sions, that the insurer had no duty to defend or indemnify the town because the town had "deliberately made business decisions which caused [the contractor] to question [the town's] commitment to the contract," which was not "negligent." 726 N.E.2d at 371.

47. The Oktibbeha court also held that, even if the litigation fell within the insuring agreement, the policy's improper profit, remuneration or advantage exclusion would apply, since the district received the benefit of employee overtime work without paying for it.

48. 282 F.3d 927 (7th Cir. 2002).

49. Interstate Fire & Cas. Co. v. Underwriters at Lloyd's London, 139 F.3d 1234 (9th Cir. 1998) (insurer adequately reserved rights to seek reimbursement from insured for settlement, court noting that insured's interests were adequately protected by counsel); Blue Ridge Ins. Co. v. Jacobsen, 25 Cal. 4th 489, 22 P.3d 313, 106 Cal. Rptr.2d 535 (2001) (prerequisites for insurer's seeking reimbursement of non-covered claims included in settlement are: (1) reservation of rights, (2) notification to insureds of intent to accept settlement, and (3) express offer to insureds that they can assume defense if they do not agree with settlement).

50. 309 F.3d 914 (6th Cir. 2002) (Ohio law).

51. The SST Fitness court collected cases which disallowed the right to reimbursement of defense costs, but explained that "[t]hese cases, however, reject demands for recoupment on the basis of defects in the reservation of rights, rather than on the basis that recoupment depends on an express agreement by the insured." 309 F.3d at 918.

52. 309 F.3d at 921.

53. 52 S.W.3d 128 (Tex. 2000).

54. 52 S.W.3d at 135.

55. Analysis of the case law interpreting the "hammer" clause is beyond the scope of this article. However, it is useful to keep in mind that a proposed settlement must generally resolve the entire "claim" as to the insured, under the language of most such clauses. See Security Insurance Co. of Hartford v. Schipporeit, Inc., 69 F.3d 1377 (7th Cir. 1995) (to fall within hammer clause, proposed settlement must effect release of insured). ■

© Copyright 2003 LexisNexis, Division of Reed Elsevier Inc., King of Prussia, PA • www.mealeys.com