Unpacking the “Pac Man” Policy: Considerations for Professional Liability Claim Professionals

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I. RELEVANT MALPRACTICE INSURANCE ISSUES

A. Check your state as to whether lawyers are required to report whether they have malpractice insurance on an annual basis. If lawyers are required to report they have malpractice insurance, the general purpose of the rule is to advise potential clients whether a lawyer has insurance that might be available to pay for damages caused by malpractice.

B. The average lawyer will have three legal malpractice claims made against him or her during the course of a career. Source: Mallen and Smith, Legal Malpractice. According to a report by insurance broker Ames & Gough, eight of the ten lawyers' professional responsibility insurers saw more legal malpractice claims in 2019 than in 2018, with three insurers reporting double-digit increases.

II. POLICY COVERAGE PROVISIONS

Every policy is different, so it is prudent to carefully review the language of your particular policy. Liability insurance policies are generally written on either an "occurrence" or a "claims-made" basis. Occurrence policies are written to provide coverage for accidents or for injury or damage occurring during the policy period, regardless of when a claim or suit is brought. Conversely, claims-made policies, with certain exceptions, provide coverage for claims that are made against the insured during the policy period, regardless of when the events giving rise to the claim occurred. Virtually all lawyers professional liability policies are written on a claims-made basis.

A. Prior Acts Coverage

1. Claims-made policies typically limit coverage for "prior acts," i.e., acts or omissions occurring prior to the policy period or a specified retroactive date.

2. Some insurers may allow you to expand coverage for prior acts by endorsement.

3. Alternatively, tail coverage may be available. *See Ballow v. PHICO Ins. Co.*, 875 P.2d 1354, 1357 (Colo. 1993) ("Insureds who purchase claims-made policies can protect themselves against claims made after the policy terminates in one of two ways. One option is to obtain 'prior acts' coverage. Under this option, the new insurer charges an additional premium to cover the insured for acts occurring before the inception date of the new policy. Insurers need not offer this coverage. Another option is to purchase . . .

'tail' coverage. . . . This coverage, which is usually available, is purchased from the first insurer and covers future claims made for incidents occurring during the time of the claims-made coverage. In effect, such coverage turns claims-made coverage into occurrence coverage.").

B. Claim

1. What is a "claim"?

   a. Should be defined within the policy. Policy definitions of the term "claim" are not uniform. Typically, a claim is defined as a demand for money, services or other non-monetary relief.

   b. Where the insurance policy does not define the term, "claim" will be construed as a demand for some asserted right; a mere request for information, in contrast, does not constitute a claim. *Nat'l. Casualty Co. v. Great Southwest Fire Ins. Co.*, 833 P.2d 741, 744 (Colo. 1992).

   c. Coverage is typically limited to claims that involve professional legal services. Courts typically limit the meaning of "professional services" to those acts or services "arising out of a vocation, calling, occupation or employment involving specialized knowledge, labor, or skill, and the labor or skill involved is predominantly mental or intellectual rather than physical or manual." *Hanover Am. Ins. Co. v. Balfour*, 594 F. App'x 526, 531 (10th Cir. 2015). Courts do not deem an act a professional service merely because it is performed by a professional. Rather, it must be necessary for the professional to use his specialized knowledge or training. *Atlantic Lloyd's Ins. Co. of Texas v. Susman Godfrey, L.L.P.*, 982 S.W.2d 472, 476-77 (Tex. App. 1998) (allegedly defamatory solicitation letter sent by lawyer to potential client was not a "professional service" because "[s]oliciting clients does not require a lawyer to use the specialized education and knowledge inherent to lawyers.").

   d. The policy may not provide coverage for claims involving matters such as billing practices, business and investment advice, the lawyer's business expenses, or alleged sexual misconduct. For example, in *Evanston Ins. Co. v. Law Office of Michael P. Medved, P.C.*, 890 F.3d 1195, 1196 (10th Cir. 2018), the U.S. Court of Appeals for the Tenth Circuit concluded the insurer did not have a duty to defend the law firm under a "professional services" policy of liability insurance because allegations of overbilling are not professional services.

e. The policy may not provide coverage for fee disputes or sanctions. *See Li v. Ironshore Indem., Inc.*, 755 F. App'x 705, 705-06 (9th Cir. 2019) (policy included an exclusion which provided that coverage does not extend to payments in connection with any claim "alleging, arising out of, based upon or attributable to the conversion, misappropriation, improper commingling of client funds, the return of or restitution, or disgorgement of fees, costs and expenses, or other amounts . . . ."; so no coverage for dispute of overcharging). *But see Figari & Davenport v. Continental Casualty Company*, 846 F.Supp. 513 (N.D. Tex. 1994).

f. Although the policy will provide that coverage is limited to professional legal services, it may expressly provide coverage for claims resulting from a lawyer's work in other capacities, such as a notary, arbitrator, executor, guardian, or trustee.

g. Claims-made policies often provide that a claim is first made against an insured when the insured receives notice of the claim.

h. Absent such language, a court may not necessarily require that the insured have notice of the claim in order to find that a claim has been made. *Jones v. Lexington Manor Nursing Center, L.L.C.*, 480 F. Supp. 2d 865, 870 (S.D. Miss. 2006) (where the policy did not define a "claim" as being made when the insured received notice, a lawsuit filed against the insured during the policy period, but not served on the insured until after the policy period, was nonetheless a covered "claim").

C. Notice

1. Providing notice of a claim to the insurer is a condition precedent to coverage.

2. "[T]he requirement of notice in an 'occurrence' policy is subsidiary to the event that invokes coverage. By contrast, the event that invokes coverage under a 'claims-made' policy is the transmittal of notice of the claim to the insurance carrier. . . . Thus, in a 'claims-made' policy, the notice provision provides a certain date after which an insurer knows it no longer is liable under the policy and, accordingly, allows the insurer to fix more accurately its reserves for future liabilities and compute premiums with greater certainty. . . . [T]his allows insurers to offer the insurance for a substantially lower cost than occurrence policies." *St. Paul Fire and Marine Ins. Co. v. Estate of Hunt*, 811 P.2d 432, 434-35 (Colo. App. 1991) (internal citations omitted).

3. The "notice-prejudice rule does not apply to a date-certain notice requirement in a claims-made insurance policy." *Craft v. Philadelphia Indemnity Insurance Co.*, 2015 CO 11, No. 14SA43 (Colo. Feb. 17, 2015). Rather, "In a claims-made policy, the date-certain notice requirement defines the scope of coverage. Thus, to excuse late notice in violation of such a requirement would rewrite a fundamental term of the insurance contract. *Id. See also Banjosa Hosp., Ltd. Liab. Co. v. Hiscox, Inc*., 788 F. App'x 531, 532 (9th Cir. 2019) (Montana does not require notice prejudice in claims made insurance policies, noting jurisdictions have uniformly rejected the argument that the notice prejudice rule applies to claims made policies).

4. Failure to report potential incidents may result in a later claim for rescission by the insurer should the failure to report rise to the level of a misrepresentation, even if there is no intent to deceive. *Hollinger v. Mut. Benefit Life Ins. Co.*, 570 P.2d 824, 827 (Colo. 1977); *Wade v. Olinger Life Ins. CO.*, 560 P.2d 446, 451 (Colo. 1977).

D. Prior Knowledge

1. Excludes coverage where, at the time of the insurance application, the lawyer knew of or reasonably should have foreseen the claim, but did not disclose it to the insurer. Prior-knowledge conditions are common in claims-made policies because they ensure that only risks of unknown loss are potentially insured and prevent an insured from obtaining coverage for the risk of a known loss which would be unfair to the insurer. *Cohen-Esrey Real Estate Services, Inc. v. Twin City Fire Ins. Co.*, 636 F.3d 1300, 1303 (10th Cir. 2011).

2. The prior-knowledge exclusion may be triggered under two circumstances: (1) if the insured "knew" that a wrongful act might be expected to be the basis of a claim; or (2) if the insured "could have reasonably foreseen" that a wrongful act might be expected to be the basis of a claim.

3. Courts are divided regarding subjective/objective standard, but most apply a two-part test to determine whether an insured had prior knowledge of a fact or circumstance that could reasonably be expected to result in a claim prior to the policy's inception.

4. Two-part test. *See Westport Ins. Corp. v. Lilley*, 292 F. Supp. 2d 165, 171 (D. Me. 2003); *Selko v. Home Ins. Co*., 139 F.3d 146, 152 (3d Cir. 1998).

    a. Subjective Component: Did the insured subjectively know of certain facts?

    b. Objective Component: Would a reasonable lawyer have recognized that an act or omission had occurred that might lead to a claim?

5. Even if a potential claim is without merit, it does not necessarily render it unenforceable.

6. Reporting potential incidents is particularly important in the insurance application. Failure to report potential incidents may result in a later claim for rescission by the insurer if the failure rises to a level of misrepresentation. As the Third Circuit has explained "A breach of a professional duty and a basis for a claim are … 'two peas in a pod.' If the former occurs, experience teaches that the latter can be expected to follow." *Coregis Ins. Co. v. Baratta & Fenerty, Ltd.*, 264 F.3d 302, 307 (3rd Cir. 2001).

7. Whether this exclusion applies has been—and continues to be—heavily litigated.

    a. *E.g., Imperium Ins. Co. v. Shelton & Assocs.*, P.A., 761 F. App'x 412, 413 (5th Cir. 2019) (affirming summary judgment in favor of insurer because the attorney made a misrepresentation in his application that he was not aware of any legal work or incidents that might reasonably be expected to lead to a claim or suit where a judgment was entered against a client based in part on the attorney's failure to respond to or show up for a hearing on a dispositive motion).

    b. *Davis & Assocs., PC v. Westchester Fire Ins. Co.*, No. 10-cv-03126-REB-CBS, 2012 U.S. Dist. LEXIS 7975 (D. Colo. Jan. 24, 2012) (prior knowledge exclusion barred coverage where the insured firm had knowledge that created a reasonable basis to believe it breached a professional duty when it failed to draft a trust properly for its intended purpose and failed to file a timely action for judicial review).

    c. *Westport Ins. Corp. v. Mirsky*, 84 Fed. Appx. 199 (3d. Cir. 2003) (where the insured attorneys committed discovery violations which resulted in the entry of summary judgment against their plaintiff-client, yet failed to report the plaintiff-client's potential claim when they renewed their insurance policy, coverage for the claim was excluded under the policy).

    d. *Ehrgood v. Coregis Ins. Co.*, 59 F. Supp. 2d 438, 443 (M.D. Pa. 1998) (where attorney representing a plaintiff in a lawsuit failed to properly effect service and knew he had no defense for the failure, yet subsequently submitted an application for renewal of his professional insurance policy denying knowledge "of any circumstance, act, error, omission, or personal injury which might

be expected to be the basis of a legal malpractice claim," coverage was properly excluded).

e. *Maynard v. Westport Ins. Corp*., 208 F. Supp. 2d 568, 575-76 (D. Md. 2002) (coverage excluded where an objectively reasonable attorney knew or should have known that a potential legal malpractice claim existed prior to the effective date of the policy); *Coregis Ins. Co. v. Baratta & Fenerty, Ltd*., 57 F. Supp. 2d 179, 184 (E.D. Pa. 1999) (same).

8. The knowledge of a lawyer no longer affiliated with the insured law firm can trigger the prior knowledge exclusion. *E.g*., *Axis Ins. Co. v. Farah & Farah, P.A*., 503 F. App'x 947, 950 (11th Cir. 2013) (holding that the insurer properly denied coverage for a legal malpractice claim, where "[a former firm lawyer] clearly had knowledge of a probable malpractice claim before the inception of the Policy," and was an insured under the policy, thus triggering the prior knowledge exclusion).

9. Key: thoroughly investigate the firm's members' knowledge of circumstances that lead to a claim.

10. Courts may reject an "innocent insured" argument. *E.g., Coregis Ins. Co. v. McCollum*, 961 F. Supp. 1572, 1579 (M.D. Fla. 1997) ("The language of the exclusion contained within [the] policy explicitly states that coverage will be excluded if any insured under the policy knew or could have reasonably foreseen a possible claim. Courts have agreed that, unlike the phrase 'the insured,' the use of the phrase 'any insured' in a policy exclusion unambiguously expresses a contractual intent to create joint obligations and to prohibit recovery by an innocent co-insured.").

III. LIMITS

1. Will the insurer pay defense costs?

a. Duty to defend must be found within the language of the policy. *Bertagnolli v. Association of Trial Lawyers Assurance*, 934 P.2d 916, 918 (Colo. App. 1997) (insurer had no duty to defend where the policy provided that the insurer had the right to approve defense counsel, but that the insurer "shall not have the right nor shall it be called upon to assume charge of the defense of any claim made or suit brought or proceeding instituted against an insured.").

b. Will insurer pay to defend disciplinary actions?

2. Do defense costs reduce the liability limits?

a. Defense costs in a legal malpractice case can be substantial. Generally, the more that is at stake, the more the case costs to defend. Depending on the exposure and the complexity of the case, the cost of defense can equal or exceed liability limits.

b. Under some policies, defense costs are not counted toward the policy limits.

c. Under other policies (sometimes called "eroding," "wasting" or "Pac Man" policies), defense costs reduce liability limits.
   i. If so, policy limits should be sufficient to cover defense costs as well as potential liability.

3. Who will defend you?

   a. Some policies allow the insurer to select defense counsel without the participation of the insured.

   b. Other policies allow the insured to participate in selection of counsel (e.g., the policies provide that defense counsel must be acceptable to both the insurer and the insured).
      i. Some insurers have a panel of approved counsel from which the insured must select.

4. How large should the deductible be?

   a. Deductibles are amounts that must be paid by the insured before the insurer has an obligation to pay.

   b. When does the policy require that the deductible be paid?
      i. Under some policies, the deductible only applies to settlements or judgments.

      ii. Under other policies, the deductible also applies to defense costs.

   c. Typically, a deductible will apply to each claim.
      i. Some policies may provide aggregate deductibles as well.

   d. Deductible should be based on the number of claims the firm anticipates, and the amount that the firm is willing to risk paying in exchange for a lower premium.

5. Types of limits

   a. "Per claim" limit: Total amount the insurer will pay for all claims arising out of the same act or omission.

b. "Aggregate" limit: Total amount the insurer will pay for all claims made within the policy year (plus any additional time provided by an extended reporting period).

c. A firm with a high volume of cases or transactions is more likely to have multiple claims in a year, and therefore may be more concerned with obtaining a higher aggregate limit.

d. A firm with a limited number of high-dollar cases or transactions may be more concerned with obtaining a higher per claim limit.

6. Minimum Limits Required by Law

a. Some jurisdictions do not require lawyers to purchase professional liability insurance.

b. C.R.C.P. 265 (located in Chapter 22 of the Colorado Court Rules) allows shareholders/partners/members who did not "directly and actively participate" in an act or omission to limit liability if, among other things, certain minimum insurance policy limits were maintained at the time of the act or omission.

i. Per "claim" limits of at least $100,000 multiplied by the number of lawyers in the firm, or $500,000, whichever number is lower.

ii. "Aggregate" limits of at least $300,000 multiplied by the number of lawyers in the firm, or $2,000,000, whichever number is lower.

iii. The limits can include a deductible amount and/or amounts to be paid for defense costs, <u>but</u> the shareholders/partners assume liability for the difference between the remaining liability limits and the minimum limits set forth in Rule 265.