Wiley Rein LLP

EXECUTIVE SUMMARY

Developments Affecting Professional Liability Insurers | March 2015

No Coverage Where Underlying Complaint Did Not Allege Conduct After Retroactive Date; Suits Involving Nearly Identical Course of Conduct Are Related

An Illinois federal court has held that an insurer owed no duty to defend an underlying lawsuit where the complaint did not allege any conduct occurring after that policy's retroactive date. *Wesco Ins. Co. v. Regas*, 2015 WL 500702 (N.D. Ill. Feb. 3, 2015). The court also held that a second carrier owed no duty to defend the suit by operation of a prior notice exclusion. Wiley Rein represented one of the insurers.

An insured lawyer was sued in two underlying cases, one of which was filed in 2010 and one of which was filed in 2013. Both lawsuits alleged a "widespread and long-lasting conspiracy," in which the insured's father schemed to defraud a bank through the issuance of improper loans. The lawyer's 2010 E&O carrier accepted a defense for the 2010 suit under a reservation of rights. However, both the lawyer's 2010 E&O carrier and her 2013 E&O carrier denied coverage for the 2013 suit.

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Pollution Exclusion in E&O Policy Bars Coverage

Applying Pennsylvania law, a federal court in Pennsylvania has held that a pollution exclusion in an insurance company's E&O policy precludes coverage for a dispute between the company and its own policyholder over pollution coverage. *United Nat'l Ins. Co. v. Indian Harbor Ins. Co.*, 2015 WL 437630 (E.D. Pa. Feb. 2, 2015). Wiley Rein represented the E&O carrier.

The E&O carrier issued an insurance company E&O policy to the company. The company was sued after denying coverage under a real estate pollution policy for costs incurred to clean up groundwater contamination. The company tendered the pollution coverage action to the E&O carrier, which denied coverage based on an exclusion in the E&O policy for claims based on or arising out of pollution and "any dispute over the existence or absence of, or particular terms, conditions or amount of, insurance coverage" for pollution.

After the company sued the E&O carrier, the E&O carrier moved to dismiss, citing the pollution exclusion. The court agreed with the E&O carrier, holding that the pollution exclusion was unambiguous and barred coverage for the pollution claim.

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ALSO IN THIS ISSUE

Colorado's Notice-Prejudice Rule Does Not Apply to Claims-Made Policies

Sitting *en banc*, the Colorado Supreme Court has held that the state's notice-prejudice rule does not apply to date-certain notice requirements in claims-made insurance policies. *Craft v. Phila. Indem. Ins. Co.*, 2015 WL 658785 (Colo. Feb. 17, 2015). Wiley Rein submitted an *amicus* brief on behalf of several trade associations on behalf of the insurer.

The insured officer sued the insurer for breach of contract after the insurer denied his claim for coverage resulting from a suit alleging misrepresentations made during a stock sale. The claims-made D&O policy required the policyholder to give notice: (1) as soon as practicable after learning of the claim; and (2) no later than 60 days after the policy's expiration. The parties did not dispute that the policyholder failed to provide notice in conformance with either provision, but the policyholder argued that the insurer was required to show prejudice before denying coverage. The district court granted the insurer's motion to dismiss, holding that Colorado's notice-prejudice rule only applied to occurrence policies. On appeal, the Tenth Circuit certified the question of whether the rule applies to date-certain notice requirements in claims-made policies.

In declining to extend the notice-prejudice rule to claims-made policies, the state supreme court first distinguished claims-made from occurrence policies. Concluding that the timely notice requirement in claims-made policies is a "prerequisite to coverage," the court added that the "conceptual differences" between the types of policies have "important practical implications for the risks that insurers undertake and the premiums that [policyholders] pay." The court also contrasted "prompt" notice provisions, which require a policyholder to notify the insurer of an occurrence "as soon as practicable" and are intended to "allow an insurer to adequately investigate and defend a claim," with "date-certain notice requirements" that fulfill the "very different function" of defining the "temporal boundaries of the policy's basic coverage terms." Because the court found that under date-certain provisions "timely notice of a claim is the event that triggers coverage," it concluded that while applying a prejudice requirement to a prompt notice provision makes sense, extending the rule to date-certain provisions "would defeat the fundamental concept on which coverage is premised."

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Wisconsin Notice-Prejudice Statutes Do Not Apply to Claims-Made-And-Reported Policies

The Supreme Court of Wisconsin has held that Wisconsin's late notice-prejudice statutes do not override the reporting requirements in claims-made-and-reported liability policies. *Anderson v. Aul*, No. 2013AP500, 2015 WL 733904 (Wis. Feb. 25, 2014).

On December 23, 2009, the insured attorney received a letter from two former clients expressing their dissatisfaction with his representation. At the time, the attorney was insured under a professional liability policy issued for the policy period of April 1, 2009 to April 1, 2010, which afforded coverage for claims both first made and first reported during that policy period. The attorney did not inform his insurer of the letter until March 9, 2011, nearly a year after the expiration of the 2009-2010 policy. In March 2012, the former clients filed suit against the attorney. The insurer intervened in the suit and moved for summary judgment, contending, among other things, that the policy did not afford coverage for the clients' claim because that claim was not reported during the policy period in which it was first made. The trial court entered summary judgment for the insurer based on the insured's untimely notice. On appeal, the Court of Appeals reversed based on Wisconsin's notice-prejudice statutes, which provide that an insured's failure to provide notice of a claim as required by the terms of a policy will not bar coverage unless timely notice was "reasonably possible" and the insurer was "prejudiced" by

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Neither "Insured vs. Insured" Exclusion nor "Investment Loss Carve-Out" Bars Coverage for Receiver's Action Against Bank's Former Directors and Officers

Applying Iowa law, a federal district court has held that neither a D&O policy's "insured vs. insured" exclusion nor its "investment loss carve-out" provision barred coverage for an action brought by a receiver against a bank's former directors and officers for losses resulting from the purchase of high-risk securities. *Progressive Cas. Ins. Co. v. FDIC*, 2015 WL 310225 (N.D. Iowa Jan. 23, 2015).

As receiver for a closed federal savings bank, the FDIC filed two suits seeking money damages based on allegations that the former bank's directors and officers caused the bank to purchase high-risk collateralized debt obligations that resulted in losses totaling $58 million. The FDIC alleged negligence in purchasing the securities without due diligence and in disregard and ignorance of regulatory guidance about the risks of such securities. After reserving its rights under the applicable D&O policy, the insurer brought suit for a declaration of no coverage based on the policy's "insured vs. insured" exclusion and its "investment loan carve-out."

On the parties' cross motions for summary judgment, the court first held that the policy's "insured vs. insured" exclusion did not bar coverage for the claims. This exclusion provided that the insurer "shall not be liable . . . for Loss in connection with any Claim by, on behalf of, or at the behest of the Company." The court found that the term "Company" in the exclusion did not include the FDIC, pointing out that where the policy "intended to address coverage issues relating

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Insurer Not Liable for Bad Faith in Absence of Special Relationship with Insured or Unreasonable Denial of Coverage

Applying Oregon law that allows bad faith tort claims "only if the insurer is subject to a standard of care that is independent of the insurance policy itself," an Oregon federal court has granted summary judgment to an insurer, holding that there was no special relationship between the insurer and the insured where the insurer did not assume the defense. *Kollman v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA.*, 2015 U.S. Dist. LEXIS 25464 (D. Or. Mar. 2, 2015). The court also held that despite the fact that the insurer incorrectly denied coverage based on the insured v. insured exclusion, there was no evidence that the insurer acted unreasonably or in bad faith in applying the exclusion to complex facts.

The insured, a company that produces and markets products derived from algae, was sued, along with its directors and others, by one of its shareholders and former employees. The insured sought coverage for itself and the defendant directors under its D&O policy. Relying primarily on the insured v. insured exclusion, and also on the fact that the claims against the company were not "securities claims" as defined by the policy, the insurer denied coverage and any defense-related obligation. The jury in the underlying case ultimately awarded the plaintiff a $40 million verdict. The plaintiff then brought suit against the insurer to recover the judgment, in which the company intervened, alleging that the insurer acted in bad faith in failing to settle for the policy limits of $5 million. The district court held in 2007 that the insured v. insured exclusion did not apply to bar coverage for the individual defendants, but the underlying suits did not constitute a "securities claim" as to the company. The United States Court of Appeals for the Ninth Circuit affirmed in 2013.

In deciding the insurer's subsequent motion for summary judgment as to the bad faith claim, the court explained that it had previously concluded that the insurer had incorrectly denied coverage based on the insured v. insured exclusion because the plaintiff was a past executive of two entities only before they became subsidiaries of the insured entity, and therefore was not an insured.

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Court Applies Objective Standard to Hold that Prior Knowledge Exclusion Bars Coverage

An Ohio federal court has granted summary judgment in favor of an insurer, holding that a prior knowledge exclusion barred coverage under either Ohio or California law for a claim involving wrongful conduct identified in cease and desist letters received by the insured prior to the operative policy period. *Maxum Indem. Co. v. Drive West Ins. Servs.*, 2015 WL 457025 (S.D. Ohio Feb. 3, 2015).

The insured, a wholesale insurance brokerage, received cease and desist letters from two insurance companies after one of the insured's "rogue" employees sold and collected premiums on behalf of the insured for policies the employee lacked authority to sell. The insured subsequently procured a professional liability policy, and it was sued by companies accusing it of negligence and breach of fiduciary duties in connection with the insured's collection of premiums from them for the unauthorized policies. When the insured sought coverage for those suits, its insurer denied coverage based on an exclusion for "[a]ny 'claim' arising out of or resulting from any 'wrongful act' . . . [y]ou had knowledge of or information related to, prior to the first inception date of the . . . coverage . . . and which may result in a 'claim.'" A declaratory judgment action over coverage soon followed.

On cross motions for summary judgment, the court ruled in favor of the insurer, holding that the prior knowledge exclusion barred coverage in its entirety. In so ruling, the court rejected the insured's arguments that the exclusion did not apply because it had no prior knowledge of actual legal claims, as opposed to wrongdoing, and that the policy's "may result" language mandated a subjective determination of its knowledge. Instead, the court ruled that the exclusion was unambiguous on its face, and it held that the claims at issue clearly arose from the "rogue" employee's "wrongful acts of which [the insured] had related information prior to the insured time-period," based on its receipt of the cease and desist letters. As a result, the court determined that there was no coverage under the policy. ■

Illinois Supreme Court Holds "Innocent Insured Doctrine" Inapplicable In Rescission Context

The Supreme Court of Illinois has held that an insurer properly rescinded a legal malpractice insurance policy in its entirety based on a material misrepresentation contained in the policy application. *Ill. State Bar Ass'n Mut. Ins. Co. v. Law Office of Tuzzolino and Terpinas*, 2015 IL 117096, (Ill. Feb. 20, 2015). In so holding, the court concluded that the "innocent insured doctrine" is inapplicable in the context of rescission, and that the insurance policy was properly rescinded as to all insureds.

The insured law firm purchased a legal malpractice insurance policy from the insurer. In completing the policy application on behalf of the firm, one insured attorney did not disclose an ongoing dispute with a client involving various allegations of malpractice. One month after the policy incepted, a legal malpractice claim was filed against the firm relating to the same facts and circumstances not disclosed on the policy application. The firm tendered the claim to the insurer, and the insurer brought suit seeking rescission of the entire policy on the basis of the misrepresentation in the application. The trial court granted summary judgment in favor of the insurer and rescinded the entire policy. The appellate court reversed, holding that the "innocent insured doctrine" applied and rescission was improper as to the attorney that did not fill out the policy application and was unaware of the misrepresentation. The insurer appealed.

The Illinois Supreme Court reversed, concluding that rescission of the entire policy was proper under Illinois law. In so holding, the court concluded that the "innocent insured doctrine" was inapplicable in the context of rescission. The court noted that the "innocent insured doctrine" is

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No Coverage Where Underlying Complaint Did Not Allege Conduct After Retroactive Date; Suits Involving Nearly Identical Course of Conduct Are Related *continued from page 1*

The court granted a motion for judgment on the pleadings filed by the 2010 carrier because the 2013 underlying complaint did not allege any conduct occurring after that policy's retroactive date. The claimant admitted that the underlying complaint did not "describe a particular action" on or after the retroactive date, but argued that the activities described in the complaint "ha[d] not been the subject of discovery" and were inherently "shrouded in secrecy." The court rejected this theory, and held that the carrier had no duty to defend "based on the allegations of the [u]nderlying complaint as they are currently pled, not based on the possibility of future discovery and/or amendments to the complaint."

The court also granted a motion for summary judgment by the 2013 carrier, holding that it owed no duty to defend the insured in the 2013 suit because of a prior notice exclusion. That exclusion barred coverage for claims noticed to prior carriers that arose out of acts in the rendering of legal services that were "temporally, logically or casually connected by any common fact, circumstance, situation, transaction, event, advice or decision." The court found this policy language to be "sweeping." Although the 2010 suit and the 2013 suit may have alleged "distinct legal claims," both suits arose out of "nearly indistinguishable" courses of conduct. As the 2010 suit was noticed to a prior carrier, the court found that the suits were related under the language of the policy and held that the insurer owed no duty to defend the 2013 suit. ■

Pollution Exclusion in E&O Policy Bars Coverage *continued from page 1*

The company argued that the E&O carrier waived or was estopped from relying on the pollution exclusion because it had not issued a coverage position for some years after the claim was tendered. The court disagreed, holding that the company had not alleged any facts showing that the E&O carrier intended to waive its coverage defenses or that the company had reasonably relied to its detriment on the absence of a coverage position. The court also dismissed the company's claim for reformation, finding insufficient allegations that the parties "intended" to cover pollution claims under the E&O policy. ■

Neither "Insured vs. Insured" Exclusion nor "Investment Loss Carve-Out" Bars Coverage for Receiver's Action Against Bank's Former Directors and Officers *continued from page 3*

to 'receivers' and other successors to the bank, it expressly identified such successors." Applying the same logic and citing the dictionary definition of "behalf," the court also rejected the insurer's argument that "on behalf of" meant "stepping into the shoes of." The court therefore reasoned that because the FDIC had the "exclusive" statutory right to bring the action, it did not assert claims "on behalf of" the bank or insured persons.

Next, the court rejected the insurer's argument that coverage was unavailable as a result of the policy's "investment loss carve-out." Under this provision, the definition of covered loss expressly did not include damages measured by "the depreciation . . . in value of any investment product . . . due to market fluctuation unrelated to any Wrongful Act." Contending that the policy was not designed to be the guarantor of the bank's unwise investment decisions, the insurer argued that the carve-out applied to preclude coverage here because the losses claimed by the FDIC equaled the amount that the securities depreciated in value. The court, however, found that the phrase "unrelated to any Wrongful Act" was ambiguous because it could modify either "market fluctuation" or "depreciation . . . in value of any investment product." The court also found that while the phrase "due to" required a causal effect, the phrase "unrelated to" did not. As a result, the court concluded that even if the alleged Wrongful Act did not cause the depreciation, coverage was available because the FDIC's allegations, if proved, would establish "some connection" between the depreciation and the alleged Wrongful Acts. ■

Wisconsin Notice-Prejudice Statutes Do Not Apply to Claims-Made-And-Reported Policies

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the delay. The Court of Appeals held that these statutes apply even where the liability policy is written on a claims-made-and-reported basis.

The Wisconsin Supreme Court reversed. After examining the history of claims-made-and-reported policies and how such policies differ from occurrence policies and pure claims-made policies, the court turned to the text of the policy at issue and the statutory language of Wis. Stat. §§ 631.81 and 632.26(2). The court observed that, on their face, the two statutes could be read literally to prohibit a liability insurer from denying coverage based on an insured's failure to report a claim within the policy period, absent a showing of prejudice. After closely analyzing the legislative history, however, the court ruled that the statutes were not intended to supersede the reporting requirements that are specific to claims-made-and-reported policies.

The court went on to hold that, even if the notice-prejudice statutes did apply to claims-made-and-reported policies, the insurer in this case would still prevail. According to the court, requiring an insurer to provide coverage for a claim reported after the end of a claims-made-and-reported policy period is per se prejudicial because it improperly expands the policy's coverage grant. ■

Colorado's Notice-Prejudice Rule Does Not Apply to Claims-Made Policies

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The court rejected the policyholder's argument that the notice-prejudice rule should apply to "fill gaps" between successive policy periods where the policyholder has renewed a policy in effect at the time a claim was made. Finding the cases cited inapplicable to the present case, the court declined to interpret the insurance contract as providing "seamless coverage." The court also rejected the argument that the same public policy concerns underpinning application of a notice-prejudice rule to occurrence policies supported extending the rule to claims-made policies. In particular, the court found that imposing a prejudice requirement on date-certain notice provisions would not necessarily benefit tort victims because the "marginal increase" in coverage created by excusing late notice in some instances would likely lead to increased premiums or reduced coverage. The court further reasoned that, because the notice requirement in a claims-made policy forms a "fundamental" term of an insurance contract and corresponding notice is a "material condition precedent to coverage," to extend the prejudice requirement would "essentially rewrite the insurance contract and effectively create coverage where none existed." ■

Illinois Supreme Court Holds "Innocent Insured Doctrine" Inapplicable In Rescission Context

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typically invoked in cases involving the enforcement of a policy exclusion for intentional or fraudulent acts caused by a single insured under a policy providing coverage to multiple insureds. According to the court, "[i]n the case of a misrepresentation that materially affects the acceptance of the risk, the issue is the effect of that misrepresentation on the validity of the policy as a whole" and "goes to the formation of the contract." On the other hand, the court noted that the "innocent insured doctrine" typically applies to a determination of whether an insurer owes a coverage obligation to an innocent insured "under a policy that is still in effect." The court stated that the "innocent insured doctrine" is thus "relevant to issues of policy exclusions and insurance coverage, but it is unsuited to the case at bar, which deals with rescission and contract formation." Finally, the court concluded that a severability clause in the policy was also inapplicable, as each insured was still bound by false statements contained in the single policy application. ■

Insurer Not Liable for Bad Faith in Absence of Special Relationship with Insured or Unreasonable Denial of Coverage *from page 3*

The court observed that under Oregon law, a bad faith action against an insurer will not lie absent the insurer being subject to a standard of care that is independent of the insurance policy itself—a standard that arises when the insurer undertakes to defend the insured. Such special relationship that arises when the insurer controls the litigation or exercises independent judgment on the insured's behalf is absent where, as here, the insurer never assumes the legal defense. The court also concluded that, even assuming a special relationship existed, the plaintiff had not shown that the insurer's denial of coverage was unreasonable or in bad faith notwithstanding the contrary coverage determination by the court given the existence of precedent from outside Oregon supporting the insurer's position that the insurer v. insured exclusion applied to claims brought by former directors of the insured entity's subsidiaries. ■

SPEECHES & EVENTS

Drone Technology, Utilization and Risks

Benjamin C. Eggert, Speaker

AGRiP's 2015 Governance & Leadership Conference

March 8 - March 11, 2015 | Las Vegas, NV

Drones are Coming: Are You Ready for Unmanned Aircraft?

Benjamin C. Eggert, Speaker

PRIMA 2015 Annual Conference

June 7 - June 10, 2015 | Houston, TX

The Amended ADA: Implications for Human Resources

Benjamin C. Eggert, Speaker

PRIMA 2015 Annual Conference

June 7 - June 10, 2015 | Houston, TX

State of Existing Allocation Law, With a Focus on Asbestos, Environmental, and Other Long-Tail Claims

Laura A. Foggan, Panelist

ACI's 2nd National Forum on Insurance Allocation

June 25 - June 26, 2015 | Chicago, IL

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