Wiley Rein LLP

# EXECUTIVE SUMMARY

Legal Developments Affecting Professional Liability Insurers | March 2017

## Insured's Failure to Obtain Insurer's Consent Prior to Executing Settlement Term Sheet Precludes Coverage

The United States Court of Appeals for the Ninth Circuit, applying California law, has held that an insured breached the consent-to-settle provision of its professional liability insurance policy by executing a settlement term sheet prior to seeking or obtaining the consent of its insurer and therefore was not entitled to coverage under the policy. *Onewest Bank, FSB v. Houston Cas. Col.,* 2017 WL 218900 (9th Cir. Jan. 9, 2017).

After extensive negotiations in the underlying case, the insured agreed to a settlement and executed a settlement term sheet. Only after executing the term sheet did the insured inform its professional liability insurer of its settlement negotiations. The insurer denied coverage on the ground that the insured had breached the policy's consent-to-settle provision, which provided that the insured "shall not admit or assume any liability, enter into any settlement agreement, stipulate to any judgment or incur any Defense Costs without the prior written consent of the Insurer." The insured filed this coverage action against the insurer. The district court granted summary judgment for the insurer, and the insured appealed.

On appeal, the Ninth Circuit affirmed the judgment of the district court, holding that the insured intended to enter into a final and binding settlement agreement when it executed the term sheet and therefore breached the consent-to-settle provision of its policy. As such, the insured was not entitled to coverage under the policy. ■

## No Coverage for California False Claims Act Suit

A California federal district court has granted an errors and omissions liability insurer's motion for summary judgment that it had no duty to defend a suit against its insured alleging violations of the California False Claims Act ("CFCA"), holding that the underlying suit created no potential for coverage and that there was no reasonable expectation of coverage in light of the nature and kind of risks covered by the policy. *Office Depot, Inc. v. AIG Specialty Ins. Co.,* No. CV 15-02416-SVW-LPRx (C.D. Cal. Jan. 4, 2017).

After the insured office supply retailer was sued by a qui tam relator for alleged violations of the CFCA, it sought a defense and indemnification from its insurer. The insurer denied coverage. The retailer settled the CFCA suit, and then filed a coverage action alleging that its insurer was obligated to reimburse it for a portion of the settlement. The court granted the insurer's motion to dismiss with respect to the indemnity claim, holding that California Insurance Code § 533 – which precludes insurance coverage for losses caused by an

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# “Capacity Exclusion” Bars Coverage for Counterclaim Against Law Firm

The New York Supreme Court, Appellate Division, applying New York law, has held that no coverage was available under a lawyer’s professional liability policy for a counterclaim filed against the insured because of an exclusion barring coverage for claims arising out of the insured’s services and/or capacity as an officer, director, partner, or employee of an organization other than that of the named insured. *Law Offices of Zachary R. Greenhill, P.C. v. Liberty Ins. Underwriters, Inc.,* 2017 WL 439650 (N.Y. App. Div. Feb. 2, 2017).

The insured, a lawyer and his law firm, sued a school, its owner, and its parent company in connection with the insured’s involvement in establishing a venture in China to provide a Chinese-American dual diploma program for students in Chinese high schools. The insured alleged that he was the senior manager of the program, in addition to the president and chief operating officer of the parent company, and as such sought to enforce a consulting agreement. The school, its owner and its parent company asserted two counterclaims against the insured based on allegations that they maintained an attorney-client relationship with the insured. First, they alleged that the insured had breached his fiduciary duty to them with respect to the negotiation and enforcement of the consulting agreement. Second, they asserted that the insured had fraudulently misrepresented that he had provided legal services to the school in connection with its educational partnership in China.

The insured sought coverage under its lawyers professional liability insurance policy. However, the policy contained two relevant exclusions. First, the policy excluded any claims arising out of the insured’s “service and/or capacity as . . . an officer, director, partner, . . . or employee of an organization other than that of the named insured.” Second, the policy barred coverage for any claims that “result[ed] from” legal services that the insured provided to an organization in which he had an equity interest of 10% or more. The insured sought a declaration that the insurer was obligated to provide a defense and pay all defense costs incurred in connection with the counterclaims. The trial court denied the insured’s motion for summary judgment, and instead ruled that the insurer had no duty to defend the insureds against the counterclaims.

On appeal, the court affirmed and held that it was clear from the pleadings in both the instant action and the underlying action that the allegations in the counterclaims fell within the policy’s capacity exclusion. The court explained that the exclusion applied because the counterclaims arose out of the insured’s capacity as the president and chief executive officer of the parent company and senior manager and partner of the program. ■

# Failure to Disclose Untimely Filings on Application Voids Lawyer's Policy

The United States District Court for the District of New Jersey, applying New Jersey law, has held that an insured attorney's failure to disclose on an insurance application an appeal filed late and a lawsuit filed outside of the statute of limitations constitutes a material misrepresentation warranting a default judgment voiding the policy. *Liberty Ins. Underwriters, Inc. v. Wolfe,* 2017 WL 481468 (D.N.J. Feb. 3, 2017).

The insurer issued a Lawyers Professional Responsibility Liability Insurance Policy to the insured, an attorney. The policy application asked whether the applicant had knowledge of any circumstance, act, error or omission that could result in a professional liability claim under the policy, to which the insured answered "no." The insured subsequently sought coverage for two legal malpractice lawsuits under the policy. In one of the underlying lawsuits, the insured had filed an appeal 60 days late and in the other underlying lawsuit, the insured filed the suit outside of the statute of limitations.  After requesting additional information from the insured for both lawsuits and defending one of the lawsuits under a reservation of rights, the insurer filed a complaint for declaratory relief and damages, alleging that the insured had made material mispresentations in his initial policy and renewal applications, rendering the policy void *ab initio*. The insured failed to respond to the complaint. The insurer subsequently moved for a default judgment.

The court granted the insurer's motion for default judgment, holding that the insured had made material misrepresentations in the insurance application by failing to disclose the basis for the two malpractice claims against the insured—facts known to the insured at the time of the policy application—and the insurer could therefore rescind the policy. The court stated that at the time the insured had filled out the insurance application, the insured "was specifically admonished by the [trial court]" for filing a notice of appeal 60 days late, filed a lawsuit outside of the statute of limitations, and failed to object or oppose a motion for summary judgment, yet none of those facts were disclosed in the policy application. The court concluded that "[n]ot only has [the insurer] established a basis for relief, [the insurer] will also suffer prejudice if default is denied because it will continue to be bound by the contract the [insured] procured through fraud." ■

# No Actual Prejudice From Late Notice Where Insurer Could Not Have Altered Outcome of Claim

The Maryland Court of Appeals, applying Maryland law, has held that an insurer could not show actual prejudice from late notice because it could not have impacted the outcome of the claim. *National Union Fire Ins. Co. v. The Fund for Animals, Inc.,* 2017 WL 383453 (Md. Jan. 27, 2017). Although the insured sustained adverse rulings in a related case which were then given collateral estoppel effect in the underlying case, the insurer would not have had any right to direct the defense of the related proceeding.

In the first of two underlying matters, the policyholder brought an action under the Endangered Species Act alleging mistreatment of various circus animals (the ESA Case). While the ESA Case was pending, the ESA defendant brought a RICO Case against the insured, alleging that the policyholder bribed a witness, obstructed justice, and engaged in wire fraud during the ESA Case. During that time, the court in the ESA Case made various adverse findings against the policyholder. These rulings were then applied in the RICO Case under principles of collateral estoppel. While the RICO Case was pending, the policyholder sought coverage for the RICO Case under its claims-made-and-reported policy. The insurer denied on the grounds that notice was over two years late. The RICO Case then settled with the insured paying $2.5 million.

In the ensuing coverage litigation, the trial court ruled for the insurer, holding that the adverse findings in the ESA Case drove up the settlement value of the RICO Case, prejudicing the insurer. The intermediate appellate court reversed. An Executive Summary of the intermediate appellate court's opinion can be found *here*.

The Maryland Court of Appeals agreed that the insurer failed to demonstrate actual prejudice from the policyholder's late notice. Maryland Insurance Article § 19-110 requires the insurer to show that it was actually prejudiced in its ability to investigate, defend, or settle the underlying action. First, the court noted that mere passage of time – here, two years – was insufficient to constitute actual prejudice. Second, the court reasoned that even if the insurer had been given earlier notice of the RICO Case, it could not have impacted the ESA Case. The insurer had no right to intervene in or defend the ESA Case because the insured was a plaintiff in the case and therefore the case was not covered. Thus, the insurer's involvement in the ESA Case was "speculative" and "dependent upon [the insured's] consent." The court found evidence of prejudice lacking because there was no basis to find that earlier notice would have altered the outcome of the ESA Case, impacted the preclusive effect of the factual findings in that matter, or changed the amount for which the RICO Case would have settled. By the time the insurer would have had notice of the ESA Case, "the direction of the ESA Case was well established and [the adverse facts were] apparent." Finally, the court also noted that despite the policyholder's delay, the insurer nonetheless received notice of the RICO Case prior to its settlement and still had the opportunity to participate in that action. ■

# Bankers' Professional Liability Policy Excludes Overdraft Fee Litigation From Coverage

The United States District Court for the Southern District of Indiana, applying Mississippi law, has held that a bankers' professional liability insurance policy did not cover a class action suit against a bank alleging that it wrongfully maximized overdraft fees charged to its customers. *Bancorpsouth, Inc. v. Federal Ins. Co.,* 2017 WL 373300 (S.D. Ind. Jan. 26, 2017). The court also dismissed the bad faith claim made against the insurer because of the absence of coverage in the first instance.

The insured was sued by a class of customers alleging that it reordered debits and engaged in other practices in order to wrongfully maximize overdraft fees. The bank's professional liability insurer denied coverage for the suit based on an exclusion that barred coverage for "any Claim based upon, arising from, or in consequence of any fees or charges." The bank eventually settled the class claims and sued its insurer.

In response to the insurer's motion to dismiss, the bank argued that the exclusion did not apply because the underlying suit was focused on the bank's policies and procedures that caused the various injuries and that overdraft fees were just a type of damage that resulted from those policies and procedures. The insured also argued that the exclusion was ambiguous. The court held that the exclusion barred coverage and dismissed the claims. The court explained that the exclusion's broad language did not make it ambiguous. The court distinguished the facts from another case where plaintiffs had alleged more expansive damages, including inaccurate account balances, related to a bank's overdraft fee scheme. In the present case, the court determined, the charging of the fees caused the plaintiffs' damages and the relief they received "came in the form of a return of those fees." Therefore, "there is no other way for us to construe [the exclusion] than to encompass the claims at issue here." The court also dismissed the bank's bad faith claim because state law required a plaintiff to establish coverage of the underlying claim as a predicate to a bad faith claim. ■

# SPEECHES & EVENTS

**Policyholder Challenges to Insurer Coverage Positions: Competing Interests**

DRI's Insurance Coverage and Claims Institute

**John D. Cole, Speaker**

April 7, 2017 | Chicago, IL

# "Employment-Related Wrongful Acts" Exclusion Bars Coverage for Wage Claims under D&O Policy

A New York intermediate appellate court has held that an exclusion "for any employment-related Wrongful Act" unambiguously barred coverage under a D&O policy for a claim against a director for failure to pay wages and earned vacation benefits. *Hansard v. Federal Ins. Co.*, 2017 WL 424688 (N.Y. App. Div. Feb. 1, 2017).

A director of a non-profit corporation engaged in the business of vocational training and job preparation was sued for, among other things, violations of the federal Fair Labor Standards Act and the New York Labor Law with respect to the payment of wages and earned vacation benefits. The director sought coverage under a D&O policy, but the insurer denied coverage based on an exclusion "for any employment-related Wrongful Act." The director then brought a coverage action against the insurer, and the trial court granted summary judgment in favor of the insured after concluding that the exclusion did not bar coverage.

On appeal, the court reversed the trial court decision and ruled in favor of the insurer. In so doing, the court noted that the phrase "employment-related," while undefined, was not ambiguous. The court held that, in context, "an 'employment-related Wrongful Act' is a Wrongful Act 'connected by reason of an established or discoverable relation to the act of employing or the state of being employed.'" Here, the court determined that the underlying suit clearly fell within that scope because the plaintiffs' claims involved alleged violations of wage laws and retaliation for complaints about violations of wage laws. On that basis, the court reversed summary judgment and remanded the case with instructions to enter judgment in favor of the insurer. ■

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insured's willful acts – barred coverage for the settlement.

Considering the parties' cross-motions for summary judgment with respect to the duty to defend, the court indicated that a duty to defend may be triggered even where § 533 bars indemnity coverage in two scenarios: (1) where the underlying lawsuit creates a potential for coverage, or (2) where there is a reasonable expectation of coverage in light of the nature and kind of risks covered by the policy.

With respect to the potential for coverage, the court concluded that, based on the allegations in the qui tam suit, the insured could not have been found liable for any conduct other than willful conduct. Although a CFCA defendant may be liable for a reckless misrepresentation where the party is deliberately indifferent to the truth, § 533 precludes coverage even for negligent misrepresentations, which are deemed a species of fraud under California law. The court also dismissed the retailer's argument that it could have been held liable for vicarious liability, because the retailer provided no analytical framework supporting how it could be held vicariously liable in light of the allegations of the complaint.

With regard to the second scenario, the court held that an insured may have a reasonable expectation of coverage where a policy provision makes a specific promise of coverage for conduct as to which indemnification is nonetheless precluded by § 533. The court determined that the retailer failed to show any policy provision which explicitly promised a defense for willful conduct. The court therefore concluded that the insurer had no duty to defend and granted the insurer's motion for summary judgment. ■

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