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Make Sure Your Professional Liability Insurance Doesn't End Before It Starts

By Nicholas R. Maxwell

Professional partnerships regularly absorb new partners, along with their existing clients. In so doing, the partners also take on potential future liabilities arising from undisclosed past wrongdoings by the new partner. All partners of a professional partnership — whether they be lawyers, accountants, private practice physicians, architects or other professionals — must understand the risk this entails and how to manage it via professional liability insurance. Of particular relevance is "innocent insured" coverage, which is designed to protect partnerships against liability for wrongdoing of which they had no knowledge. This article explains (1) why innocent insured coverage may not protect innocent partners from claims arising from *pre-policy-period* wrongdoing, and (2) how policyholders can ensure they are fully protected.

Innocent Insured Coverage: The Policy Provision That Isn't

Professional liability insurance companies often require a completed policy application before they will sell a policy. Most such applications specify that the partner who signs the application attests, on behalf of the entire partnership, that there are no existing circumstances that could give rise to a claim against the partnership. This representation includes any wrongdoing lurking in the history of a newly acquired partner, even if the partner signing the application is unaware of it.

Insurance companies know, however, that partnerships will not always know about every single instance of wrongdoing by one partner. This is the underpinning for innocent insured coverage. As the name suggests, innocent insured coverage theoretically covers partners with no knowledge of a culpable partner's conduct, even if the claim would otherwise be denied. Understanding why the coverage would potentially *not* apply when the underlying wrongdoing occurred prior to the policy period, however, requires understanding the precise nature of innocent insured provisions in professional liability policies. Generally, such provisions are not found in the policy's insuring agreements; they are instead structured as an exception to the typical exclusion for criminal or fraudulent acts. In other words, the innocent insured exception rescues innocent partners from otherwise applicable exclusions.

ANDERSON KILL
1251 Avenue of the Americas
New York, NY 10020
(212) 278-1000

ANDERSON KILL
1600 Market Street, Suite 2500
Philadelphia, PA 19103
(267) 216-2700

ANDERSON KILL
1055 Washington Boulevard, Suite 510
Stamford, CT 06901
(203) 388-7950

ANDERSON KILL
1717 Pennsylvania Avenue, Suite 200
Washington, DC 20006
(202) 416-6500

ANDERSON KILL
One Gateway Center, Suite 1510
Newark, NJ 07102
(973) 642-5858

www.andersonkill.com

who's who

Nicholas R. Maxwell is an attorney in Anderson Kill's Philadelphia office. Mr. Maxwell's practice concentrates in corporate and commercial litigation, insurance recovery, exclusively on behalf of policyholders, and in environmental and employment law.
nmaxwell@andersonkill.com
(267) 216-2722

We invite you to contact the newsletter's editor, Pamela Hans, at phans@andersonkill.com or (267) 216-2720 with your questions and/or concerns.

However, for the innocent insured exception to come into play, an exclusion must apply, and for an exclusion to come into play, the claim must first trigger the policy's insuring agreement. Therein lies the problem — many insuring agreements, or related provisions elsewhere in the policy or policy application, state that no coverage will be afforded under any circumstances if the policyholder answered any questions incorrectly on its policy application. In other words, if the application contains a misstatement, the analysis ends there; no exclusions — or exceptions thereto — are even considered.

Generally, the location of the innocent insured provision in a typical policy does not cause problems when the culpable partner's wrongdoing occurred *during* the relevant policy period. That is because the partnership would not have been misstating anything by attesting that *at the time of the application*, there were no circumstances reasonably likely to give rise to a claim. The result is different where *pre-policy-period* wrongdoing gives rise to a claim during the policy period. In that situation, the same answer on the policy application would be incorrect. As a result, the threshold requirement of the insuring agreement — specifically that all questions on the policy application be answered correctly — may not be met.

In the face of such scenarios, an insurance company may attempt to rescind the entire policy on the basis that it never would have sold the policy if the previously existing circumstances had been disclosed. Courts often agree, albeit reluctantly, using the same chain of logic set out above: (1) An exception only applies to an exclusion, (2) an exclusion can only apply if there is a claim meeting the requirements of the policy's insuring agreement, and (3) the insuring agreement is only met if all questions on the policy application were answered correctly.

In *Continental Casualty Co. v. Marshall Granger & Co.*, for example, one partner in the firm, on behalf of all other partners, signed an insurance application certifying that the partnership was unaware of any preexisting circumstances that could give rise to a claim. 921 F. Supp. 2d 111, 115 (S.D.N.Y. 2013). However, prior to the policy period, one partner fraudulently sold fictional securities to clients of the partnership. *Id.* at 115-16. After one of the clients uncovered the fraud, he informed the Securities and Exchange Commission, which brought charges against the partnership and all partners. *Id.* at 116.

The partnership and the innocent partner attempted to invoke their policy's innocent insured provision, but the insurance company moved to rescind the entire policy based on an alleged misrepresentation in the policy application. *Id.* at 115. The court sided with the insurance company, finding that "[b]y its terms [the innocent insured exception] cannot be read as affecting whether the Policy was void as a whole from inception." *Id.* at 123. Accordingly, the partnership and its innocent partner were left holding the bag, despite having procured innocent insured "coverage." While this result was clearly unjust for the policyholder, courts sympathize with insurance companies as well: "while we sympathize with the innocent insureds' position, and recognize that innocent employees are likely to suffer if the entire policy is voidable because of one man's fraudulent response, it must be recognized that plaintiff insurers are likewise innocent parties." *Am. Int'l Specialty Lines Ins. Co. v. Towers Fin. Corp.*, No. 94-cv- 2727, 1997 U.S. Dist. LEXIS 22610, at *31 (S.D.N.Y. Sep. 12, 1997).

How Can Policyholders Fill this Gap in Their Innocent Insured Coverage?

All policyholders should negotiate with their professional liability insurance companies to avoid manifestly unjust results like the one in *Marshall Granger.* One way to do so is via a "severability" term stating that answers on the application bind each partner only to the extent that s/he had actual knowledge of or involvement in the pre-policy-period wrongdoing. Another means to the same end is an endorsement changing the definition of "you," so that where the insuring agreement conditions coverage on "you" attesting that no prior wrongdoing could give rise to a claim, "you" does not automatically encompass all partners.

Policyholders should be prepared to pay a higher premium for these changes, since not being able to rescind their policies outright in the face of potentially costly claims means the insurance companies are taking on additional risk. But in the world of professional partnerships, new partners are frequently absorbed because of their existing client base. It can be well worth the additional cost to gain the peace of mind that any liabilities lurking in the newly acquired partner's relationship with one of those clients will not eventually damage the entire partnership.