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Late Discovery Of An Employee's Wrongdoing — Does It Equal Late Notice To The Insurer?

By Diana Shafter Gliedman


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Although to err is human, in business, to forgive is more than divine — it's exceedingly rare. For that reason, Errors & Omissions ("E&O") Insurance, covering companies and individuals for malpractice, mistakes or negligence made in the line of work that allegedly cost a client or customer money, is a core component of most corporate risk management programs.

Notice Provisions

Virtually all E&O policies contain notice provisions that require that companies inform their insurance companies of claims, or circumstances that could give rise to a claim "as soon as practicable." It is therefore crucial for a corporate policyholder to inform its insurance company as soon as it becomes aware of any mistake made by any employee that could possibly give rise to a claim. But what happens when an employee, fearing censure, termination, or just plain embarrassment, goes out of the way to hide his or her malfeasance? When that mistake finally comes to light, and the inevitable lawsuit is finally filed, has the corporation lost its right to E&O coverage due to late notice?

In most cases, no. The majority of courts hold that an employee's knowledge of his or her own error or omission will not vitiate insurance coverage for the employer where the very thing insured against was the alleged error or omission of the employee. To do so would be to severely and unreasonably curtail the scope of professional liability insurance.

This rule is well-demonstrated by the New York case of *Holloway v. Sacks and Sacks, Esqs.* In *Holloway*, a law firm associate allegedly committed malpractice while commencing an action on behalf of a client. The firm discovered the malpractice in September 1996 and reported the misconduct to its professional liability insurance company. The insurance company denied coverage, however, because in March 1996, the law firm had submitted to the insurance company a renewal application in which it represented that (a) inquiry had been made to all professional employees and (b) no circumstances had been reported in response to that inquiry which would result in a claim for malpractice being made. The insurance company argued that while the firm may not have been aware of the alleged malpractice, the associate's knowledge of his own wrongdoing should be imputed to the firm as a whole, vitiating coverage. The court disagreed, holding that:

"When [an employee's hidden malfeasance] finally comes to light ... has the corporation lost its right to E&O coverage due to late notice?"

> [T]he precise issue here is whether the defendants should have had actual or constructive knowledge of the former associate's misconduct. There was no actual knowledge on the part of the inquiring partner and there is insufficient evidence on which he or the firm could be deemed to have had constructive knowledge. The former associate concealed his misconduct and there is no basis for either imputing his knowledge to defendants or for finding that they should have known of such misconduct.

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The court therefore found that the law firm was entitled to a defense and indemnification for the underlying malpractice action.

The Rule In Other States

New York is not the only jurisdiction to hold that an employee's knowledge of his or her own misdeeds should not be used to vitiate insurance coverage for the employer. Indeed, the rationale behind this rule was well expressed by the Supreme Court of Ohio in the case of *American Financial Corp. v. Fireman's Fund Ins. Co.*:

> Where the purpose of a policy of insurance is to protect an employer from losses caused by an error or omission in the performance of his duty by an employee, the doctrine of imputed knowledge will not operate to defeat recovery by the employer under the policy where there is an exclusion from liability clause based on notice to the employer and only the employee at fault has actual knowledge as to his own error or omission.
> Such a holding is the only logical holding:
>
> [I]t must be remembered that the insurer agreed to protect the insured against errors or omissions of the insured's employees. The knowledge in the instant case is not such as the ordinary employee would divulge to his employer. It is not the tendency of the average employee to disclose his errors or omissions to his employer. The ordinary employee will either seek to remedy the error or omission without the employer's knowledge or will try to conceal it from him.

Other cases have reached the same conclusion. For example, the Alabama Supreme Court, in *Nat'l Union Fire Ins. Co. v. Lomax Johnson Ins.* Agency, held that "[p]rinciples of tort liability whereby a principal is held liable for the negligent acts of his agent cannot serve . . . to prevent coverage where the very thing insured against was the negligent acts of the insured's agents." And a federal district court in *Florida, in Kopelowitz v. Home Ins. Co.*, has declared that "it seems illogical to argue that knowledge of one partner may be imputed to another for purposes of requiring disclosure of such imputed knowledge."

Exceptions

There are, of course, exceptions to this general rule. In a New York case entitled *Rosenberg & Estis, P.C., v. Chicago Insurance Company*, the court held that a partner's malpractice would not be imputed to his firm, holding that it could be "assumed that a 'bad actor' does not advise his partners or employers of his bad acts, until they are otherwise uncovered. Were such imputation of knowledge to take place, the scope of [an E&O Policy] would be limited. Common sense dictates that such limitation was not in the parties' expectation when the policy was written." The court cautioned, however, that:

> Obviously, if [the wrongdoer] gave [his firm] some notice of his wrongful actions, i.e., by admissions or otherwise, the issue would be decided in defendant's favor. ... But then, the issue would not strictly speaking be one of "imputation." Further, [the law firm] appears to be a law firm with many attorneys. The matter would be different if it related to a single practitioner or possibly to a very small and well integrated firm. These are threshold factual issues which must be resolved before the issues of [the insurance company's] obligation to defend and indemnify can be resolved.

Steps To Take

As these cases make clear, corporations would be well-advised to monitor their employees' work and implement safeguards and procedures to detect mistakes or malpractice as soon as possible. Once such mistakes are discovered, notice should

immediately be provided to the appropriate insurance company. There are times, however, when employees compound their malpractice by hiding them. When these mistakes are eventually uncovered, corporate counsel may be at a loss for words. Fortunately, they should not be at a loss for insurance coverage.

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Are You Covered While Doing Good?

By Mark Garbowski

Are you and your employees protected by your insurance while doing volunteer or pro bono work? The time to check is now.

After the September 11, 2001 attack on the World Trade Center, numerous people showed up at the site to help as volunteers. Recently, a group of engineering firms has made the news because the firms' reward for this effort has been thousands of claims. *The New York Times* profiled one engineering firm that has been hit with 8,000 lawsuits in connection with services it performed while the debris was cleared. Most allege that the claimants became ill by breathing the air at the site during the recovery or where the debris was stored. The engineering firms (most of which eventually were required to become paid contractors in order to continue the work) argue that they had no control over, or responsibility for, the air at the site.

The arguable merits of those claims aside, they can provide a useful reminder to review your coverage to check that your company is covered for pro bono, volunteer, or charitable activities. It is by no means certain that such activities are covered under your standard policies.

Certain professional liability policies, for example, only provide coverage for wrongful acts performed while providing professional services "for a fee." Other policies might have other language that would allow your insurance company to argue that the liability or claim was not incurred in connection with your firm's primary business activities. If you have such language in your policies, look for an endorsement or other provision that specifically restores coverage for unpaid, charitable activities.

Another related issue is coverage for spontaneous "Good Samaritan" activities. Firms that employ healthcare professionals, for example, might need an endorsement to cover the company, and individual employees, should those professionals provide emergency assistance to an acci-

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dent victim. Such coverage might be advisable even if your company does not carry medical malpractice insurance because you are generally not in the business of providing medical or healthcare services.

If your company does have the proper coverage in place, the insurance claim process should be little different from claims relating to your company's core business activities. As with all other claims, provide notice without delay, and hold your insurance company to the same standard you would with any other claim.

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