

PROFESSIONAL LIABILITY UPDATE

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Juan C. Araneda

Jennifer A. Becker

David P. Borovsky

Robert J. Buccieri

Chip B. Cox

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Kevin Whittaker

Irene K. Yesowitch

PROFESSIONAL MALPRACTICE COVERAGE

California Law

By Jennifer A. Becker

Root v. American Equity Specialty Ins. Co. 2005 WL 1515941

The Fourth District decides that the reporting requirement in a “claims made and reported” policy is a condition precedent that in some instances can be excused on equitable grounds.

Walter Root had a legal malpractice insurance policy with American Equity Specialty Insurance Company. His policy period was from February 28, 1998 to midnight, Sunday February 28, 1999. On Thursday, February 25, 1999, Root’s former client filed a malpractice suit against him, but did not serve it. The same day a reporter called Root seeking his reaction to the suit. Root thought that the call was a possible prank or mere hearsay. When he returned from a long weekend on March 2, 1998 Root read an article about his client’s legal malpractice action and immediately notified American Equity of the claim. American Equity denied coverage because Root had not reported the claim during the policy period. Root defended the claim on his own and sued American Equity for breach of contract, seeking fees incurred in defending the action. American Equity obtained summary judgment based on the lack of any report during the policy period.

The Court of Appeal noted that the terms of the contract required the claim to be both made and reported during the policy period. A claim was defined as a demand for money, including service of suit or institution of arbitration proceedings. The policy did not have an extended reporting period endorsement, which would have given Root a set amount of extra time to report claims he learned of under ambiguous circumstances.

First, the Court of Appeal concluded that a claim had been made during the policy period. The definition of claim in the policy was ambiguous, and did not exclude the mere filing of a suit as a claim. An ordinary person would consider a lawsuit a demand for money.

Given this ambiguity an insured might have two claims based on one malpractice suit falling on either side of a policy expiration date. Ambiguities in insurance policies are construed according to the reasonable expectations

of the insured and should favor the insured on both sides of the policy period. In Root's case American Equity denied coverage because the report was two days late, while his subsequent insurer denied coverage because Root had a "basis to believe" there was a claim during the prior policy period. If insurers define claim to include events on either side of the expiration of a policy period, insureds should get the benefit of the ambiguity in either direction. The alternative is to preclude coverage on both sides of the expiration date.

Second, the court defined the central issue as whether the policy period reporting requirement was a condition precedent of coverage or part of the defined risk. Because the reporting requirement was found in the insuring clause it appeared as if it was an element of the defining scope of coverage rather than just a mere condition. While there are well-established differences between insuring clauses, exclusions, and conditions just because something is mentioned in an insuring clause does not necessarily mean that it goes to the scope of basic coverage. Otherwise all insuring clauses would consist of one long run-on sentence encompassing all the terms of the policy. Despite the reporting requirement's presence in the insuring clause, it functioned like a condition.

Furthermore the reporting condition was repeated in the claims section of the policy. The two identical reporting clauses rendered the policy ambiguous as to whether the requirement was an element of coverage, a condition, or both. One reasonable interpretation is that there is one requirement to report during the policy period, announced in

the insuring clause, further delineated in the conditions, and therefore is a condition.

The commercial reality behind the reporting requirement demonstrates that it is a condition. Insurers changed from "occurrence" to "claims made" to "claims made and reported" policies to close the gap between the time the insurer prices a risk and the time it incurs an obligation to pay on the risk. With traditional "occurrence" policies the risk of a claim surfacing at some future date after the policy period has expired is borne by the insurer. "Claims made" policies shift the risk to the insured, who pays present dollars for protection against claims that will be paid in those same dollars. Professional malpractice insurance is particularly vulnerable to gaps between the time of pricing and the time of obligation. The reporting requirement does not add significantly to the shift of the risk because the basic risk of the late surfacing claim has already been addressed by changing to claims made coverage.

The reporting requirement does shift the administrative burden of monitoring potential payouts. A reporting requirement gives the insurer administrative closure, and the insurance industry puts value on simply being able to close a file. More importantly a claims made policy facilitates the faster accumulation of loss history, and with a claims made and reported policy loss history is accumulated slightly quicker than with a pure claims made policy.

Another shift is the risk that claims that would otherwise be within the scope of basic coverage are not paid because of an action the insured does not take. As

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such, the reporting requirement operates as a simple forfeiture clause.

Considered either way, as a shift of administrative monitoring costs or as a naked forfeiture clause, the reporting requirement functions as a condition precedent to coverage, not as a definition of coverage.

Finally, the court reasoned that California's common law of contracts has traditionally allowed for the equitable excusal or remediation of conditions in contracts when they cause forfeiture. There is also a statutory basis for an anti-forfeiture rule under Civil Code § 3275. The Court concluded that Root should be able to demonstrate an equitable excuse for his failure to meet the condition precedent of reporting the claim in the policy period.

A rule that allows the court to excuse a condition when it results in forfeiture is not as broad as the notice-prejudice rule. The notice-prejudice rule is an inflexible instrument because prejudice is hard to show under the rule. The burden is on the insurer to show that it has been prejudiced by any delay, and the mere passage of time does not establish a presumption or inference of prejudice. To apply the notice-prejudice rule to a claims made and reported policy would effectively obliterate the "and reported" part of the policy giving the insured a better policy than he paid for.

Equitably excusing a condition precedent is much more flexible, nuanced, and does no violence to the claims made and reported nature of the policy. It is not a bright line test as equities vary with the peculiar facts of each case. Most of the time it will not be

equitable to excuse the non-occurrence of the reporting condition.

In the *Root* case the court, exercising its equitable powers, could consider that the insurer did not give Root the opportunity to buy an extended reporting endorsement which would have given him an extra 60 days to report any claims. If he had been given the opportunity and chose not to purchase the extended period, equity would probably not require excuse of the condition. If Root had sufficient time to conduct an investigation as to whether a claim had been made against him, or had delayed reporting the claim beyond the day on which he received confirmation of the claim, equity would not excuse the reporting condition. However the factual record was sufficient to support the equitable excuse of the reporting condition, so summary judgment should not have been granted.

Comment: Although Root ultimately prevailed in this coverage case, it was only after a lengthy delay, great expense, and with unusual facts. In general, insureds should read their policies to become aware of the definition of "claims" and promptly report claims to avoid distracting coverage issues.