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Disclosing a potential malpractice claim to insurers

Law firms may face exclusion if they reveal, rescission if they don't.

BY VEDICA PURI

How does a firm know when a client may accuse it of malpractice? When the client asks for a discount off the bill? When he or she doesn't reply to e-mails for days? When the client says he or she is "upset" with a result in a case or "can't believe" a particular ruling? It is the question almost every insurance application asks before insuring a firm against legal malpractice. Sometimes, it is also a classic Catch-22: If a firm discloses a potential claim, it may be excluded from the policy. If the firm doesn't disclose a claim that later turns into a malpractice suit, the insurer may rescind the policy on the ground that the firm knew that a suit might materialize when it signed the application and therefore made a material misrepresentation.

What if a lawyer in a California firm files a Calif. Code Civ. Proc. § 473 motion admitting a mistake in calendaring and missed a deadline? Does that mean that every such motion need be disclosed on the penalty of rescission? In this scenario, imagine that the insurance application is signed by the managing partner of a hypothetical firm, "the ABC law firm." The application asks: "After inquiry, does any lawyer to be insured under this policy have knowledge of any circumstance, act, error, or omission that could result in a professional liability claim? If 'Yes,' please complete a Claims Supplemental Application for each instance."

In addition, consider that another part of the application deems the managing partner to be speaking on behalf of all the firm's lawyers. Application questions such as these are known as "polling" questions requiring some level of inquiry or polling prior to answering. The ABC law firm comprises 10 to 15 senior lawyers who have been practicing for 20 or more years. The managing partner is kept apprised of major case events but leaves day-to-day deadlines and case strategy to his senior attorneys with the expectation that, if something is amiss or a client is disgruntled, he would be informed. When it comes time to fill out the insurance application, the managing partner truthfully responds "No" to the key question.

A few months later, the ABC firm is sued by a client claiming that the firm's failure to timely designate experts was the reason the client ultimately lost its bench trial. The ABC firm tenders the matter to its errors-and-omissions insurance carrier, which then rescinds the ABC firm's policy on the ground that the adverse bench trial ruling and failure to timely designate experts should have alerted the ABC firm to a potential malpractice claim that should have been disclosed on its application. The insurer reasons that the ABC firm should have disclosed this potential claim because the adverse ruling had been issued months before the application was signed, and the firm had filed a § 473 motion requesting relief from the untimely-expert designation, thereby admitting its mistake in pleadings.

The managing partner knew about the adverse bench trial ruling, and the senior lawyer in charge of the case reported that the clients instructed the ABC firm to file an appeal. Based on that instruction, the managing partner believed his senior lawyer had the matter under control and the client expressed no dissatisfaction. What the managing partner did not know is that the senior lawyer had apparently missed the expert-designation deadline and filed a declaration with his § 473 motion admitting the missed deadline and requesting relief. The managing partner also did not know that the court had denied this motion and the adverse bench ruling specifically cited the lack of expert testimony as a reason for ruling against the ABC firm's client.

The issue is then: How much due diligence is required before answering the prior-knowledge policy application question? Is the fact that a managing partner trusted his senior lawyer to tell him

about a missed deadline tantamount to a material misrepresentation? Or does the fact that the managing partner knew about the adverse ruling enough to justify his application response? If the answer is truthful, can it still be the basis for rescission? Representations on a policy application may be questions of fact that preclude rescission. See *O'Riordon v. Federal Kemper Insurance Co.*, 36 Cal. 4th 281, 288 (Calif. 2005). These insurance coverage issues are critical for lawyers and their firms.

There are important due diligence steps a lawyer and law firm can take when renewing a policy to help avoid denial of an errors-and-omissions claim. The bottom line is that this function cannot be delegated to a broker and must be taken seriously. The flow of communication from the lawyer who is working up the case with direct client contact on a day-to-day basis to the managing partner of the firm is not always easy or direct.

MEANINGFUL DUE DILIGENCE

Establishing links in between so that lawyers feel comfortable reporting information and partners can better track case events is important. The level of inquiry necessary to respond to the prior-knowledge question should be established by every firm and documented. Large law firms can form committees dedicated to conducting renewal due diligence without causing a panic (i.e., obtaining information from department heads). Smaller firms should keep some form of case list that is routinely updated with major deadlines. Regardless of size, if an application contains a polling question requiring a response on behalf of all of its lawyers, firms must implement some form of meaningful due diligence. It is vital to manage the client expectations during the course of the case through specific updates in writing to alleviate a client's surprise factor if there is an adverse result.

Typically, a defense duty is excused only when "the third party complaint can by no conceivable theory raise a single issue which could bring it within the policy coverage." See *Montrose Chemical Corp. v. Superior Court*, 6 Cal. 4th 287, 295 (Calif. 1993).

Insurers will argue that misrepresentations on a policy application void the policy and obviate its duty to defend. However, in *Maryland Casualty Co. v. NAICC*, 48 Cal. App. 4th 1822, 1833 (Calif. 4th Ct. App. 1996), the court rejected this argument. There, the insurer argued that it had no duty to defend a construction-defect lawsuit because its insured had concealed pre-existing damage, thereby voiding coverage. The court held: "While NAICC raised evidence of concealment, it did not present sufficient evidence to establish that defense as a matter of law. If, at a later time, NAICC successfully proves up its concealment theory, this would eliminate its obligations under the policy, including its duty to defend. However, until such time..., its duty to defend continues." State law varies somewhat on the duty to defend; however, it is generally considered broader than the duty to indemnify. With respect to the ABC firm, the *Maryland Casualty* precedent would likely persuade a California court to overturn the insurer's rescission.

Law firms should use the ABC firm story as a precautionary tale and take some time to check the wording of the prior-knowledge question on their errors-and-omissions policy application.

Vedica Puri (vpuri@pillsburylevinson.com) is a partner at Pillsbury & Levinson in San Francisco.