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Insurance Coverage 101 For Investment Advisers

by Edward Susolik, Partner in Charge, and Tae J. Im, Senior Attorney, Callahan & Blaine

With the downturn in the financial markets in the last few years, it is not surprising that many investors who lost money in the market blame their investment advisers for their losses and have made claims in arbitration, or in lawsuits.

Although professional liability policies for investment advisers share many things in common with such policies for doctors, lawyers, accountants and other professionals, limitations on coverage in investment advisers' policies seem to lead more often to insurers denying coverage outright, or disputes as to the proper allocation of defense fees and costs and settlement costs between covered and uncovered claims than with most other types of professional liability policies.

This article will set forth some of the most important provisions of typical policies that an investment adviser should be aware of if a claim has been made, or when purchasing or renewing such coverage.

Many policies require that services be performed pursuant to a written agreement with the client. A coverage defense that some insurers have actually raised based on such a requirement is that claims arising out of work done before the client signs on the dotted line, such as due diligence on an investment, are not covered.

Immediately notifying an insurer of a claim is vital. Almost all professional liability coverage is written on a claims made basis and most policies are "claims made and reported" policies. A "claims made and reported" policy requires that a claim be made during the policy period and reported during the policy period, or a set time after the claim is made, typically 30 or 60 days. Although *Campbell v. Allstate Ins. Co.* (1963) 60 Cal.2d 303, 308 holds that delayed notice of a third party claim by an insured does not allow an insurer to deny coverage unless the insurer can prove actual prejudice, this holding does not apply to "claims made and reported" policies, even if the subsequent policy issued by the same insurer. *See Westrec Marina Management, Inc. v. Arrowood Indemnity Co.* (2008)163 Cal.App.4th 1387, 1396.

Most policies have "burning limits," i.e., defense costs count toward the limits. Because defense costs reduce the limits available for any judgment or settlement, it is important for an insured to keep track of defense costs as a claim progresses, especially in a case where there is a potential for liability above the remaining limits.

Typical policies have a self-insured retention, i.e, the amount of defense costs and indemnity costs an insured must pay before the insurer's obligation to provide coverage kicks in. The limits of liability are usually in addition to the amount of the self-insured retention, but the specific language of the policy is controlling.

Many policies require the insurer to reimburse defense costs, as opposed to requiring the insurer to defend. This often leads to disputes over the allocation of defense costs if there are uncovered claims as duty to reimburse policies usually require only reimbursement of defense costs for covered claims. Duty to defend policies are preferable because the insurer must pay all defense costs and then seek reimbursement from the insured for defense costs solely allocable to uncovered claims, which rarely ever happens. *See Buss v. Superior Court* (1997) 16 Cal.4th 35, 48.

An all too common ground for denial of coverage for seemingly covered claims is the retroactive date. A policy will not cover liability arising out of acts prior to the retroactive date. Typically the retroactive date will remain the same when an insurer renews a policy, which provides a strong incentive to keep renewing.

All too often, insureds purchase a policy with a retroactive date that is the policy inception date because an insurer will charge more for an earlier retroactive date, or refuse to provide an earlier date. This means that there will be no coverage for claims arising out of alleged wrongful acts that occurred before the policy incepted. Many insurers take the position that if any alleged wrongful act occurred before the retroactive date, there is no coverage for the claim, even though alleged wrongful acts also occurred after the retroactive date.

When an insured is facing the choice of renewing a policy or going with a different carrier and the insured wants coverage for prior acts, the insured should consider the cost of getting an extended reporting period for the current policy, or getting a new policy with a retroactive date that is earlier than the policy inception date. This is often not an easy choice because the premium for even a one-year extended reporting period is typically equal to the premium for the policy.

Another common ground for denial of coverage for seemingly covered claims is the failure of the insured to give notice of a potential claim. Even if a claim has not been made, most policies allow the insured to give notice of a potential claim to the insurer and the insurer will provide coverage if the potential claim later becomes an actual claim, even if the claim is made outside the reporting period. By failing to give notice of a potential claim, the insured loses the potential for coverage under the current policy and often loses coverage under the subsequent policy when the claim is made, because of alleged misrepresentation in the application for failing to give notice of potential claims.

Another common issue that all too often arises is when insureds renew their policies without realizing that unilateral changes in coverage have been imposed upon them by their insurers. These unilateral changes are often brought on by the fact that certain types of claims are being made more often and the insurer wants to exclude or severely limit coverage for such claims. For instance, one well-known national insurer added an endorsement to professional liability policies issued to investment advisers upon renewal which raised the retention for "specialty investments" (which was defined as commodity futures, real estate, options, private placements, unregistered securities, direct placements, oil and gas joint ventures, foreign securities, limited partnerships of any type and derivatives and/or strips of mortgage backed securities or collateralized mortgage obligations) from $25,000 to $50,000 and changed the retroactive date for such investments to the inception day of the renewal policy. This endorsement eliminated all coverage for claims arising out of "specialty investments" under the renewal policy unless claims arose out of acts taken after the renewal date.

> MOST POLICIES HAVE "BURNING LIMITS," I.E., DEFENSE COSTS COUNT TOWARD THE LIMITS. BECAUSE DEFENSE COSTS REDUCE THE LIMITS AVAILABLE FOR ANY JUDGMENT OR SETTLEMENT, IT IS IMPORTANT FOR AN INSURED TO KEEP TRACK OF DEFENSE COSTS AS A CLAIM PROGRESSES, ESPECIALLY IN A CASE WHERE THERE IS A POTENTIAL FOR LIABILITY ABOVE THE REMAINING LIMITS.

One argument that can be raised against such changes in policy terms is the fact that the law requires specific notice of a reduction in coverage, and a general admonition to read the policy for changes is not sufficient. *See Davis v. United Services Auto. Assn.* (1990) 223 Cal.App.3d 1322, 1332. One often overlooked weapon to fight such unilateral changes is Insurance Code section 678.1 which essentially requires that a "notice of nonrenewal, and the reasons for the nonrenewal, if the insurer intends not to renew the policy, or to condition renewal upon reduction of limits, elimination of coverages, increase in deductibles, or increase of more than 25 percent in the rate upon which the premium is based" must be sent to the insured at least 60 days, but not more than 120 days, before the policy expiration date.

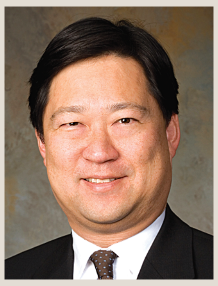
In conclusion, investment advisers need to carefully purchase and renew their professional liability coverage if they wish to avoid unpleasant surprises when a claim is made.

Callahan & Blaine's website is found at www.callahan-law.com.

Edward Susolik

Edward Susolik is the partner in charge of the Insurance Department at Callahan & Blaine, an Orange County boutique litigation firm with 28 attorneys. Mr. Susolik is an adjunct professor at USC Law School, and has been an editor of the *Rutter Guide on Insurance Litigation* since 2003. Mr. Susolik has been named one of the "Top 100 Attorneys in Southern California" by *Super Lawyers* for 2010, 2011 and 2012, and one of the "Top 50 Attorneys in Orange County" for every year since 2005. He can be reached at esusolik@callahanlaw.com or 714.241.4444.

Tae J. Im



Tae J. Im is a senior attorney with Callahan & Blaine. Mr. Im specializes in complex insurance litigation, including insurance coverage and insurance bad faith. Mr. Im can be reached at tim@callahan-law.com or 714.241.4444.