BEFORE CLAIMS ARISE

Insureds Need To Sort Out Potential Hammer Effects

It's claims settlement time: Do you know what leverage your insurance company has?

BY PETER R. TAFFAE

Buyers should be aware of any hammer clauses in policies limiting their settlement options.

What do a mallet, sledgehammer and jackhammer have in common? One of them is in each of your employment practices liability, directors and officers liability, and errors and omissions policies.

Most comprehensive general liability policies contain limit language, which states the insurer has a "right" to settle claims—thus leaving an opportunity for discussion. The settlement language in D&O, E&O and EPL policies are quite different.

Although the terminology used in this article is tongue-in-cheek, the real life significance is critical. The hammer clause deserves more attention than many insureds give it.

It is wise to understand the potential impact this clause will have on a claim before it's too late. It is important enough to revisit in light of recent changes in underwriters' approaches and its effect on claims settlements.

There is technically no "hammer clause" in the policy. Instead, it is insurance jargon that refers to a caveat in the policy that limits the insured's options during claim settlement discussions.

The clause detailing these limits actually is the part of the policy that defines the insurer and insured obligations when both do not agree on whether to settle a claim.

In most E&O, EPL and D&O policies, the insurer reserves the right to make that decision at least to some degree. Usually the clause can be found under the "Defense Settlement" section, although it can also appear in the "Definitions and Reporting/Notification" sections.

In broad terms, the hammer clause dictates whether the insurer will pay anything over the first proposed settlement, and if so, how the settlement amount in excess of the proposed settlement (and related defense costs) will be divided up between the insurer and the insured. The insurer's clout in the matter has given rise to the "hammer" terminology.

There are a number of options being offered and ways in which carriers approach this important clause, making it a crucial part of the insured's insurance buying decision. (See accompanying textbox, "Avoid The Hammer.") Although rarely referred to as co-insurance, in reality that is exactly what it should be considered.

For example, assume an attorney or physician, or consultant or supervisor (in an E&O claim case) is facing a $200,000 settlement and has a $1 million limit policy. If this policy has the harshest hammer language available—we refer to it as a "jackhammer" clause for descriptive purposes—the attorney or other professional insured now has to decide if he will settle and reduce his limit (thus the amount available for future claims in this policy period) by $200,000 (excess of the SIR) or pay the costs to litigate until final adjudication.

In addition to lowering the aggregate limit for any remaining or future claims, it will now be part of the insured's loss experience and could set a precedent for future plaintiffs—a situation that is often experienced in the EPL world.

By settling the claim, the insured also runs the risk of the incumbent carrier non-renewing and insured facing a challenging process of replacing coverage with negative loss experience.

Another example of jackhammer impact involves an EPL policy purchased with $1 million limit subject to a $100,000 self-insured retention. An employee brings a sexual harassment suit and is willing to settle for $150,000.

The insurer wants to accept, resulting in a cost to the insured of $100,000 and an insurance company cost of $50,000.

The insured, however, does not want to settle due to a strong defense, fear of setting a precedent, attracting other plaintiffs and risking its reputation. The insured decides to litigate at a cost of $250,000 and ultimately is victorious.

The total cost to insured is $200,000—the SIR of $100,000, plus the excess over the SIR ($150,000) reduced by the carrier contribution ($50,000). The carrier's contribution is the amount the carrier would have paid if the insured had decided to accept the original settlement.

If the only change in this scenario was the policy was issued with a "mallet," the out-of-pocket cost for insured would be the SIR of $100,000 plus $30,000 (30 percent of the $100,000 over the original $150,000 settlement proposal) for a total of $130,000.

See the significance?

Add a "rubber handle" and the insured could have saved another $50,000 (50 percent of retention) and/or if "rubber handle" included a "victorious bonus" the $30,000 would have been waived.

Let's outline why this should be an important consideration.

A number of factors need to be considered.

An insured's loss history is required for at least five years and plays a significant part in the underwriting process.

E&O and D&O underwriters in general shy away from claims-experienced accounts. Claims experience also affects the quality of coverage underwriters are willing to provide, especially E&O and D&O underwriters, and the cost of such insurance.

Another often overlooked but important factor is the additional financial costs the insured has to take into consideration when deciding to pursue the judicial process. Without the right 'hammer clause' the insured's ability to make a wise business decision to pursue litigation could easily be adversely impacted.

It is important to provide the option

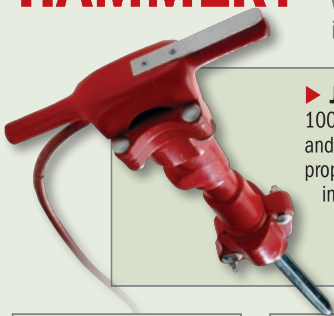
continued on page 19

CLAUSE LANGUAGE

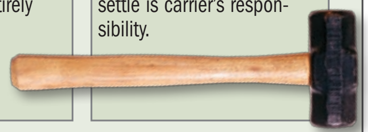
HOW CAN YOU AVOID THE HAMMER?

Language contained in management and professional liability policies explaining how much an insurer will pay over a proposed settlement varies from hard to soft, depending on the carrier.

Listed below are several variations. Descriptive names were made up to give a sense of the strength of the insurer's hammer to enforce a proposed settlement.

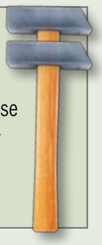


JACKHAMMER 100 percent of any defense costs and settlement exceeding first proposed settlement is entirely insured's responsibility.

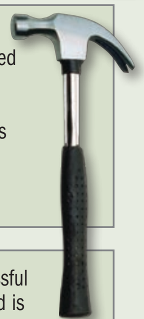


SLEDGEHAMMER 50 percent of final cost exceeding first proposal to settle is carrier's responsibility.

MALLET 70 or 75 percent of final cost exceeding first proposal to settle is carrier's responsibility.



DOUBLE MALLET The above and 100 percent of defense costs over retention are carrier's responsibility.



RUBBER HANDLE If the insured accepts a "hammer clause" and litigation ultimately settles for less than the first proposed settlement, insured retains the "underage."

RUBBER HANDLE TWO If insured is successful in litigation, retention is reduced by 50 percent; if insured is victorious the co-insurance percentage is reduced to zero.

Peter R. Taffae is managing director of Executive Perils, a Los Angeles-based national wholesaler solely dedicated to D&O, E&O, EPL, digital, intellectual property, media, legal malpractice, insurance agents E&O, crime and fiduciary liability insurance. He can be reached at petert@eperils.com

A contractor's claim usually involves an allegation that the work is not done correctly, such as a newly installed roof leaks. Since the policy is not a warranty for the contractor's work, it wouldn't cover replacement of the roof as a work product.

While coverage for the actual roof—the work product—would be denied, the policy could provide coverage for residual damages triggered by the "bad" roof, such as water damage inside the home.

Another example of a typical claim is when the contractor causes actual property damage. These claims would be things like the contractor breaks something in the house, damages a walkway or car, or drops tools on a marble floor and it cracks.

If an agent isn't aware of the policy exclusions, there is a potential, particularly in these examples, that most, if not all, of the claims could be denied.

The best thing for an agent to do is ensure that regardless of the type of contractor, the policy chosen for the client is free from as many exclusions as possible to help ease the burden should a claim

HAMMER EFFECTS

continued from page 13

to pursue litigation through the judicial process if an insured cares to make that business decision. Pursuing litigation is a critical component of managing a business and needs to be available to insureds.

With that said, the insurance carrier will suggest that they are entitled to make an economic business decision. I suggest a strong hammer as this is a no-win situation for the insured and probably will live with them for some time.

Read on because there are ways to compromise between carrier and insured.

Sometimes settling early and often encourages other plaintiffs. Although the rule of thumb is that these claims only get worse with time, depending on the coverage, most notably EPL, settling early, in some situations, sends a message of "we pay."

In some cases, the outcome of the settlement could be significant in both monetary and nonmonetary terms—for example, in patent infringement litigation for Research In Motion, the Ontario-based wireless device company that developed the BlackBerry. In such situations, insureds may want to litigate, and without the financial support of their insurance carriers, they might not have the financial wherewithal.

The partnership between insured and insurer should not be tested during this critical time.

Another question begs to be asked which is often overlooked—what happens if the insured pressures for litigation and ultimately the final settlement is far less than the originally proposed settlement or the insured is found innocent? Who is the beneficiary of the insured's diligence and conviction?

In summary, there are many approaches to addressing the hammer clause—each with their own advantages and disadvantages.

While it is not the only factor when purchasing insurance, the hammer clause should be studied carefully during the purchasing decision-making process and understood. NU