

Financial Gain Exclusion Bars Coverage for E&O Claim; Insurer May Be Estopped from Asserting Exclusion

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The Fifth Circuit, applying Mississippi law, recently held that the financial gain exclusion in an E&O policy barred coverage for an improper assessment of tax. *Twin City Fire Ins. Co. v. City of Madison, MS.*, No. 01-60378 (5th Cir. Oct. 28, 2002). The court also held, however, that the insurer might be estopped from denying liability based on the exclusion because of its delay in asserting the exclusion and its failure to provide independent counsel.

Several housing developers brought a lawsuit against the insured, a city in Mississippi, claiming that it improperly assessed fees in connection with building permit applications. The city tendered the defense of the action to its E&O carrier and the carrier defended the city in the underlying action under a reservation of rights. Thereafter, the city settled the claims for \$250,000. The insurer agreed to pay the settlement amount subject to a reservation of its rights to seek reimbursement of the payments based on the financial gain exclusion, which barred coverage for "[l]iability arising out of any insured obtaining remuneration or financial gain to which such insured was not legally entitled." The insurer brought a declaratory judgment action. The city filed a counterclaim maintaining that the E&O policy provided coverage by estoppel based on the insurer's improper claims handling and breach of the duty to defend and third party claims against the insurer's claims adjusters based on bad faith claims handling.

The Fifth Circuit held that the fee assessed by the city was an unauthorized tax and thus constituted "an illegal 'financial gain'" within in the meaning of the financial gain exclusion. Therefore, the court found that there was no coverage for the underlying action under the E&O policy.

The city maintained that a conflict of interest existed based on the insurer's reservation of rights since the application of the financial gain exclusion depended on the outcome of the underlying litigation for which the insurer provided a defense-if the city lost in the underlying action, there would be no coverage under the financial gain exclusion. Moreover, the city argued that the insurer did not timely notify the city of the conflict and its right to select independent counsel, and that it did not separate its claims handling from its coverage analysis. The court initially noted that in the duty to defend context, estoppel could create coverage where an exclusion would otherwise apply. The court found that questions of fact existed regarding whether the insurer's

coverage letters provided the city with adequate notice of the insurer's position that any damages awarded to the plaintiff in the underlying litigation would not be covered under the E&O policy, the potential conflict of interest and the city's right to retain independent counsel. Moreover, the court also noted that the insurer might have breached the duty to defend by continuing to defend the city despite the potential conflict of interest and failing to provide independent counsel. The court further held that questions of fact existed regarding whether the insurer's claims handling constituted bad faith.

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