

ALERT

Municipal Insurer's Professional Liability Policy Does Not Cover Settlement Within Limits of the Underlying Policy

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The United States District Court for the Middle District of Alabama, applying Alabama law, has held that a professional liability policy issued to a municipal insurer afforded no coverage for the municipal insurer's settlement of a lawsuit alleging it failed to settle underlying litigation against its policyholder town within the limits of the underlying policy. *Scottsdale Ins. Co. v. Alabama Mun. Ins. Corp.*, 2013 WL 5231928 (M.D. Ala. Sept. 16, 2013)

The municipal insurer refused to settle an underlying auto accident claim within the \$2 million limit of liability of the policy it issued to an Alabama town, believing the town's liability to be limited to \$200,000. Following the refusal to settle, the underlying plaintiffs obtained a \$4 million jury verdict against the town. The underlying plaintiffs then sued the municipal insurer for breach of contract and bad faith for refusing to settle.

The municipal insurer had a professional liability policy covering loss resulting from claims alleging an act, error, or omission in the performance of professional services, including claim handling and adjusting. The policy excluded coverage for any claim arising from, based upon, attributable to, or related in any way (directly or indirectly) to any obligation assumed by the municipal insurer arising out of any written contract, unless the municipal insurer would have been liable in the absence of the contract. The policy also contained a "hammer clause," permitting the professional liability carrier to withdraw the defense of a claim if an insured refused to accept a settlement the carrier recommended.

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The professional liability carrier invoked its hammer clause and recommended that the municipal insurer settle the underlying bad faith litigation for \$2 million—the limit of liability of the policy it issued to the town. The municipal insurer and the professional liability carrier agreed to split the settlement and reserve their rights to litigate concerning coverage under the professional liability policy.

The professional liability carrier sought declaratory judgment that it had no obligation to pay any portion of the settlement. The court agreed. First, the court rejected the argument that the carrier waived its ability to rely on its contract exclusion. The carrier timely issued a general reservation of rights letter, which is sufficient under Alabama law for the insurer to later deny coverage under a specific policy provision. Second, the court found that the contract exclusion barred coverage for the settlement. The professional liability policy affords coverage only for negligent acts and omissions in the municipal insurer's handling of claims, not for its liability to its insureds for breaching its insurance contracts. In other words, the court stated, the policy does not require the professional liability carrier to take the place of the municipal insurer with respect to the latter's insurance contract. The court further held that the inclusion of a "bad faith" count was not dispositive, because the relevant inquiry is whether the municipal insurer's loss "arose out of its contractual obligations to its insured." The court reasoned that the municipal insurer's refusal to settle for the policy amount and the resulting bad faith lawsuit did not convert its contractual liability to its insureds into an error or omission under the professional liability policy.

The court also rejected the municipal insurer's claim that its professional liability carrier violated the "enhanced duty of good faith" by forcing the municipal insurer to accept a settlement with the underlying plaintiff. The court found that the professional liability carrier had a reasonable and sincere belief that the municipal insurer was liable for \$2 million and that accepting the settlement was in the municipal insurer's own interest, since refusing the settlement would expose it to over \$4 million in liability. Accordingly, the professional liability carrier did not breach its duties.

The full opinion is available [here](#).