Commercial Real Estate Organization
Professional Liability Insurance
"Are you Really Covered"?
December 01, 2004

AXIS INSURANCE SERVICES

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About the Author

Mike W. Smith, is the President of Axis Insurance Services, LLC, a member of the Axis Management Group family of companies. Mr. Smith formed Axis Management Group in 1996 and Axis Insurance Services in 1998 to specifically focus on Insurance Consulting and Risk Management related businesses. He has consulted with hundreds of companies in almost all Professional Services Industries. His clients include Commercial Real Estate Organizations, Property Managers, CPA's, Medical Groups, Internet Companies, Professional Employment Organizations and other companies.

Mr. Smith has developed a niche in the Commercial Real Estate Industry and currently has clients in dozens of states ranging from small brokers to very large multinational real estate companies. Mike is a seasoned professional in the area of Professional Liability risk management and Insurance. As a CPA, Mike spent 10 years with Coopers and Lybrand (now PriceWaterhouse Coopers) as a senior audit manager. While at C&L he was responsible for the audit and consulting work related to dozens of insurance companies, including large multinational public insurance companies, as well as, smaller privately held specialty insurance companies. His specialty in mergers and acquisitions brought him into the M&A business as Vice President for a large publicly traded professional liability insurance company where he was responsible for mergers and acquisitions, product and sales development, reinsurance, and financial analysis.

Mr. Smith is former practicing CPA and is a licensed Life, Health, Property, Casualty and Surplus Lines Insurance Broker with Corporate Offices located in Northern New Jersey.

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Commercial Real Estate Organization E&O
Are You Really Covered?

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What is Professional Liability Insurance?

Professional Liability is a broad term applied to the liability associated with Professional Service Firms or individuals arising from the conduct of their business for either providing or failing to provide a professional service. Professional liability among other things may include liability for claims associated with:

Errors and Omissions (Negligence)
Malpractice
Directors and Officers Liability
Employment Practices Liability
Fiduciary
Crime and Theft
General Partnership Liability

Most Real Estate professionals are familiar with each of the above terms either because they have been sued or the terms have been discussed with colleagues or friends, read in periodicals or other similar means. After all, everyone needs E&O, correct? These terms are discussed at conferences, board meetings and at client negotiating meetings. Typically, Real Estate Organizations (**REOs**) are requested to provide evidence of E&O coverage in the amount of at least $1 million prior to entering into any service contract with large companies or governmental agencies. Most REOs do maintain at least $1 million of E&O coverage and many maintain similar amounts of Directors and Officers (D&O) Liability insurance. However, most companies never review their polices and are not aware of what is *actually covered* and most importantly what is *not covered* under their existing policies. This leaves them virtually unprotected in the event of an actual loss.

In the event of a loss, not only is the organization at risk for a potentially uncovered loss, thus jeopardizing the financial viability of the organization, the ***Directors and Officers can be held personally liable*** for mismanagement for failing to maintain proper insurance coverages and safeguard corporate assets. Additionally, no corporate structure in the US protects an individual from their own acts of negligence. Potential plaintiffs might include landlords, lenders, tenants, employees of tenants or even governmental authorities.

What is an Error or Omission?

Is it simply a mistake? Well, maybe or maybe not! An error or omission is an unintentional act, error or mistake that may cause someone or some organization

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damages by either providing or failing to provide a professional service. An error or an omission may be either *direct* or *indirect*.
An example of a *direct* error or omission would be related to failing to check with the local township for approved uses of a parcel of real estate prior to sale or lease. An example of an *indirect* error or omission could be related to the *vicarious (by association) liability* associated with a landlord failing to deliver a piece of property on time or selling a contaminated piece of property. The true liability may lie with the seller or landlord, however, the agent/broker will inevitably be brought into the suit through the concept of *vicarious liability*. *Vicarious liability* can be alleged against the broker in almost any landlord/tenant or buyer/seller dispute.

In once instance, for example, the broker was brought into a suit for delivering an inadequate environmental study to a potential tenant that subsequently rented a particular space. A subsequent environmental study commissioned by the tenant revealed an environmental hazard condition, not specified in the original study commissioned by the landlord. Even though the broker was not involved in the selection of the original expert, and the report was reported and certified by an independent third party, the broker was brought into the case. This broker was eventually dismissed from this case, but not prior to incurring approximately $25,000 in legal fees. This case involved a very minor contaminant, however, in larger cases costs and fees could be substantially more.

In another case, a broker rented a space that subsequently flooded; mold spores grew from the flooded space and caused illness to the workers. The Broker was brought into this suit, because it was alleged that the Broker should have known that the space could have flooded and therefore the tenant should have been warned about the possibility of such an occurrence in the disclosure forms, even though the flood was a rare occurrence and classified as a 100-year flood.

What's covered by an E&O policy?

E&O policies are designed to cover sums, which an **insured** becomes legally obligated to pay as damages arising from a **Negligent Act** committed in the course of providing or failing to provide **Professional Services.** Well, that sounds simple enough, however, you must ask who is an **insured**, what is a **Negligent Act** or a **Professional Service**? It may be clear to you, however, the policy wording may specify otherwise. Without careful consideration of what is and what is not covered, an REO can be simply left without coverage. I have taken the liberty of addressing a few items that **should be addressed** in a Commercial Real Estate Organization E&O policy. Please keep in mind that all companies are different and other items may be more relevant to a specific REO.

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Who is Insured under the Policy?

Insureds

Insureds refers to who actually has coverage in the policy. First and foremost, the *Named Insured* which will appear on the face page of the Declarations of Insurance, second any specifically named *additional insureds* either on the Declarations page or in an endorsement. Then comes the tricky part. Who else is insured under the policy? A typical Miscellaneous Professional Liability Policy would list employees, managers, and others while working within their capacity for the *named insured.* With that definition, many potential defendants are left out. Such as independent contractors, part-time or leased employees. A properly crafted Real Estate E&O policy would address these issues.

Named Insureds

The *named insured* is the owner of the policy. The *named insured* is the one with the ability to make changes in the policy, report claims, and pay premiums. The *named insured* should be the one that is providing the Professional Services listed in the *Description of Services* in the E&O policy. Although many companies can be named, any company that is named has the rights under the policy to change alter or cancel the coverage. Additionally, they also have the right to authorize the settlement of claims.

Additional Insureds

Companies may add *additional insureds* to their E&O policy. In doing so they extend coverage to a person or entity in addition to the *named insureds* for the services of the named insured. This method provides coverage, but does not afford the rights listed above. This coverage does not increase limits or change any other terms in the policy other than who is covered under the policy. REOs must ensure that all companies for which they desire coverage are listed as either a *named* or *additional insured* and specifically noted in the policy. If a claim arises from the conduct of an unnamed entity, the insurer will most likely deny the claim. We have seen many cases where one company primarily performs the sales and leasing services, however, they have formed several companies to provide other services such as property management, General Partnership or even maintenance type companies. In the event of a claim, companies not listed either as *insureds* or *additional insureds* will not be covered.

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Clients as Additional Insureds

It is common practice for clients and vendors to name each other as additional insureds in a general liability policy. For example, in the event of a slip and fall on a property managed by a REO, you would want the landlord's general liability policy to defend both the landlord, tenant and property manager. A landlord similarly would require a tenant to name them as an additional insured for the same reason. That is **General Liability.**
Many Real Estate clients will request of a REO that the client be named as an additional insured on the REO's E&O policy. In three words ----**Don't Do it.** The reason is simple. If the client is named as an *additional insured* under the REO E&O policy, they are now insured under the policy. As an insured, they cannot collect under the policy. Therefore, if the client were to sue the REO, that suit would not be covered under the policy. Putting clients on the E&O policy as an *additional insured* actually eliminates the coverage that the client is attempting to secure. I have seen incidents where the Broker fulfills the request, thus supporting the lack of knowledge of the coverage. Professional Liability Brokers should handle Professional Liability insurance.

Independent Contractors

Most REOs utilize the services of Independent Contractors (ICs) for their sales force. Most E&O policies will list somewhere in the policy who is insured under the policy. Most Miscellaneous Professional Liability (**MPL)** policy forms list employees, officers, directors, etc., but do not specifically list independent contractors. A common omission from a **MPL** policy is to not list IC's as insureds. Under this scenario, if a claim were to arise from the services of an independent contractor and IC's were not listed an *insured* then no coverage would be afforded under the policy. The company most likely would still be covered, however, the IC would not. A simple endorsement to the policy listing IC's *"while working in their capacity for the company"* would extend coverage for the Professional Services of these individuals. In the absence of such an endorsement, the IC might seek damages from the Company for any losses they may incur, which might invalidate the E&O coverage altogether.

Independent contractors may be covered under the E&O policy, however, their coverage is only to the extent that they are providing services to the *named insured.* Many ICs believe they are covered under the company's E&O policy since they may pay for all or a portion of the premium. It must be communicated that their coverage does not apply to any services they may perform outside of the scope of services for the *named insured.*

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In one example, an independent contractor (IC or 1099 employee) was sued for services provided by them while moonlighting on a part-time basis. The REO was aware that the IC was engaged in such activities. The suit alleged that since the defendant for all practical purposes was an employee, through the theory of "ostensible agency", the REO was responsible for the ICs actions regardless of whether the REO was involved in the specific transaction. This case is further complicated by the fact that the IC used a REO business card, even though he was not working for the REO at the time. The claim was denied by the insurance company based on the following:

1. The Professional Liability policy only pays for claims provided by "insureds" while working in their capacity for the named insured (the REO).
2. The policy listed employees, officers and directors as insureds under the policy. However, no extension of coverage was provided for independent contractors.
3. Since no fee inured nor was contemplated to be inured to the benefit of the REO, it was supported that the IC was not working in their capacity for the named insured.

In this case, the REO had to defend itself from the plaintiff. Further, since the IC did not have their own policy, the REO chose to defend the IC so their interests would be protected in the process.

There are many ways to protect the REO in this instance.

1. Know your sales people and what they are doing.
2. If you do use independent contractors, require them to only work for you and get it in writing.
3. If your independent contractors moonlight require them to maintain their own E&O policy and to name the REO as an additional insured under the policy.
4. Maintain formalized Broker Guidelines and regularly review procedures regarding the conduct of independent contractors and other sales personnel.

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An example of the required wording for an endorsement to the independent contractor's E&O policy would be as follows:

"In consideration of the premium charged, it is hereby understood that the persons or entities below shall be named as additional "insureds" under this policy, but only as respects to their liability for your negligent acts or omissions."

Name of Entity: ***ABC REO, Inc.***

"It is further understood that this inclusion shall not serve to increase the limit of liability under this policy. All other provisions of this policy shall remain the same."

Common mistakes relating to the identification of who is an insured.

1. Not listing all the companies or entities providing Professional Services
2. Not taking into consideration other related companies with similar ownership interest
3. Naming clients as additional insureds on the REO policy
4. Not listing employees, officers, directors, independent and subcontractors as insureds under the policy
5. Not filling out the application properly
6. Not reporting to the insurance company changes in ownership (policies are not automatically transferable unless you have the insurer's consent)
7. Failing to list the name of predecessor companies or affiliates

Joint Ventures/Partnerships

Commercial Real Estate E&O policies provide coverage for claims relating to real estate *Professional Services*. These services will be further defined later in this paper, but basically refer to sales and leasing, property management and real estate consulting type services. They do not have cover also cover services that might be performed as a JV partner, General Partner or other type of investor. Further, most E&O polices exclude coverage for any services provided if the underlying property is greater than a certain percentage. That percentage is usually 10%, but can range from 10% to 50%, with certain limitations.

Use of Indemnifications and Hold Harmless Agreements

Indemnification agreements and hold harmless agreements are severely overrated. The reason is simple. An indemnification is only as good as the financial capacity of the

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person or entity making the indemnification. For example, if an independent contractor indemnifies the REO for any of its activities; that does not prevent a third party from suing the REO. If the REO can collect under the indemnification that's great however, the REO must still defend itself in the suit and seek reimbursement later. If the claim is a large one, an individual or small company will be unable to pay its indemnification. Therefore, yielding the indemnification worthless. A hold harmless works exactly the same way.

What are Professional Services?

On the Declarations Page of an E&O policy (Usually the first page that describes the limits of the policy, the premium and the *named insured*), it will usually state a Description of Professional Services to which this policy will respond (This means what services you are actually covered for). Some real estate specific policies list this right in the policy. Most people don't realize that the application becomes an integral part of the policy and what is listed in the Description of Services, the staff and income on the application will serve as the basis for what is covered by the policy. ***Failure to adequately describe your Professional Services in the application will result in a GAP in coverage for those services not listed.***

For example, if a Company lists on the Professional Liability application that they are a commercial real estate company engaged in sales and leasing activities for others for a fee and do not indicate that they also perform property management and/or appraisal services, their E&O policy will most likely exclude claims relating to such services.

Many REO's have multiple companies that perform various services including Property Management, appraisal, consulting and fairness of value opinions. Other common mistakes relate to omitting on the application additional services such as consulting, managing owned real estate, involvement in joint venture partnerships and the use of independent contractors in the provision of services to clients. If it is not noted on the application, the policy will most likely not respond claims arising from such activities.

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The *Definition of Professional Services* varies widely among E&O policies. This definition could be the single most important wording in the entire policy. A typical definition of *Professional Services* is:

"Solely in the performance of services as a licensed real estate agent/broker for others for a fee"

Although, this definition seems broad it is very limiting. This definition does not include services for property management, short term escrow, appraisal, corporate services such as Tennant Rep Services or other similar services. Even though a company may not perform appraisal services, they clearly could be brought into a suit as a result of a referred appraisal. Tennant Rep services often include services such as engineering, planning, financial forecasting, etc. Those services would not be covered unless so defined. A copy of a standard real estate *Description of Services* is included in the Exhibits to this paper.

The wording *"for others for a fee"* excludes any services that might be performed on properties owned by any of the insureds (including the agents personal properties)

Common Omissions from the Description of Professional Services

Property Management	Appraisal Services
Tennant Representation or Corporate Services	Governmental Contracting
Management of Owned Real Estate	Work on Boards and Non-Profits
Leasing Activities	Commercial vs. Residential Services
Development	Auditing Services
Professional Services of Related Companies	Environmental Consulting

Many commercial real estate organizations conduct their day-to-day operations through a series of partnerships, joint ventures and other companies. The REO should be aware that professional liability policies only cover the insured while working in his or her capacity for the named insured. Therefore, if the company is not listed on the policy, typically, services provided on behalf of these various entities are not covered under the standard E&O policy. Many E&O policies will extend coverage automatically to 50% or greater owned subsidiaries, however, if these subsidiaries are not listed on the application, the insurer may deny coverage.

Owned Real Estate

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Almost all Commercial Real Estate E&O policies initially exclude coverage for any and all claims relating to owned real estate or partially owned by the insured or anyone insured under the policy. This is because many claims might be related to their ownership of the property not their professional services. Many carriers will build such coverage back in for an additional premium, however, most insurers will not add this coverage under any circumstances. Most standard E&O policies will exclude coverage when the ownership percentage by either the named insured or anyone else insured under the policy reaches 10%. Some companies will offer different breakpoints with conditions. When offered this coverage is typically subject to a sublimit or other reduced coverage. For example, if the policy has a $1,000,000 limit, the coverage might be subject to a $250,000 defense only sublimit for claims relating to owned real estate. If the REO owns real estate that it manages then it should ensure that it has such coverage afforded in its E&O policy. This is accomplished through a combination of a property constructed E&O and G/L policy. However, you should be aware that not all risks can be covered. One additional note of risk for larger companies is that their sales, property management and other personnel often work on company owned property. Although, the company may be willing to take the risk of uninsured services on owned property, the individual sales person or property manager may not know that they are not insured. In the event of a loss, they may come back to the company and seek recovery of their damages which were not insured.

Development Services

Development is always a hot topic. The risks associated with development are quite different than those provided by Professional Service Firms. Risks associated with Development include specific performance, defects, environmental, discrimination, zoning and other issues that simply are not the same as those risks associated with being an agent or Broker. Most of the typical markets for Real Estate E&O do not cover activities associated with development. Most insurers won't even cover the other professional activities of companies that are involved in development, even if the development is in a separate company, because of the related exposure to non-real estate agency services. .

In many of the larger companies, Development and the Professional Service activities are highly integrated. A REOs owners may develop a property and have their staff lease or sell the property. A REO should ensure that each coverage provided is cross-collateralized with the other to ensure that activities conducted by the REO are adequately protected. Even if the REO does have an E&O policy, unless the developmental activities are fully described in the application and coverage is afforded specifically for such activities, any claims associated with the development will be excluded under the policy.

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Mold Spores and Fungus Growth

A new and emerging trend relates to claims associated with the growth of mold spores, fungus or other similar contaminants. The first hint of this type of exposure on a national scene was with the Legionnaire's disease in Philadelphia, however, with the collapse of the World Trade Centers, we have seen significant increases in such exposure. This risk has been elevated in states such as Texas, Florida, California and Pacific Rim states. In the state of New Jersey for example, many homeowners and general liability policies now exclude any coverage all together for such exposures or offer reduced limits. In 2003, we began seeing the first of the outright exclusions in E&O policies for any cases associated with the growth of mold spores and/or fungus related contaminants. By the end of 2003, all policies that we are aware of exclude coverage for claims alleging mold or similar claims. The professional liability insurers are taking the position that the exposure is a property liability exposure rather than a professional liability exposure. In theory that is correct however, we have seen multiple cases, where the sales/leasing agent and in some cases the buyers agent have been brought into these suits.

Traditionally, people that were injured relating to this type of exposure were employees who are typically covered under workers compensation policies. This is true and legislation except in the case of gross negligence usually protects the employer. However, workers compensation coverage does not protect the owner/landlord or the agent/broker from litigation from such incidents. Since mold spore and fungus growth liability affects the long-term health of the individuals inflicted, the damages could be substantial. Assume an individual in their 20's, making $100,000 per year were unable to work for the rest of their life and unable to bear children. Workers compensation insurance, might cover a part of the healthcare bills and provide some monthly earnings, however, a settlement for this type of case could be in the millions of dollars just on actual damages (loss of earnings, etc.) not to mention the imputed punitive damages that could be assessed. We have seen multiple cases where the REO either as the leasing/sales agent or especially as the property manager have been brought in suits for failure to disclose. Meaning they should have known that the growth of mold spores or fungus was there or likely to be there.

Currently, we are able to secure coverage for contractors, building owners, consulting and others, however, we have been unable to secure coverage for a REO. The reason for this is that when you insure a building, the underwriter can inspect a specific piece of property, however, for a commercial real estate company, it would be impractical to underwriter every property. In any case the REO should insist on proper disclosure from the seller. The seller can buy specific mold spore /environmental hazards insurance

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coverage on a property by property basis. In that regard the agent/broker should take adequate disclosure steps to mitigate the potential for loss.

Property Management

Property Management risks are inherently different than sales and leasing activities and have to be covered separately. In many cases there is an inherent conflict of interest in property management activities. Listed below are some common issues with coverage for Property Managers.

1. The agent/broker might recommend their company as property manager.
2. The property manager (**PM**) may recommend companies to provide services from vendors that they have a financial interest in.
3. The PM may be held accountable for not getting tenants in the spaces on time and therefore causing damages to both the landlord and the tenant.
4. The PM may hire a contractor that does an inadequate job.
5. The PM has care, custody and control of rents and other monies. The PM may be accused of mismanagement of funds or commingling of funds.
6. The PM determines how to allocate Common Area Maintenance (CAM) and taxes. They may do so improperly and cause damages to the landlord.
7. Property Managers may not be afforded E&O coverage relating to properties that they have a financial interest in.
8. Property Managers may procure insurance, however, they have no coverage in their E&O policy for any procurement or placement of insurance

The main issue with Property Management activities is to ensure that the policy form provides coverage for the activities of the REO. Most standard E&O policies exclude Property Management Services, unless they are specifically endorsed back into the policy. From a legal perspective, the property manager is assumed to know everything about the property, including environmental and zoning related issues. Sometimes, they will be sued for owner related issues that they did not know anything about.

PM Services for Owned Property

Other property management issues relate to the PM services provided for properties for which the owner/partners have an interest in. Many policies will specifically exclude coverage for any owned property or property for which the insured or is principals has a stake in, however, will cover property management services, which includes leasing, but not sales. Understanding you company's risk exposure is essential in securing the proper insurance policy. One further thing to consider is that the ownership limitations (i.e. 10% rule) combine all insureds under the policy. Therefore, if the owners of the REO

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individually own the property, then they would combine there interests for purposes of the threshold.

Property Owned by Employees or IC's

Many real estate companies allow their agents to utilize the REO for purposes of listing and selling their own properties. This could relate to person residences or even properties that they have an interest in such as a condo, shopping center of Joint Venture. Using the same concept of the owned property exclusion, claims relating to services on these properties most likely would not be covered.

Maintenance

One big area of concern in property management relates to the use of the insureds own maintenance personnel to perform daily tasks. This can include everything from security to cleaning to major maintenance. Take in mind that maintenance services are not considered professional services. Therefore, if a loss occurs as a result of maintenance services and the REO is sued, the professional liability policy most likely will not respond. There is always a fine line between being sued as the property manager for oversight of the maintenance services and the maintenance services themselves. These types of losses would typically be covered under the company's general liability policy. In many cases the insured is sued in their capacity as Property Manager and their professional decision to hire their own personnel to do the maintenance. This is an often-debated issue when the claim arises. Coverage would be dependent upon the specific allegation and the policy form used by the insurer.

Where many property management companies have a problem in the insurance is that they have obtained a Business Office Policy general liability policy. This policy is designed for office workers and does not take into account maintenance type services. Therefore, when the claim is filed against GL policy, it is denied based on misrepresentation. A property management company should make sure they have a general liability policy that covers their maintenance services.

Residential Real Estate Activities

Most Commercial Real Estate Companies do not participate in any Residential Real Estate activities. Residential activities and Commercial activities are very different and each has their unique risks and challenges. Many Commercial REO E&O policies will not provide any coverage for residential activities. However, if your REO is involved in residential activities, make sure it is on the application and that it is properly covered under the policy. Residential activities involve a high degree of discrimination claims.

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Discrimination is excluded from most Commercial Real Estate E&O policies. Therefore, on must ensure that the underwriter of the related E&O policy is aware of all the activities of the *named and additional insureds*.

What is a Negligent Act?

Negligent acts, either real or implied, are those acts alleged that could have been performed differently by a reasonable prudent person and therefore prevented an incident from occurring. Such negligence can be alleged for both providing and also for failing to provide a Professional Service. At the end of the day, an E&O policy should respond to those "*negligent acts*" for which the insured is legally obligated to pay. Is a Commercial Real Estate Organization legally obligated to pay the defense and claims of an independent contractor sales person who moonlights and is sued while moonlighting? Unless stipulated in the By-Laws of the REO, the answer is no.

However, what happens if the REO is brought into the suit for the moonlighting subcontractor? In most instances, the REOs E&O policy will also not respond. This specific issue will be discussed later in this article.

Many companies believe they are insulated from claims by disclosure checklists, buyer representations, hold harmless agreements, etc. Those items help mitigate damages, however, they do not protect the company from suits. Often times if the owner is brought into a suit, so will the real estate agent vicariously. It is possible that the real estate agent has done everything in their power to mitigate the claim, but they are still sued.

In a recent case, a seller knowing withheld information about a previous Phase I environmental report that disclosed an environmental hazard from both the broker and buyer. After the new buyer conducted a study, they withdrew from the deal and requested their deposit back. The seller refused. The ensuing lawsuit sued the seller form misrepresentation and the broker for failure to disclosure a know pollutant. Did the broker do anything wrong, most likely not, but they are the one that cannot release the deposit.

In a similar case, failure to return the deposit in a timely fashion denied the buyer the opportunity to purchase another piece of property. At that point damages were much higher than the deposit. To make matters worse, in the mean time, the town council changed the zoning. The final settlement was in excess of $1,000,000.

<u>Common Examples of Negligence for a Commercial Real Estate Organization:</u>

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1. Conflict of Interest associated with being both the listing and selling agent/broker
2. Failure to disclose known contaminants to a potential buyer/tenant (future suits can also come from employees of that site)
3. Failure to check the use clause of other tenant when leasing a space
4. Failure to properly renew leases when automatic provisions are in place
5. Failure to inform a buyer/tenant of changes in ordinances or variances
6. Misrepresenting the seller/landlord and causing a potential deal to not materialize
7. Discrimination of one buyer vs. another
8. Failure to disclose knowledge of new construction nearby or changes in traffic patterns
9. Failure to deliver a piece of property on time
10. Failure to adequately check the qualifications of sales and other personnel.
11. Failure to check ordinances and variances for proper use of real estate or land.

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Commercial Real Estate Organization E&O
Are You Really Covered?

Miscellaneous Professional Liability Policies

Many insurance companies issue a specific Commercial Real Estate Organization (REO) E&O policy that addresses most real estate related issues, however, **many** REO E&O policies are written on a Miscellaneous Professional Liability (**MPL**) policy form. This means that the REO is being covered by a policy form that may be generically used for real estate professionals, CPAs', medical groups or any other organization. This policy must then be endorsed for coverages specific to the real estate industry; this includes adding back into the policy many coverage features not covered by or specifically excluded by a standard MPL policy. Without these separate endorsements, the MPL policy is useless, because it does not, in its generic form, address the industry related business risks. Often times the MPL is the appropriate answer, because it does allow you to customize the coverage for risks specifically attributable to an *insured.*

Common exclusions to the MPL policy

1. Environmental Hazards
2. Discrimination/Fair Housing
3. Any claim related to owned property
4. Any claim related to the use of subcontractors or independent contractors
5. Construction or development
6. Punitive damages, fines and penalties
7. Employment related claims
8. Illegal activities
9. Fiduciary Claims
10. Uncovered Allegations

Environmental Hazards

Coverage for environmental hazards relates to the coverage for the brokers failure to disclose. All E&O policies exclude coverage for property damage and bodily injury. These are common claims relating to environmental hazards. Such as the cost of clean up of a building with asbestos, removal of underground storage tanks and health issues related to everything from mold, to asbestos to overhead power lines. Typically, the building owner would be responsible for removal remediation and damages. The broker often gets brought into the suit because they either knew about the contaminants or should have known. Most E&O policies exclude coverage for any claims that relate to pollutants, seepage, mold, fungus. airborne contaminants and similar related claims. Coverage can be purchased as an add on to may policies, but the endorsement is only for failure to disclose and is often subject to sublimits and other restrictions. Restrictions

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almost always include a provision relating to owned property. Meaning environmental claims are not covered if the insureds own more than a certain percentage of the property.

Discrimination

Discrimination claims are more prevalent in residential brokerages or commercial brokerages that deal with residential properties, such as Property Management services for Condo Associations or sales and leasing of low income properties.

The Fair Housing Standards Acts provides among other things for protection of a homeowner from discrimination. This Act extends to all transactions involving real estate. Discrimination claims often arise in a commercial situation where one buyer is successful over another buyer. In many cases the seller has to weigh multiple offers and evaluate the financial strength and credibility of each potential buyer. Inevitably, the seller has to choose one buyer over another. The broker is often brought into this suit, because it is alleged that participated in the decision. In some of the higher payout cases, this issue was exaggerated by the dual agency of the broker. In this case the listing broker's agent was successful over another agent. Even though the unsuccessful broker was less financially qualified and provided a lower offer, the suit was brought forth. Eventually, the unsuccessful buyer won their case by proving that the Real Estate Broker should have disclosed information such as the price of the winning bid. Because discrimination was one of the main allegations was reduced part of the final settlement from the insurance company. ,.

Discrimination claims relating to any Professional Services provided relating to a residential property is high. In underwriting an E&O policy, the underwriter will take into consideration the amount services provided to residential properties in determining the level of discrimination coverage to provide.

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Owned Property

Owned property is the single most difficult thing to insure (other than mold) in a commercial real estate policy. Almost all E&O policies will exclude coverage for claims relating to any services provided for owned or partially owned properties. In come polices there is not even an incremental amount of ownership that would be allowed. In other policies the coverage is eliminated in various capacities at 10%, 20%, 25%, 50% ownership. The problem with many companies is that they own interests in various properties ranging for 2%-40% or more. In many cases, they also lease the properties, manage the properties and even sell them. An insurance company does not want to provide an *insured* E&O coverage for business decisions they make. They are trying to limit claims to professional services. For example, if a building owner fails to pay to have the elevator fixed and someone falls down the stairs. Should the owner be responsible for this or the property manager? Well, the owner clearly made the decision and the claim should be paid by the building owners GL policy, not the Property Managers E&O, even if they are the same individual.

However, there are clearly professional services that are performed on owned property such as leasing and property management. The trick is to property craft the policy to provide the coverage for professional services and not the general liability risks of the owner.

Consent to Settle

A *Consent to Settle* clause simply means that the insurer will not settle a claim without your written consent. Although, this is often good, make sure you are aware of the *"Hammer Clause"*. The *Hammer Clause* is the fine print of the *Consent to Settle* Clause. It states that the company will not settle a claim without the insureds consent, however, if the company recommends a settlement and the insured refuses to settle, then the insured is responsible for any losses in addition to the amount that the case could have been settled for. The *Hammer Clause* puts the insured at risk if they do not settle the claim as recommended by the insurance company. The hammer clause can work in one of two ways, depending upon the type of policy. In most cases, the insurer will continue to defend the insured, but will only pay an indemnity payment up to the amount that they could have settled for. However, in some policies, the insured is completely responsible for all defense and costs subsequent to the date the insured refuses to settle. The is a very hard hammer clause, however, some of the major insurers have adopted it in their most recent policies.

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Duty to Defend

There are two types of policies as it relates to defense.

A *Duty to Defend* policy puts the insurance company on the hook for defending the REO regardless of if the allegation has merit or is groundless. The REO is responsible for the deductible, but the insurance company is responsible for defending the case. Since most policies include defense costs inside the limit of liability, the insurers responsibility for defense ends when the limit of liability is exhausted. A *Duty to Defend* policy almost always requires the use of the insurance company's approved counsel (See below). This is often a rub with the REO, since they already have their own counsel and typically would prefer to use their own counsel.

A *Reimbursement* policy requires the REO to defend itself and seek reimbursement from the insurance company. A reimbursement policy has drawbacks in that you have to get the invoice approved. Often times there are items paid for by the REO that are not covered. For example, in some cases, insurers will allocate claim costs between covered and non-covered allegations. In that event, the REO may find out that although they can be reimbursed, the insurer is only going to reimburse them a specific percentage of the total costs submitted.

In almost all cases, we would recommend a *Duty to Defend* Policy.

Allocation of Claims Costs and Expenses

This clause in an E&O policy basically says that the insurer reserves the right to allocate claims costs and expenses according to some method. These methods include according to covered versus non covered claims as adjudicated by a court, according to covered versus non covered allegations. Further, some policies will address the issue of defense and the *hammer clause* noted above. In this section, the insured should require that the company defend them regardless of the merit of the allegation and pay for all defense up to policy limits, even if only one count is covered under the policy. Upon final adjudication the final settlement would then be allocated between covered and uncovered claims. This can be important since even in a *Duty to Defend* policy, the insurer may charge back uncovered claims costs incurred.

Use of Approved Counsel

This is often a significant issue in the issuance of a policy. Most REOs prefer to use their own counsel. However, it should be noted that most counsel utilized by REOs are

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corporate counsel and typically have very little experience in the areas of Professional Liability Errors and Omissions. Most REOs would believe that the reason they must use the approved counsel is because of cost, however, the primary reason in most cases relates to experience in real estate specific errors and omissions litigation. The REO should be able to obtain a list of approved counsel prior to purchasing the policy.

Retroactive Date

Most REO E&O policies are written on a claims-made basis. This means that the policy only covers claims that are reported during the policy year. Often times when companies change insurance carriers they fail to make sure that the new policy has the same retroactive date as the expiring policy and they have a gap in coverage. Most E&O policies will pick up the retroactive date consistent with the expiring policy. If for some reason, the new carrier will not pick up the prior exposure, the expiring policy will have an Extended Reporting Endorsement (ERE or Tail Coverage), which should be purchased. The ERE usually costs from 100% to 200% of the expiring premium and will usually cover claims reported for up to two years that occurred during the policy period. You should note however, that some policies will only provide 12 months of extended reporting and some companies will not provide retroactive coverage. In this case, a company must purchase the extended reporting endorsement from the prior carrier which could me double the premium.

Innocent Insured

The innocent insured clause in a Professional Liability policy is very tricky since some insurers treat it differently than others. The intention of the clause is to protect others insured under the policy including the *Named Insured* in the event of an intentional or malicious act of an employee or other individual. Typically, all insurance policies are void in the event of fraud, criminal behavior or intentional acts by the insured. However, it is possible for an employee to commit an intentional act and the insured is in no way involved and does not have any knowledge of the event. Be care with the reading of the innocent insured clause in the policy, since it typically only relates to those instances where there is dishonest fraudulent or criminal type behavior. We have had instances where employees withheld information from management regarding a potential claim and management was not aware of the incident. A claim was denied since an insured under the policy failed to inform the insurer of a pending or threatened claim. Even though management was unaware of the incident, the employee was an insured under the policy and therefore, coverage was denied.

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Report Date

A common problem in an E&O policy is what is that actual report date of a claim. This sounds really simple, but many companies are left without coverage simply because they did not understand the significance of the report date. The choices are as follows:

1. When the incident occurred.
2. When the REO found out that there is the potential for a suit.
3. When the potential plaintiff threatened they would sue.
4. When an actual claim was filed.
5. When the REO was actually served

Many policies only treat the incident as a claim when there is a "written demand" for payment, not necessarily when there is a threat of legal action. This is significant when changing carriers in that a new carrier will not provide coverage for any known incidents prior to the effective date of the new policy. If you simply know that a claim is coming, but you have not received any written notification from the potential plaintiff, the company could have a gap in coverage for that specific claim.

A better wording in the policy is one that provides that the insurer will treat the incident as if it were a claim if it is reported to the insurer in writing and other relevant information is provided prior to the termination date of the new policy or extended reporting dates allowed in the policy.

Terrorism

Terrorism coverage is required to be offered as a result of the Federal Terrorism Act in November of 2003. Most carriers exclude coverage for claims resulting from Certified Acts of Terrorism. However, the Federal Law requires that all carriers provide an option for the coverage. This coverage typically costs anywhere from 5% to 10% of the underlying premium. This coverage is probably more important in property managers since failure to properly secure a property would fall on the negligence of the Property Manager, however, most companies should consider the coverage in their E&O policy.

Punitive Damages

Punitive damages are those damages you read about in the newspaper. In most cases the larger $10, $20, $200 million judgments are related to punitive damages. Actual damages are seldom that high. In many states, insurance companies are prohibited from paying punitive damages, however, some states do allow it. Almost all E&O policies exclude punitive damages, fines and penalties. There are however, insurance policies

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that will pay for punitive damages and some that will allow for a change in venue to a more favorable state in order to provide the coverage. This coverage can only be purchased by endorsement. Very few companies, however, will even offer the option.

Admitted vs. Non-Admitted Carrier

Most Errors and Omissions insurance for larger commercial real estate companies is written on a policy and by a carrier that is non-admitted. This has both advantages and disadvantages. An advantage is that the specific rates and depending upon the state policy endorsements do not have to be filed with the state insurance department. This allows an insurer to modify coverage to best meet the needs of the insured and also to accommodate pricing for the related products. In a filed product, there is very little flexibility with the endorsement/policy wording or the price that can charged.

A drawback is that since the policy and rates are not filed, they also may not contain the necessary policy features that an intense scrutiny by the insurance department would require. Further, these companies are not licensed as admitted carriers and not subject to either the premium tax rules or the guarantee fund rules. A policy written with a non-admitted carrier is charged an Excess and Surplus lines tax in addition to the premium. This rate can vary by state from 3% to 5% of the premium. Additional, these policies are not guaranteed by the state guarantee fund. What this means is that if the insurance carrier is unable to pay the related claims that he state will not step in and pay them on the behalf of the insurance company. With an admitted carrier, the state guarantee fund will pay for claims in the event of an insolvency of the insurance company.

This is why it is very important to check the AM Best ratings of the insurance companies writing this business.

AM Best Rating

AM Best is an Insurance Company rating agency. www.ambest.com. They rate almost every major insurance company in the county based on a series of ratios and analysis and in-depth review of the insurance companies. Companies are rated from NR (not rated) to A+ (Superior) and every where in between.

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Typically, anything that is A-, A or A+ is acceptable and anything lower than that is a warning for a potential problem. You should never secure E&O coverage with a company that is rated under an A-. The ratings are outlined below:

Secure		**Vulnerable**	
A++, A+	Superior	B,B+	Fair
A, A-	Excellent	C++, C+	Marginal
B++,B+	Very Good	C,C-	Weak
		D	Poor
		E	Under Regulatory Supervision
		F	Liquidation
		S	Rating Suspended
		NR	Not Rated

Another rating is in the size of the assets of the underlying company. AM Best rates companies from I to XV. Each number has a range of assets. They are listed below:

Adjusted Policy Holder Surplus (millions)		**Adjusted Policy Holder Surplus (millions)**	
I	Less than 1	IX	250-500
II	1 to 2	X	500-750
III	2 to 5	XI	750-1,000
IV	5 to 10	XII	1,000-1,250
V	10 to 25	XIII	1,250-1,500
VI	25 to 50	XIV	1,500-2,000
VII	50 to 100	XV	2,000 and up
VIII	100 to 250		

In the Professional Liability the size of the company is relevant since claims may not actually be paid out for many years. We do not recommend placing E&O insurance with any company that is not rated at least an IX ($250-$500 million in assets)

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Websites

Websites create a unique risk that is above a traditional errors and omissions insurance policy. Websites create security risks, privacy and penetration risks. These types of risks are covered under a "Technology" policy and are not typically covered under a Real Estate E&O policy. For Internet Related risks, you should purchase a separate specific Technology policy. In the case of websites, they often are designed to provide broad services, even though the company may not actually provide the services. A company should remember that if the boast about being the best or the only in their marketing material or websites, then they create a higher degree of standard and therefore a higher degree of insurance risk.

Website liability can includes items such as:

1. Unauthorized access to client information
2. Distribution of malicious information, including viruses, mailing lists etc.
3. Defamation/slander, etc
4. Unauthorized use of a business name
5. Loss of business income associated with a malicious act
6. Regulatory, legal and marketing reimbursement for reestablishment of a good name.

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This article is too short to address all the issues that should be addressed in an Errors and Omissions policy. However, I hope the items addressed in this article provided some insight into some of the more important issues. Listed below are some additional issues that should be addressed.

1. Defining the use of the Company's Website and related risks
2. Providing a full description of all Related Entities that should be covered under the policy
3. Describing specifically in the application what the Company does relating to all of its activities, including:

    a. Property Management
    b. Appraisals
    c. Joint Ventures
    d. Use of Independent/subcontractors
    e. Commercial vs. Residential business
    f. Fiduciary responsibilities
    g. Segregation of Defendants
    h. Fiduciary Coverages (Not part of the E&O policy)
    i. Extended Reporting Endorsements

Please feel free to call one of our licensed representatives to discuss your specific needs or to have us perform an analysis of your current professional liability risks. Please visit our website at www.axisins.com.

Mike W. Smith, President of Axis Insurance Services, LLC, an Axis Management Group Company in Franklin Lakes, NJ, was a practicing CPA and former Vice President of a publicly traded Professional Liability Insurance Company. His Firm provides Professional Liability Consulting and Insurance for Professional Organizations. If you would like to learn more about professional liability risks and insuring those risks please contact Mike directly at (201) 847-9175 or visit the company site at www.axisins.com.

Axis Insurance Services
Balancing Risk…Managing Business

Let us show what we can do for you!

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Coverage Checklist

E&O Checklist

	Item I	Notes
❑	Company Name	Insurance Company Name should be specific
❑	Am Best Rating	The AM Best Rating should be at least an A-, IX
❑	Named Insured	Should list the main company or companies providing services exactly as their Corporate name is registered
❑	Additional Insureds	Any company providing services that need to be listed on the policy
❑	Limits	Limits should be at least $1,000,000 for each claim and for all claims in a given policy period. Depending upon the size of the company and geographic location, additional limits should be considered.
❑	Retroactive Date	Should match your expiring policy to avoid a gap in coverage.
❑	Policy Type	Most E&O policies are Claims Made
❑	Definition of Professional Services	Should include all services provided by the company
❑	Extended Reporting Endorsement	Should be at least 12 months and up to 36 months
❑	Defense Costs	Typically included within the limit of liability
❑	Duty to Defend	The E&O policy should be a Duty to Defend policy
❑	Consent to Settle	The insured should have the right to not settle a claim. Be careful of the hammer clause
❑	Use of Approved Counsel	Obtain a list of approved counsel
❑	Environmental Hazards	Excluded on most policies. Should provide coverage for failure to disclosure. Most likely will exclude mold and or lead based claims

Please note that the above coverages are for a standard Commercial Real Estate Organization and individual insured requirements may vary

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Coverage Checklist

	Item I	Notes
❑	Discrimination	Excluded on most policies. Most likely subject to a sublimit and for defense only.
❑	Owned Property	If services are provided for owned properties, ascertain the percentage ownership restrictions
❑	Innocent Insureds	Policy should have an innocent insured clause
❑	Terrorism	Coverage most likely excluded. Can be added in for additional premium. Typically this is 10% of premium
❑	Joint Ventures	Services related to joint ventures and partnerships typically not covered. If significant, a separate General Partnership Liability policy is required
❑	Property Management	If involved in Property Management Services, make sure PM is listed in the description of professional services.
❑	Incident Reporting	Policy should allow for incident reporting to reduce likelihood of a gap in coverage
❑	**Other Coverages to Consider:**	
❑	General Partnership Liability	Protects against claims relating to services as a general partner in a partnership, such as financing, investment choices, and mismanagement
❑	Directors and Officers Liability	Protects the officers and directors from claims relating to their role as an officer or director.
❑	Employment Practices Liability	Covers employee related claims such as harassment, discrimination, wrongful termination and maintenance of a hostile working environment. Coverage should be extended to independent contractors and third parties

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