

A LAWYER'S GUIDE TO

Lawyers may be accomplished, even expert, in their chosen practice areas, but law practice questions often take a back seat in the minds of many attorneys. Striving to do the best for their clients, lawyers may defer or ignore questions about the business side of practice. And even when lawyers turn their attention to those issues, their complexities may baffle and frustrate even the most detailed of attorneys.

Professional liability insurance—commonly known as “malpractice” or “LPL” insurance—can appear to fit that description, though it doesn’t have to. This year especially, lawyers should strive to become familiar with the nuts and bolts of the topic.

This article is not intended to be a discussion of insurance law or the law of coverage or coverage disputes. It is intended merely to introduce lawyers to the world of claims-made insurance and to assist potential policyholders in understanding the fundamental concepts that make up the framework of legal malpractice insurance.

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The New Disclosure Rule

In 2005 the Arizona Supreme Court adopted a new rule requiring Arizona attorneys to disclose whether they carry legal malpractice insurance. That rule may give pause to lawyers and may lead many to review their insurance decisions.

Effective January 1, 2007, Supreme Court Rule 32(c)(11), based on the ABA’s Model Rule on insurance disclosure, requires members to disclose by February 1 each year if they are engaged in private practice and, if so, whether they are covered by professional liability insurance. Members’ information will then be published on the State Bar Web site. If lawyers who reported having insurance later discontinue coverage or are cancelled, they must report that change within 30 days; lawyers who were previously not insured and pick up coverage may inform the Bar of the change and have it reflected in the Bar’s public records.

Because of the new disclosure rule, lawyers who do not presently carry lawyers professional liability insurance may discover a new or renewed interest in obtaining that coverage. The State Bar, in conjunction with its Lawyers Professional Liability Insurance Committee is currently engaged in developing resources to assist members who are interested in obtaining malpractice insurance for the first time.

Aside from the new rule, there are other reasons to consider obtaining legal malpractice coverage. Lawsuits against lawyers have increased dramatically in the last 15 years. There is a disturbing increase in the number

of legal theories being successfully advanced against lawyers. And the cost of defending legal malpractice lawsuits has risen dramatically, a trend that shows no sign of slowing or reversal.

By carrying malpractice insurance, lawyers protect their personal assets and the assets of their law firms from depletion by the high cost of professional liability. And it provides protection for clients who might sustain damage as a result of a mistake.

Despite many compelling reasons for carrying it, to many lawyers, legal malpractice insurance—what it covers, how it works and how to buy it—is still a mystery. This article is intended to generally familiarize lawyers with the LPL marketplace and LPL insurance policies. My intention is to demystify the process of understanding, shopping for and selecting a legal malpractice policy.

Introduction to Claims-Made Insurance

Lawyers Professional Liability (LPL) policies are written on a “claims-made” basis. That fact may be the single most important distinction to grasp when you are used to commonly understood insurance terms. But what does it mean?

Though most lawyers are familiar with occurrence-based insurance (which is widely used for general commercial liability insurance and other, nonlegal professional liability coverage), relatively few are well versed in claims-made policies and how they work.

In short, occurrence-based policies cover



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claims arising out of *conduct or errors made while the policy is in force*, even after the policy expires. An occurrence-based policy written for the calendar year 2006 will cover a lawsuit brought against the policyholder in 2007, even though the 2006 policy expired.

In contrast, a claims-made policy only covers claims *made and reported to the carrier while the claims-made policy is in effect*. Unless the claims-made policy provides prior acts coverage (explained subsequently), to be covered the claim also must arise out of an error made while that policy was in effect.

Thus, in a claims-made policy, three conditions must coincide for coverage to exist:

1. A policy must be in effect at the time the claim is brought against the insured and reported to the carrier.
2. There must have been an effective policy in place at the time of the act, error or omission giving rise to the claim.
3. There must have been continuous coverage—without a gap—from the time of the act, error or omission to the time the claim was made and reported.

There is often a lag between when a legal error is made and when it is discovered or when the aggrieved client brings a legal malpractice claim. With an occurrence policy this would not be a problem, because as long as the lawyer had a policy in place when she made the error, the occurrence policy would cover it even after the policy expired.

This is not the case with claims-made coverage. When the claims-made policy expires, so does the insured's ability to report a covered claim under that policy.

Notwithstanding these apparent limitations, claims-made insurance can and will provide the same extensive breadth of coverage as occurrence-based policies, but only if the policyholder understands how claims-made coverage works and follows certain guidelines in obtaining and keeping coverage. In particular, lawyers should be aware of three fundamental concepts that provide the framework for claims-made legal malpractice coverage.

- The first of those concepts is that of a “loss inclusion” or “retroactive” date. These terms are interchangeable; they refer to and coincide with the first date that a policyholder obtained and maintained continuous claims-made coverage.
- “Continuous claims-made coverage” refers to an unbroken string of consecu-

tive claims-made policies, with no passage of time occurring between the expiration of one policy and the inception of the next.

- A “gap” refers to a period of time for which no claims-made policy coverage is in force and effect. Great care should be taken to avoid a gap in coverage, because once one exists it might be impossible to bridge it. And even when it is possible to bridge the gap, it will be expensive.

Only by understanding how these concepts work together, and then by maintaining continuous claims-made policies without any gaps between them, can a lawyer obtain the broadest coverage possible from his LPL policy. In other words, to get the most value out of your legal malpractice premium dollars, you need to put these concepts to work for you. The next section should help you understand the importance, once you purchase a malpractice policy, of maintaining continuance claims-made coverage and avoiding a gap.

Anatomy of a Legal Malpractice Policy

It is unlikely that anyone will be inspired by the new disclosure rule or this article to read an LPL policy in its entirety, but for newcomers and current policyholders alike, there are four sections of an LPL policy that must be read in order to have a workable understanding of what protection the policy provides. Those sections are *the declarations, the insuring agreement, the conditions and the exclusions*.

The declarations page is the portion of the policy that describes the coverage purchased by the policyholder. It identifies the named insured and contains the “policy period” (usually reflected as “effective dates of coverage”), the amount of coverage purchased (commonly referred to as the policy limit), the amount of deductible, if any, and the amount of premium paid in consideration of coverage. The declarations also identify any special endorsements that modify policy language. With claims-made coverage, the declarations should also reflect the named insured's retroactive or loss inclusion date.

Another must-read portion of the policy is the “insuring agreement,” which may or may not be clearly labeled. This is the language that creates coverage by describing what risks are protected, who besides the



named insured is included within the policy's protection, and what types of events trigger coverage. Typical insuring agreement language reads like this:

In consideration of the premium paid, the Company shall pay, on behalf of an Insured, all sums in excess of the deductible, which the Insured shall become legally obligated to pay as damages for Claims made against the Insured and reported to the Company during the Policy Period, by reason of any act, error or omission in the rendering of Professional Services by the Insured or any person for whom the Insured is legally liable, while acting on behalf of the Named Insured.

The "conditions" portion of an LPL policy describes conditions that must exist for coverage to apply and usually states obligations of the policyholder in the event of a claim. This section specifies how and what an insured must report to trigger coverage. It might also require the insured to report to the company whenever the insured learns of facts or circumstances that might give rise to a claim, but which have not yet ripened into a claim. This last clause is important because it permits a policyholder to trigger coverage under that policy for a mistake or potential claim, even though the claim has not yet been brought. Likewise, failure to timely report to the Company when an insured learns of a potential claim can compromise coverage for that claim when it is finally made.

Finally, all LPL policies have an exclusions section, which usually begins "This policy does not apply to" Virtually all LPL policies exclude claims arising out of dishonest, fraudulent or intentional conduct, exclude coverage of punitive damages, statutory fines or penalties, and do not cover damages resulting from commingling client funds. Most policies also exclude extraordinary risks such as securities-related practices, investment counseling or sexual harassment. The exclusions may also address known risks not reported to the carrier in the application, claims that are covered by other policies, and

TABLE 1 – Able & Crane P.C. Insurance History

RETROACTIVE DATE	1995-2000	2001	2002	2003	2004
	BARE <small>(no liability insurance)</small>	AC-01	AC-02	AC-03	AC-04
COVERAGE AMOUNT		\$100,000	\$100,000	\$250,000	\$1 million

claims arising out of services rendered before the policyholder's retroactive date.

How Claims-Made Legal Malpractice Coverage Works

Consider the mythical law firm of Able & Crane P.C. ("A&C"), a firm of two lawyers who first began practicing together in 1995.

For the first few years, the partners focused on building their small practice. By 2000, the lawyers had amassed a small fortune in assets and maintained a thriving practice. Able and Crane thus determined at the end of 2000 that it was time to purchase malpractice insurance. A&C bought Policy No. AC-01, with a policy period of Jan. 1, 2001, to Jan. 1, 2002, and a \$100,000 per claim policy limit. Because this was the law firm's first-ever claims-made policy, A&C's retroactive or loss inclusion date was Jan. 1, 2001, the same as the inception date of this first policy.

In June 2001, A&C received a letter from a fellow attorney, which claimed that in October 2000, Able missed a former personal injury client's statute of limitations. A&C promptly reported the claim to its LPL carrier, which promptly denied coverage for the claim because even though the claim was made and reported during the AC-01 policy period, the error was made *before* the firm's retroactive date of Jan. 1, 2001. Stated another way, the mistake occurred when there was no claims-made policy in place.

As shown in Table 1, A&C P.C. renewed its coverage in 2002, 2003 and 2004 and was issued consecutive claims-made policies

with limits as stated. In February 2004, the law firm was sued by the estate of a client for whom Crane drafted a Last Will & Testament in March 2001. When A&C reported this claim, it received confirmation that the lawsuit was covered by Policy No. AC-04, with limits up to \$1 million, because the claim was made and reported during the AC-04 policy period and the error was made after the law firm's Jan. 1, 2001, retroactive date.

It is through the retroactive or loss inclusion date that a claims-made policy provides coverage for prior acts. As long as A&C timely renews its insurance coverage and maintains consecutive policies without any gaps in coverage, it can avail itself of protection against claims arising out of errors made all the way back to Jan. 1, 2001, the date it first maintained "continuous claims-made coverage." If, however, A&C for some reason fails to renew its coverage, it will irretrievably lose that loss inclusion date.

Assume, for example, that A&C received a claim in October 2005 and only then discovered that it forgot to pay its 2005 policy premium. This new claim will not be covered because there was no claims-made policy in place when it was made against the firm and reported to the carrier. And when A&C buys a new policy effective Nov. 1, 2005, its new retroactive date will be Nov. 1, 2005, *not* Jan. 1, 2001, as it had before. A&C will have a gap from Jan. 1, 2005 to Nov. 1, 2005 (see Table 2).

An error made during that gap will not be covered under Policy AC-04, which expired on Jan. 1, 2005. It will not be cov-

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TABLE 2 — The Effect of a Gap in Coverage

RETROACTIVE DATE	1995-2000	2001	2002	2003	2004	1/1-11/1/2005	11/1/05-11/1/06
	BARE	AC-01	AC-02	AC-03	AC-04	Bare	AC-06
COVERAGE AMOUNT		\$100,000	\$100,000	\$250,000	\$1 million	Gap	\$1 million

TABLE 3 – The Effect of Tail Coverage

	1/1-11/1/2005	11/1/05-11/1/06	11/1/06-11/1/08
	Bare	AC-06	Extended Reporting Endorsement (Tail)
COVERAGE AMOUNT →	\$0	\$1 million limit under AC-06	

ered by the new policy, even if it is reported after Nov. 1, 2005, because the error was made *before* the firm’s new retroactive date.

That brings us to the concept of an “extended reporting period,” or what lawyers commonly refer to as a “tail policy.” Tail coverage is one of the ways that the LPL marketplace addresses what would otherwise be a harsh application of claims-made liability insurance. The term is a misnomer, because tail coverage is not actually an insurance policy but rather an agreement with the carrier that permits the policyholder to continue reporting claims after a policy expires. By purchasing a tail you merely extend the period of time within which claims may be reported. A tail does not change the policyholder’s loss inclusion date or the applicable limits and deductible.

To illustrate, imagine that our mythical lawyers at A&C decide to donate two years of their time to building homes for charity. From Nov. 1, 2006 until Nov. 1, 2008, the lawyers will not be practicing law; therefore A&C has no need for ongoing coverage. Nonetheless, the law firm does not want to lose the ability to report claims arising out of mistakes made before their sojourn into charity. As the law firm’s Policy No. AC-06 expires on its own terms, Able purchases a two-year Extended Reporting Period, effective the same date. When the law firm is sued in March 2007 for an error made in December 2005, the law firm can report the claim under the tail and have it covered, subject to the limits and deductible of the expired AC-06 policy (see Table 3).

These simple examples are designed to illustrate basic concepts in claims-made coverage. Modern law practice is rarely this

simple; lawyers leave and return to private practice. It is therefore vital that lawyers develop, for their own protection, a basic understanding of how legal malpractice insurance works. Partners and associates alike should know whether and to what extent they are protected by LPL insurance. This knowledge is especially crucial when you change firms, take a leave of absence, or move into or out of private practice from other sectors.

Shopping for and Purchasing Legal Malpractice Insurance

Insurance Carrier Nomenclature

The many companies that write LPL policies vary, among other things, in organizational structure and ownership. Many of these differences have little practical importance for LPL consumers. There are some differences, however, that lawyers should be aware of and consider when looking to acquire LPL coverage. The significant differences relate to how (and by whom) the carriers are regulated and what happens if they dissolve or become insolvent.

Admitted vs. Non-Admitted Carriers.

These terms refer to the extent to which an insurance carrier is regulated by and authorized to conduct business in a certain state. Arizona, like all other states, has a governmental department charged with overseeing and regulating insurance business conducted within that state. An admitted insurance carrier is fully regulated by the Arizona Department of Insurance (DOI) and is fully authorized to write certain types of insurance policies within this state. Like other states, Arizona also maintains a guarantee fund designed to provide a certain level of protection for

Arizona consumers in the event an admitted carrier becomes insolvent. Admitted carriers are required to participate in the guarantee fund by paying into it a certain portion of premiums generated in this state. If an admitted insurer becomes insolvent, the fund takes over and covers that carrier’s claims, up to a certain amount of per-claim limit. Currently, the guarantee fund provides a per-claim limit of \$100,000.

Non-admitted insurance companies are not fully licensed and regulated here but are still permitted by the DOI to write certain types of policies within the state. Non-admitted carriers are sometimes called “surplus” carriers, which refers not to the amount of coverage but to the type of insurance they are permitted to write. Non-admitted or surplus carriers do not participate in the guarantee fund, and the DOI can control them to a lesser extent than it can for admitted carriers. For example, if an admitted insurer violates DOI regulations or falls below a required level of capitalization, the DOI can suspend its authority, revoke its license or move to place the carrier into receivership. The same is not true for non-admitted or surplus lines carriers.

Risk Retention Groups. Another type of entity offering LPL coverage is a risk retention group. Risk retention groups are unique in that their existence is authorized by federal law, whereas other insurance companies are generally authorized and regulated exclusively by state law. Risk retention groups are not fully regulated by the DOI and are even less subject to the state’s control and oversight than non-admitted carriers. Most important, RRGs may not participate in the state guarantee fund. It may therefore be prudent before purchasing a policy from an RRG to verify its industry rating and financial history.

Mutual vs. Stock. Finally, an insurance company may be referred to as a “mutual” or a “stock” company. As a practical matter it makes little difference, but a mutual insurance company is owned by all its policyholders collectively, whereas a stock insurer is owned (like any corporation) by its shareholders. Mutual carriers sometimes pay dividends to their policyholders, but the dividend amount is usually negligible,

There is no magic formula designed to help lawyers choose the “correct” policy limit or deductible.



and the policyholder's ownership interest disappears when the insurance policy terminates.

Buying Malpractice Insurance

The LPL insurance market generally follows the cycle of the property and casualty insurance market; it is described as a "hard" market when premiums are higher, coverage is more narrow and insurance carriers are able to select more attractive risk profiles for their books of business. A "soft" market describes the part of the cycle when policyholders are easily able to obtain coverage, policies provide "bells and whistles" to make them more attractive and carriers are more flexible and competitive when pricing coverage.

Whatever the location of the LPL marketplace on the hard-soft continuum, lawyers and law firms have the option, when purchasing coverage, of doing so directly from the carrier or going through an insurance broker or agent. Both options have advantages and disadvantages, and the method one chooses seems to be a function of time and personal preference.

Direct Purchasing. In today's marketplace it is relatively easy to locate, learn about and communicate directly with the various insurance carriers that offer legal malpractice insurance. The Internet is useful for this purpose and many LPL insurers permit lawyers and law firms to submit applications, obtain quotes and even purchase policies online. By purchasing directly, a lawyer also can avoid the added cost of a commission, which a carrier pays to a broker or agent for placing its policy. In a hard market characterized by higher premiums, buying directly might save premium dollars.

Another advantage is that buying a policy directly from the carrier exposes a potential policyholder to the company's customer service practices before buying its product or experiencing a claim. If you are applying for coverage directly, take advantage of this opportunity by inquiring about the company's structure, ownership and insurance or financial industry ratings. It is also wise to ask whether the carrier employs in-house claims attorneys or uses outside adjustment agencies to handle its claims.

Insurance Brokers and Agents. Purchasing coverage directly may save premium dollars, but getting the most out of that process requires a great deal of time and effort such that using a professional is a better option.

Insurance brokers are professionals licensed to assist consumers in locating and purchasing insurance coverage. Generally speaking, insurance brokers have knowledge of and access to several different carriers, whereas unless they are "independent," insurance agents typically represent one particular insurance carrier. Insurance agents usually do not represent the insurance consumer, but rather they are agents of the insurance company or companies whose products they offer.

Because they have access to several different carriers, insurance brokers can help you shop around for the best coverage and the best premiums. They can help you apply for coverage, compare policies and obtain competing quotes. An experienced professional can also help a law firm address a negative claims history or risky practice profile, which is especially useful in a hard market. The expertise provided by an experienced

CHOOSING AMONG POLICIES

Before committing your premium dollars to a specific insurance carrier or policy, it is useful to compare the important features that might make one of those policies more desirable to you than another. The following items can be used as a checklist to help you identify key provisions and compare the policies under consideration.

Definition of "Professional Services": Do any of the definitions exclude activities particular to your practice? Is one more restrictive or expansive than the others?

Definition of "Insured": Does the insuring clause or definitions section exclude independent contractors? What does the language say regarding new hires? Some policies automatically cover new hires until the next policy period without additional premium charges.

Disciplinary Proceedings: Typically, disciplinary proceedings do not fall within the definition of covered claims or are specifically excluded from coverage. However, many carriers now offer an expense allowance for defense of disciplinary or other administrative proceedings.

Participation in Choosing Defense Counsel: Some policies require an insured to accept the lawyer chosen by the carrier, or require you to select defense counsel from the carrier's pre-approved panel. Other carriers are more flexible on this important feature.

Settlement Rights/Consent Clause: All LPL policies grant the carrier the right to settle but have some version of a consent clause. The harshest (to the consumer) is a "hammer clause." If a policyholder withholds consent to settle, a hammer clause lim-

its the carrier's exposure to the amount it could have settled for, but for the policyholder's refusal to consent. In other words, by refusing to settle, the insured assumes the risk of uncovered exposure if a verdict exceeds the amount the carrier could have settled for.

Exclusions: Although different LPL policies are usually consistent in what they exclude from coverage, it is still important to scan the exclusions and identify any important clauses before committing to a particular policy.

ADR: Some carriers reduce the policyholder's deductible if the insured agrees to mediation and mediation resolves the claim.

Trial Expense Allowance: Does the policy provide an expense allowance that pays the insured lawyer for days he or she is required to attend depositions or trial?

Extended Reporting Periods/Tail Cover: While all claims-made carriers provide from some extended reported period, some offer free tail periods on a lawyer's disability or retirement from the practice. Legal malpractice carriers vary greatly in their treatment of availability, cost and duration of extended reporting endorsements, so this is one concept new policyholders should be aware of when shopping for malpractice insurance.



broker may therefore result in your selection of better coverage at a more competitive premium than you would otherwise obtain directly. Most important, a knowledgeable broker or agent will have a full understanding of how claims-made coverage works and can help you identify the carrier and policy most suited to your particular risk profile.

Choosing Appropriate Limits and Deductibles

Unfortunately there is no magic formula designed to help lawyers choose the “correct” policy limit or deductible. An insurance policy, after all, is little more than a contract for the transfer of risk; the more risk transferred, the more costly the contract. There are, however, three primary considerations when choosing limits:

1. What is the most likely size (in dollars) of any particular risk?
2. What is the risk of multiple claims in a single policy period?
3. How much risk can you afford to retain by way of a deductible or self-insured retention?

The first consideration refers to the “per-claim” policy limit. A law firm should factor into this choice the amount of protection it wants to provide for its assets and the relative dollar value of the cases it handles.

The second consideration pertains to how much “aggregate” coverage a lawyer chooses to buy. The aggregate limit refers to the maximum amount the carrier will pay for multiple claims made under that particular policy. Most LPL carriers offer split limits—that is, a greater amount of “aggregate” limit than the “per-claim” limit. You might therefore choose limits of \$1 million per claim, \$1 million aggregate, or a split limit of \$1 million per claim, \$3 million aggregate.

The final factor—choosing a deductible—deserves greater discussion. A policyholder’s deductible is the amount the policyholder is required to pay (i.e., the risk the insured retains) before the carrier’s obligation to pay kicks in. Because there are important differences among carriers and

policies in treatment and application of the deductible, it is essential to know how the deductible works under a particular policy and when the deductible obligation is triggered. You may be able to purchase a policy that applies your deductible to indemnity payments only. In that case, your deductible obligation will only be triggered in the event of a settlement or adverse judgment against you.

One of the most important and valuable aspects of LPL insurance is that it provides not only indemnification for, but also defense of, malpractice claims. According to data compiled by the American Bar Association Standing Committee on Lawyers’ Professional Liability, published in the *PROFILE OF LEGAL MALPRACTICE CLAIMS 1996–1999*, an overwhelming 74 percent of legal malpractice claims files were closed without any indemnity payment. The Standing Committee collects and publishes data every five years from several malpractice carriers who participate voluntarily in the study. Because so many legal malpractice claims are successfully defended, whether your deductible applies to defense expenses is an extremely important consideration.

It is also important to know whether the policy limits you purchase are in addition to, or exclusive of, your deductible. For example, with a \$100,000 per-claim policy limit, the carrier may be required to pay \$95,000 after your \$5,000 deductible is satisfied, or it might be obligated to pay \$100,000 after your \$5,000 deductible is satisfied. The answer to this important question is usually found in the insuring clause or definitions section of your policy.

Finally, it is absolutely essential to know, before choosing policy limits and purchas-


RESOURCES

Several excellent resources are available to provide information on the many differences among LPL policies and the carriers who write them.

- One of the most exhaustive references is *LEGAL MALPRACTICE: THE LAW OFFICE GUIDE TO PURCHASING LEGAL MALPRACTICE INSURANCE*. The *LAW OFFICE GUIDE* includes a detailed comparison of LPL carriers and policies and constitutes a comprehensive guide for purchasing LPL coverage. It is compiled and updated annually by Editor-In-Chief Ron Mallen in conjunction with other lawyers at Hinshaw & Culbertson LLP and is published by Thomson West. Its cost is \$73.50 (<http://west.thomson.com>).
- In addition, the ABA Law Practice Management Section in 2004 published *THE ESSENTIAL FORMBOOK—COMPREHENSIVE MANAGEMENT TOOLS FOR LAWYERS, VOL. IV*, authored by Gary A. Munneke and Anthony E. Davis, which explains in much more expansive fashion the concepts introduced in this article. The *FORMBOOK* costs \$199.95 (www.abanet.org/abastore).

ing a policy, whether there is an allowance for defense costs outside (in addition to) the policy limit, or if defense expenses are included within the policy limit. Most lawyers are familiar with the concept of self-consuming or “burning limits” policies. With self-consuming policy limits, the amount your carrier spends defending a claim reduces, on a dollar-for-dollar basis, the limits available to pay for any verdict or settlement. Some carriers offer both types of policy, and some carriers offer a separate expense allowance outside the policy limits.

To summarize, before committing to a policy, you should know the answer to the following questions:

1. Do defense expenses reduce the amount available for indemnification, or is there a separate expense allowance (i.e., is this a burning limits policy)?
2. Does the carrier offer an “indemnity-only” deductible, so that defense expenses will not trigger your deductible obligation?
3. Is your policy limit in addition to or does it include the deductible (i.e., how much coverage are you buying)? 

NEXT MONTH

- WHAT YOU MIGHT PAY FOR YOUR POLICY
- TRENDS IN PROFESSIONAL LIABILITY INSURANCE
- HOT-BUTTON PRACTICE AREAS THAT ARE A RED FLAG FOR CARRIERS