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A Crack in the Shield? Malpractice Coverage at Risk

Abstract
A recent, unreported opinion of the Minnesota Court of Appeals has opened up a major hole in the liability shield of professional firms. Continental Casualty Co. v Duckson-Carlson, LLC, misapplies the doctrine of equitable estoppel, misinterprets the Minnesota Professional Firms Act, ignores the fundamental distinction between an entity and its owners, and sub silentio turns the law of third party beneficiaries on its head. From a practical perspective, the decision should trouble every lawyer, doctor, accountant, and other "319B" professional in the state and, moreover, has serious implications for individuals covered by D&O insurance.

Keywords
liability insurance, malpractice, attorney lawyer, professional firm, third party beneficiary, separate legal person

Disciplines
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A recent, unreported opinion of the Minnesota Court of Appeals has opened up a major hole in the liability shield of professional firms. Continental Casualty Co. v Duckson-Carlson, LLC misapplies the doctrine of equitable estoppel, misinterprets the Minnesota Professional Firms Act, ignores the fundamental distinction between an entity and its owners, and sub silentio turns the law of third party beneficiaries on its head. From a practical perspective, the decision should trouble every lawyer, doctor, accountant, and other “319B” professional in the state and, moreover, has serious implications for individuals covered by D & O insurance.

The facts in the case were relatively simple. A professional limited liability company practicing as a law firm obtained malpractice insurance through a policy that included a $15,000 deductible. A former client of the firm brought a malpractice suit against the firm and one of its lawyers. The lawyer adamantly denied any breach of duty but — recognizing the brevity of life and believing that he had no financial “skin in the game” — agreed to a settlement. The malpractice carrier paid the settlement amount to the plaintiff, the firm became insolvent and could not pay the deductible, and the carrier then demanded $15,000 from the individual lawyer.

Only then did the lawyer learn that the malpractice policy purported to make every member and associate of the firm jointly and severally liable for any deductible the firm failed to pay. Not surprisingly, in the author’s experience of similarly situated professionals, the lawyer had never read the malpractice policy. The attorney had certainly not signed the policy, and during the settlement discussions with the carrier: (1) he did not ask whether he would be personally liable for any portion of the settlement; and (2) the carrier did nothing to alert him to the issue.

The trial court granted summary judgment to the insurance company, and the Court of Appeals affirmed in a decision that makes a series of fundamental conceptual errors.

The panel’s core rationale was equitable estoppel, i.e., that the lawyer could not accept the benefits of the malpractice coverage and then seek to escape the deductible responsibility imposed by the policy:

This case invites equitable estoppel. … Appellant [the lawyer] intentionally took full advantage of respondent’s malpractice insurance coverage (why not — appellant knew that as a member of his firm that even though he did not personally negotiate the policy and sign off on it he was covered if someone sued him for malpractice — he expected that benefit from his law firm, and received it). Appellant knew that he was required to have malpractice insurance and that respondent was providing him with the required insurance so that he could practice law. Up until respondent sought reimbursement directly from appellant for the deductible (because [the firm] had been dissolved), appellant took advantage of respondent’s malpractice coverage. It is unequivocally safe to say that during the suit alleging malpractice appellant depended, expected, and relied upon respondent to provide him with his safety net of malpractice insurance. He can not now claim that he “was not a party” to the insurance contract, and can have its benefits but no responsibility for the deductible.

Viewed superficially, this holding might seem reasonable and could even resonate with notions of ratification. But equitable estoppel presupposes some “voluntary conduct of a party [and] … another person, who has in good faith relied upon such conduct, and has been led thereby to change his position for the worse.” Equitable estoppel is synonymous with “estoppel by misrepresentation,” and the attorney in Duckson-Carlson made no representations. Nor can his silence during settlement discussions suffice as misrepresentation by silence. That concept applies only “when one … by his silence when he ought to speak out, intentionally or through
culpable negligence induces another to believe certain facts to exist and such other rightfully relies and acts on such belief, so that he will be prejudiced if the former is permitted to deny the existence of such facts.”8 Why “ought” the attorney to have spoken out when he was ignorant of the provisions of a policy to which he was not a party? How could an insurance carrier rightfully rely on the silence of a person with whom the carrier was not in privity?

Similarly, the doctrine of ratification is initially intriguing but ultimately inapposite.9 A ratification analysis would: (1) view the firm as purporting to act as the lawyer’s agent when assenting to the policy provision that imposed the deductible obligation on the lawyer; (2) treat the lawyer’s acceptance of the coverage protection as affirming the firm’s act (i.e., as a manifestation of ratification), on the theory that a person cannot ratify only part of a deal;10 and (3) overcome the lawyer’s ignorance of the material fact of his purported liability by asserting the carrier’s reliance on the ratification.11 However, for a manifestation to constitute affirmance, the person ratifying must be aware that the affirmance is retroactively approving another person’s prior conduct in purporting to bind the ratifier.12 The lawyer in Duckson-Carlson agreed to the settlement having no idea that his firm had purported to act as his agent with regard to the deductible obligation.13

The Court of Appeals also justified its decision in terms of the Reporter’s Notes to Minn. Stat. §319B.06 and the treatment there of London, Anderson Hoeft, Ltd. v. Minnesota Lawyers Mut. Ins. Co.14 London involved Chapter 319A, the predecessor statute to the Professional Firms Act. Both sides in Duckson-Carlson sought to make use of London, and defendant-appellant’s position was that the law had changed:

Appellant argues that the holding in London has been overruled by the repeal of Minn. Stat. §319A.10 (2004) and the enactment of Minn. Stat. §319B.06 (2004) and therefore he is not liable under the insurance policy. We are not persuaded by appellant’s argument. The general comments to Minn. Stat. §319B.06 specifically state, “[Minn. Stat. §319B.06, subd. 3] addresses the questions of liability ... and intends no substantive change from Minn. Stat. §319A.10. Minn. Stat. Ann. §319B.06 general comm. (West 2004). The subdivision does, however, use a different approach in the hope of clearly producing the same result.” Id. (Emphasis added [by the court]). The comments specifically discuss the decision in London, explaining that the holding was a correct interpretation of the law. The comments further explain that “Minn. Stat. §319A.10 was never intended to go so far ... .” Id. It is apparent that the comments intended to add weight to the London holding that members of a professional corporation can not be held liable for malpractice if they are not personally named in the suit. The comments continue to clarify the London decision by explaining that a member can assume the debts of the professional corporation by contract “for some or all of the organization’s debts.” We interpret this statement to mean that each member must assume by contract personal liability for instances where they are not personally named in a malpractice suit. For instances where they are personally named in a malpractice suit, as here, no such contract is required. This interpretation will ensure that Minn. Stat. §319B.06, subd. 3 produces the same result as repealed Minn. Stat. §319A.10.15

Either the Court of Appeals read the Reporter’s Notes carelessly,16 or the Notes’ drafter was not blunt enough. The “same result” sought by Section 319B.06, subdiv. 3(c) was that members of professional firms would not by that status be liable for the debts of the firm. The Notes expressly disapprove of London. They:

- explain that “the detailed language contained in Minn. Stat. §319A.10 has confused the courts on at least one occasion,”
name the London case as that occasion of confusion, and
state that “Paragraph (c) seeks to avoid confusing cases such as London … .”17

The Reporter’s Notes recognize that “public policy does not prevent a stockholder, LLC member, or LLP partner from assuming by contract personal liability for some or all of the organization’s debts.”18 However, nothing in the Duckson-Carlson facts supports a contractual undertaking by the individual lawyer. That is precisely why the Court of Appeals had to resort to its flawed theory of equitable estoppel.

The Court of Appeals simply did not recognize the distinction the Professional Firms Act makes between the firm and its members. Juridically, absent a piercing claim, the members and the firm are entirely separate. The firm has no greater power to bind its members to an obligation than the author of this article has to bind the author of the Duckson-Carlson opinion.19

Contract law helps further explicate the error of Duckson-Carlson. The malpractice insurance policy referred to the firm (the policyholder) as the Named Insured,20 but in the lexicon of contract law the carrier is the promisor, the firm is the promisee, and the individual lawyers are third party beneficiaries. In the language of the Restatement (Second) of Contracts, §302(a), the lawyers are “intended beneficiaries.” The older label is “creditor beneficiary,” indicating that the carrier’s promise of coverage serves to perform an obligation that the firm has toward its lawyers.21 Providing the coverage was a material part of the remuneration the firm promised the lawyers in return for the lawyers’ services.

It is axiomatic that a promisor’s obligation to a third party beneficiary is subject to whatever defenses on the contract the promisor has against the promisee.22 However, there is simply no authority for the notion that the promisor has an affirmative claim against and may recover from the third party beneficiary if, after the promisor has rendered performance to the third party beneficiary, the promisee renders defective performance to the promisor or otherwise defaults.23 Put more simply, a third party beneficiary is subject to defenses and offsets due to defects in the promisee’s performance but is not the guarantor of that performance.

Case law on this subject is scant, but one Missouri case is directly on point. In Continental Cas. Co. v. Campbell Design Group, Inc. a professional liability carrier sought to recover a $75,000 deductible from both the professional firm and individual defendants. The carrier contended that, just as the coverage extended to the individual additional insureds, so too did the deductible obligation. The Missouri Court of Appeals flatly and categorically rejected that argument:

What is not discussed by Continental is the basic legal premise that a contract generally binds no one but the parties thereto, and it cannot impose any contractual obligation or liability on one not a party to it. The record does not establish that either of the individual defendants was a party to the contract. Language in a contract to which they were not parties cannot bind them.24

The Duckson-Carlson decision ignores this basic tenet of contract law and, as a result, threatens the expectations of a wide range of “additional insureds.” Not only the members and associates of professional firms are at risk but also by implication every contractor, subcontractor, owner, vendor, and lessor covered under the contractual liability provisions of a comprehensive general liability (CGL) policy. The risk also extends to another classic set of third party beneficiaries — officers and directors covered under a D & O policy obtained by a corporation or other organization.
There is nothing in public policy that prevents a malpractice carrier from requiring a firm’s members and associates to guarantee the firm’s deductible obligation as a condition to the issuance of a policy. But such guarantees must be obtained directly, from each member and associate, and not through the firm’s unauthorized commitment on behalf of those who own and work for it.

Fortunately, Continental Casualty Co. vs. Duckson-Carlson, LLC is an unreported decision and not precedential.25 Unfortunately, even an unreported decision can be influential.26 During the 2007 legislative session, the MSBA Business Law Section may obtain corrective amendments to Chapter 319B (and even blunter Reporter’s Notes). Until then, however, each lawyer in private practice ought to be carefully reading the malpractice insurance policy of his or her firm and admonishing each of the firm’s professional firm clients to do the same.

Notes
1 Cont’l Cas. Co. vs. Duckson-Carlson, LLC, A05-1173, 2006 WL 1073075 (Minn. App. 04/25/06), rev. denied 06/28/06. The author submitted a pro bono affidavit to the trial court in Duckson-Carlson.

2 Chapter 319B is the Minnesota Professional Firms Act and applies to the following professions: practice of medicine and surgery, physician assistant, chiropractic, registered nursing, optometry, psychology, social work, marriage and family therapy, dentistry and dental hygiene, pharmacy, podiatric medicine, veterinary medicine, architecture, engineering, surveying, landscape architecture, geoscience, and certified interior design, accountancy, or law. See Minn. Stat. Ann. §319B.02, subdiv. 19 (West 2006).

3 The trial court decided the case on summary judgment, and the Court of Appeals affirmed. It is well understood that in deciding a motion for or reviewing the grant of summary judgment, a court must view the evidence in the light most favorable to the nonmoving party. The following factual account takes the same approach.

4 Duckson-Carlson, 2006 WL 1073075, at *2. (“When [the lawyer] began working at [the firm], he was not given a copy of the professional liability insurance policy nor did he ask to see a copy of the policy. He never read or signed the policy.”).

5 Id. at *3-4.

6 Moberg v. Commercial Credit Corp., 230 Minn. 469, 475-76, 42 N.W.2d 54, 58 (Minn. 1950). Moberg is the sole case cited in Duckson-Carlson as support for the equitable estoppel holding. Duckson-Carlson, 2006 WL 1073075, at *3.

7 31 C.J.S. Estoppel and Waiver §58. The Moberg decision cites this section of C.J.S. as authority, and indeed in formulating its holding borrows heavily (but without quotation) from the words of this C.J.S. section.

8 Id.

9 Ratification is the only agency law analysis that is even arguably relevant, because while an LLC member might have the authority to bind the LLC, the LLC has no authority to bind its members. Carter G. Bishop & Daniel S. Kleinberger, Limited Liability Companies: Tax And Business Law ¶¶5.05 [1] [c] and 7.05 [1] (1998 and Supp.2006-01).
10 See Restatement (Third) of Agency §4.07 (2006) (“A ratification is not effective unless it encompasses the entirety of an act, contract, or other single transaction.”); see also Restatement (Second) of Agency §96 (1958) (“A contract or other single transaction must be affirmed in its entirety in order to effect its ratification.”). Affirmation by silence is also possible, but that concept has the same flaws as the “misrepresentation by silence” notion discussed above. See Restatement (Second) of Agency §94 comment a (1958) and Restatement (Third) of Agency §4.01 comment f (2006).


12 Id. §2.7.2, at 51.

13 Another perspective would negate the ratification theory by disconnecting the lawyer’s acceptance of benefits from the carrier’s reliance. This perspective views the lawyer as accepting the benefits of the policy long before the settlement discussions. The lawyer accepted the benefit of having a policy in place (and relied substantially) every day he remained part of the firm.

14 530 N.W.2d 576 (Minn. App.1995).

15 Cont’l Cas. Co. vs. Duckson-Carlson, LLC, A05-1173, 2006 WL 1073075, at *3 (Minn. App. 04/25/06).

16 The court’s opinion refers to the Comments to §319B.06, but the accurate appellation is Reporter’s Notes.

17 Minn. Stat. §319B.06, subdiv. 3(c), Reporter’s Notes.

18 Id.

19 This article’s criticism of the Duckson-Carlson opinion does not reflect any disrespect for Judge Randall, who wrote the opinion. To the contrary, the author has had particular cause to appreciate Judge Randall’s jurisprudence. See Losoya v. Richardson, 584 N.W.2d 425 (Minn. App. 1998).

20 Cont’l Cas. Co. vs. Duckson-Carlson, LLC, A05-1173, 2006 WL 1073075, at *1 (Minn. App. 04/25/06).

21 Restatement (Second) of Contracts § 302 comment b (1981).

22 See Id. §309(2) and comment b.

23 Id. Section 309(3) implies the contrary. See also 16 Couch on Insurance §226:133. Deductibles (“An insurer is entitled to reimbursement from the named insured or from a party to the insurance contract of deductible amounts paid on behalf of an insured, at least where the insurer can identify the deductible amounts paid.”) (emphasis added).

a carrier’s claim for a deductible asserted against the named insured (the policyholder) for settlement payments made in connection with an additional insured under comprehensive general liability policy) and Northbrook Ins. Co. v. Kuljian Corp., 690 F.2d 368, 369 (3rd Cir. 1982) (affirming the trial court’s decision “requiring . . . one of two ‘named insureds’ [i.e., policyholders] on a professional liability insurance policy, to pay the deductible amount notwithstanding that it was the other ‘named insured’ which had incurred the underlying liability”).
