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TECHNICAL ADVISORY

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SUBJECT: E&O – The Dangers of the Agency Paying Small Claims

BACKGROUND: E&O claims are often substantial; some are huge. Where there is a potential for a large E&O claim, every agency owner or manager knows instinctively to report the claim or potential claim immediately to the E&O carrier.

However, where a small, first-party loss amounts to less than the agency's E&O deductible, there is a temptation to pay the claim directly out of the agency's own funds, without ever notifying the agency's E&O carrier. The rationale is that in cases where the agency clearly dropped the ball, and a potential claim is less than the E&O deductible, it's better to just pay the claim and save the embarrassment and trouble.

This practice, while seemingly logical and expedient, is extremely dangerous. Every E&O expert advises against it. Here's how it can come back to haunt the agency in the long run.

MAIN POINTS: Two recent, true-to-life cases illustrate the dangers of paying small claims without reporting them.

Real case #1: A Personal Auto insured is on vacation out of state. While pulling in to a fast-food restaurant, he dings a car in the parking lot. No one is in the car, so being a good citizen, the insured goes into the restaurant looking for the car's owner.

Following a brief inspection in the parking lot with the car's owner, both agree that the damage is minor, and is not worth reporting to the police. Our insured gives the car's owner his driver and insurance information, "just in case more damage is found later."

Upon returning home, our insured calls his agent to report the damage to his new car. When the insured's file is pulled, the agency discovers to its horror and embarrassment that the new car was reported to the agency, but was never added to the policy. The file has an undated "sticky-note" about the new car, but apparently no action was taken. The CSR has since left the agency.

Since the new car was an additional auto and not a replacement auto, both physical damage and liability coverages are limited if not reported in time (30 days in the 1994 PAP, and 14 days in the 1998 PAP).

The agency thus decides to pay the $950 collision claim to their insured's new car.

Two months later, the insured brings in a large envelope from a law firm in the city where the accident took place. The owner of the car is alleging bodily injury from the accident.

While the allegation is clearly fraudulent, since no one was in the car when our insured dinged it, the agency reports the potential claim to their E&O carrier. However, when the E&O carrier later discovers that the agency has already paid the $950 first-party collision claim, they deny coverage and defense in the bodily injury allegation.

Real case #2: The insured is a residential contractor. His son recently joined the business, and until he can get established on his own, the son lives in one of the model homes.

The builder calls the agency to add coverage for the son's personal belongings, which the builder estimates to be worth around $8,000. This includes an expensive DVD player and sound system, custom made guitar, laptop computer, and over 300 CDs.

Five months later, a fire severely damages the model home. When the builder reports the fire claim, the agency discovers that a former producer who handled the account had simply added an additional $8,000 to the Business Personal Property of the builder's Commercial Property policy.

Realizing that an HO-4 should have been written instead, and with a $10,000 E&O deductible, the agency tells the builder that they made a mistake in how the son's personal property was handled, and the agency will provide the coverage.

One month later, two lawsuits arise out of the claim. The first is by the son, who is disputing the value the insurer placed on his custom made guitar and CD collection. He is suing the agency for failing to write adequate coverage on his property.

Also, a bed-ridden neighbor who suffered serious smoke inhalation injury is suing the son. The fire investigation revealed that the cause of the fire was due to the son having had too many electrical items plugged into one outlet.

Since the agency had previously paid the fire claim on the son's property, the agency's E&O carrier refused the new claims and any defense.

E&O policy language. While E&O policy language varies from one insurer to the other, the following provision in the ERC/Westport E&O policy is typical.

General Terms & Conditions.

I. Reporting and Notice. Insured's duties in the event of a claim or any potential claim:

A. The insured shall <u>not</u>, without our written consent, do any of the following:

1. *Admit liability;*
2. *Participate in any settlement discussions nor enter into any settlement; or*
3. *Incur any costs or expense.*

Clearly, when the agencies in these two cases paid small, first-party claims out of agency funds, they violated the provisions of their E&O policies. Such violations of policy terms could jeopardize coverage. It is therefore extremely important that any and all claims or potential claims be reported immediately to the E&O carrier, regardless of size, and irrespective of how clear-cut the agency's mistakes. In addition, no agency staff person should ever admit fault or liability to an insured, or anyone outside the agency, without advice from the E&O carrier.

It is also important to note that claims only impact loss experience for underwriting purposes if there is actual loss payment, or claims costs in excess of $5,000. Potential claims reported "for information

only” or groundless claims which are closed without claim payment and claim expenses less than $5,000 **DO NOT** impact underwriting or renewal premiums.

NECESSARY ACTION: Circulate this Technical Advisory to all agency staff. Establish clear agency policies for prompt reporting of potential agency E&O claims, and which prohibits agency settlement of E&O claims.