



Managing Legal Malpractice:

*A Professional Liability Risk
Management Handbook for Lawyers*



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WILEY

**MANAGING LEGAL MALPRACTICE:
A PROFESSIONAL LIABILITY
RISK MANAGEMENT HANDBOOK
FOR LAWYERS**

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INTRODUCTION

Legal Malpractice

Improper, negligent or unethical conduct or treatment by a lawyer.

(The American Heritage Dictionary, Third Edition)

Myth—I won't be sued for legal malpractice

Reality—Attorneys in private practice have a 4% to 17% chance of being sued for malpractice each year, depending on their jurisdiction and area of practice, according to the American Bar Association's (ABA) *Lawyer's Desk Guide to Legal Malpractice*.

Myth—My firm is well-run. I don't need legal malpractice insurance.

"The first duty of business is to survive. The guiding principle of business economics is not the maximization of profit. It is the avoidance of loss."

—Peter Drucker

Reality—Even well-run law firms can be sued. If your firm is sued, not only does it face financial and reputational risk, but its directors and officers may be personally liable. Sound corporate governance requires directors and officers to act in good faith and in the best interest of the organization. With respect to managing corporate risks, this means providing

direction and supervision to ensure management 1) understands inherent risks and their potential impact on the organization and 2) dedicates appropriate resources and responsibilities to ensure these risks are mitigated and, where they cannot be mitigated, transferred or otherwise financed.

Myth—My firm is protected. I buy insurance, so I have transferred the risk to the insurance company.

Reality—Insurance only covers the direct costs of a malpractice suit, damages, and defense costs. A law firm has much greater, uninsured costs associated with malpractice suits. These may include, but are not limited to:

- The self-insured portion of the claim.
- Injunctive or non-monetary relief.
- Any uninsured fines, penalties, or fees returned or ordered disgorged.
- The cost of correcting, reperforming, or completing any professional services or any other restitution.
- Lost time and productivity.
- Possible costs to hire temporary staff, outsource, or otherwise make up for lost production.
- Time spent in internal investigations and claims management and with the insurance company.
- Increased cost of, or difficulty obtaining, legal malpractice insurance going forward.
- Breach of fiduciary duty claims.
- Directors and officers liability suits.
- Deteriorating partner relationships within the firm.
- Reputation injury and possible professional discipline of the firm and/or attorneys involved.

All of these potential consequences must be factored into the true cost of malpractice suits. Experience suggests that the relationship between direct and indirect costs is 1:4—for every insurable dollar, four dollars are uninsured (and this ratio does not include the cost of reputation injury).

Risks to the Firm

Legal malpractice claims can occur in good or bad economic times.

During good economic times, the size and number of engagements accepted by law firms trend upward. In such an environment, attention to detail may falter, management oversight may be overstretched, and time for training and supervision is often reduced, creating increased potential for errors that might lead to claims.

Equally, when economic times aren't so good, and matters go badly, those on the losing end look for someone to blame, preferably someone with "deep pockets." So found a 2001 study of legal malpractice claims by the American Bar Association (ABA), which reviewed claims information from 23 malpractice insurers from 1996 to 1999. According to the study, some practice areas and activities present more exposure to malpractice than others: 24% of the claims reviewed arose from plaintiff personal injury law practice; 17% from real estate cases; 10% from family law; 9% from estate, trust, and probate work; 9% from corporate/business organization work; and 8% from collections and bankruptcy cases. Most claims arose out of preparation, filing, and transmittal of documents (25%), investigation other than litigation (17%), commencement of action or proceeding (16%), and title opinion activities (13%). Additionally, and more recently, securities and intellectual property malpractice claims have increased in both frequency and severity.

Avoiding these claims is often a matter of risk management and of practice management—which should be one and the same. This handbook offers some advice for maximizing the benefits of law firm risk management.

A thoughtful legal malpractice risk management assessment and plan should:

1. Define the risk appetite (risk tolerance) of the firm.
2. Identify potential risks to the firm.
3. Evaluate and prioritize these risks according to the relative likelihood of an event and the potential severity of an event's impact on the firm in the context of the firm's risk appetite.
4. Implement risk mitigation strategies.
5. Purchase adequate insurance to transfer those risks that pose a significant threat to the firm's financial stability.
6. Monitor and update risk mitigation strategies appropriately as firm priorities and its operating environment change.

FIRM ORGANIZATION AND MANAGEMENT STRUCTURE

Firm Structure

Practice management, and therefore risk management, begins with properly designing the legal ownership structure of the firm and its attendant formation documents (partnership or shareholder agreements). These agreements should be consistent with the firm's business strategy and philosophy—including a management structure that will support the firm's business objectives. For example, if top quality legal work is a business objective of the firm, their compensation arrangements should not excessively reward origination. Firms with well-written owner agreements that clearly define management structure, duties, and responsibilities are less likely to experience malpractice claims.

Partnership/Shareholder Agreement

The following checklist presents some key items to consider when drafting a partnership/shareholder agreement:

- General structure of the firm, including a risk management partner or (in larger firms) a general counsel or the assignment of those responsibilities.
- Duties and responsibilities of owners.
- Compensation scheme. (This should reward more than origination and billable hours. For example, staff training and supervision are critical to the risk management of the firm.)
- Income distribution.
- Death or withdrawal of partners.
- Disability of partners/shareholders.

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- Retirement of partners/shareholders.
 - Capital accounts.
 - Voting, including special majority provisions, such as the method of election of new partners, borrowing thresholds/caps, relocation, negotiating leases, opening of new offices, etc.
 - Management structure and terms of service for managing body(ies) including frequency and intended scope of meetings, nature and number of committees, etc.
 - Practice departments and election or appointment of department heads.
 - Financial management, planning, and oversight.
 - Management of legal staff and allocation of resources.
 - Management of non-legal staff and allocation of resources.
 - Employment practices and procedures.
 - Dissolution of the firm.

Financial Management

Another source of legal malpractice claims is financial mismanagement, particularly fee disputes with clients. The well-run firm minimizes the potential for such disputes. Following is a selection of best practices for accomplishing this; many of these suggestions can be supported with work-tracking and time-utilization systems:

- Establish and manage revenue and expense budgets in accordance with the firm's business strategy and philosophy.

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- Establish realistic hourly rates reflective of attorney experience and practice specialty.
 - Establish and enforce a policy requiring client-countersigned engagement letters before work commences.
 - Establish and enforce effective time-keeping and recording procedures.
 - Maintain a volume of business that keeps firm attorneys gainfully occupied with billable client matters.
 - Manage work assignments on all individual client matters so that excessive hours and billing are not required.
 - Bill frequently (monthly), avoiding large outstanding receivables.
 - Manage collections, including prompt follow-up on overdue bills, and restrict individual partners' freedom to continue to work on matters that are more than 90 days in arrears.
 - Audit using external auditors at least annually.
 - Establish protocols for handling client trust funds, cash receipts, stock and other negotiable instruments, and all other client property held by the firm. In particular:
 - Prohibit the co-mingling of client funds.
 - Require two signatures on client fund accounts.

INTERNAL POLICIES AND PROCEDURES

General Checklist

A well-managed office that effectively supports the firm's structure and business strategy is second only to the partnership agreement in practice (and therefore risk) management importance. The following questions may help in evaluating and/or developing basic risk management systems and practices that are appropriate for your firm:

- Does the firm have a full-time office administrator/manager?
- Does the firm maintain a formalized risk management program?
- Does it maintain a firm-wide risk management manual?
- Does a partner or someone else act as the firm's risk manager?
- In the past two years, have the firm's risk management procedures been audited by an outside risk management specialist?
- Does the firm share office space with, or sublet office space to, any attorneys who are not employees?
- Does the firm ever subcontract or refer legal work of any kind to other law firms or outside attorneys?
- Does the firm maintain an off-site location for maintaining or storing duplicate computer records?
- Does the firm have a disaster recovery plan in place in case its current space is rendered unusable?

Review your responses to these questions in light of the factors outlined in the discussion of risks to the firm on page 5 to make sure that the firm's risks, its appetite for risk, and its risk management practices are aligned.

Client Intake

It is the rare law firm that can be all things to all people. Therefore, it isn't reasonable—or advisable—that a firm accept every potential client who walks in the door. It is important that a firm screen out cases that are high risks or simply can't be handled because the firm doesn't have the manpower or the expertise. A formal client intake process should address the following four questions.

1. “Do I have the expertise needed to handle this matter?” General practitioners should ask this question whenever faced with a new business opportunity. If the case requires knowledge of a specialty practice area, it should probably be referred to counsel specializing in that area. Specialty practice areas that usually require expertise and present greater malpractice exposure can include:

- Antitrust
- Bankruptcy
- Class action
- Entertainment
- Financial institutions
- Intellectual property (especially patent prosecution)
- Mergers and acquisitions
- Plaintiff personal injury
- Probate—trusts and estates
- Real estate (especially commercial)

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- Securities
 - Tax

2. “Do I have the capacity to handle this matter?” Attorneys with unmanageable caseloads are apt to miss deadlines and have claims arise alleging inadequate preparation, document filing, and investigation. It is up to the firm to determine whether it has the resources to handle any given matter that presents itself.

3. “Are there any potential conflicts of interest?” Maintenance of a conflict-of-interest database facilitates this process. Such a database should be kept up to date and searched whenever a new client or matter is brought to the firm. Furthermore, it should be rechecked for conflicts whenever new parties are brought into a case since lateral hiring of attorneys may create a conflict.

Having no system or methodology for maintaining client lists and avoiding conflicts of interest—i.e., relying only on oral contacts and memory—is an unacceptable control mechanism. It is recommended that the firm use a computerized system to maintain client lists and to help it avoid conflicts of interest. Characteristics of such a computer system include the following:

- It should be centralized, with firm-wide access.
- All branch offices should be integrated into the system.
- The database should be indexed by:
 - Client’s name.
 - Client’s principal’s name.
 - Client’s subsidiaries.

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- Name of adverse party.
 - Name of adverse counsel.
- Data should be backed up and stored off site.

For more about conflicts of interest, see “Specific Conflict-of-Interest Areas” on page 16.

Another step the firm can take to help it identify and avoid conflicts of interest is to generate a new-business report to circulate throughout the firm prior to acceptance of an engagement. Attention should also be given to conflicts arising from corporate formation work completed for entities with more than one owner, who at first are not adverse to each other but may become adverse over time. Similarly, the firm should clearly identify whether the firm is representing a corporation, its owners, its directors and officers, or all of the above. If the answer is all of the above, be mindful of potential future conflicts arising, even if they have not yet arisen at the time of corporate formation.

4. “Is this a desirable client?” A significant number of suits arise out of fee disputes, so the client’s financial ability to comply with the fee agreement is critical to avoiding suits, as well as to the efficient operation of the firm’s collection department. Besides inability to pay, a potential client may be undesirable for other reasons. Does the client have unrealistic expectations of the potential outcome? Is the client argumentative or confrontational? Are you only the most recent in a string of attorneys who have turned down the client’s case? Does the client have a history of suing lawyers or other professionals? Any “yes” answers should be red flags in the client intake review.

The Role of Management in Client Intake:

Management is crucial to effective new client intake. No individual partner should be able to unilaterally approve any proposed client engagement without some level of independent review by the firm to assure that it meets the firm's criteria for acceptability. The firm's client intake policies and procedures should require or provide that:

- New client acceptance requires approval from at least one partner (in addition to the “introducing” partner), the management committee, or the standing committee of the firm charged with overseeing such matters;
- A firm-wide communication is sent advising firm employees of the proposed engagement prior to the acceptance of the new client;
- A credit check is performed on the new client prior to acceptance;
- A background check (including pending and/or prior litigation involving the new client) is performed on the proposed new client prior to acceptance;
- A conflict-of-interest check is performed on the proposed new client prior to acceptance;
- Written procedures exist for handling conflicts of interest once they are determined; and
- Once a conflict of interest is identified, acceptance of the new client requires the approval of the risk management partner, general counsel, or the standing committee charged with overseeing such matters.

Finally, the firm should have policies and procedures in place for addressing the outcome—whether accepted or declined—of the client intake review process. Practice management policies should specify the nature of work that

can be accepted and procedures should be instituted to ensure compliance with such policies. Identifying those engagements to be avoided, and delineating the reasons in a “paper trail,” are critical to avoiding future claims.

Where representation is accepted, an acceptance or engagement letter should clearly outline the terms of the engagement, including fee arrangements.

Where representation is declined, a non-engagement letter should make it clear that the firm will not represent the party and accepts no responsibility for the case. Non-engagement letters are especially appropriate if a prospective client has met in person with a firm attorney to discuss such representation. Additionally, the firm should promptly return all belongings and paperwork to prospective clients whom the firm declines representing.

Engagement Letter Tips:

- Required for all new clients.
- Notice letters required for all new matters for existing clients.
- Countersigned letter must be received by firm prior to commencement of work for the new client.
- Standardized firm-wide (or practice group- or department-wide) letters, customized for each client.
- No manuscripting of engagement letters by individual attorneys without review and approval by the risk management partner, general counsel, or the standing committee charged with overseeing such matters.
- Use is *not* at sole discretion of attorney responsible for the client.
- Firm’s policies and procedures for engagement letters should be in writing, regularly circulated, and explicitly expressed at the orientation of all newly hired attorneys, especially lateral hires.

Non-Engagement Letter Tips:

- Required in all cases where representation is declined, especially after meeting prospective clients in person and when statute-of-limitations deadlines are imminent.
- Use is *not* at sole discretion of attorney declining representation.
- Sent by regular mail and by certified/registered mail.
- Does not itself constitute the rendering of legal advice, such as referring to the applicable statute of limitations.
- Firm's policies and procedures for non-engagement letters should be in writing, regularly circulated, and explicitly expressed at the orientation of all newly hired attorneys, especially lateral hires.

Disengagement Letter Tips:

- Required in all matters at conclusion of representation.
- Use is *not* at sole discretion of attorney responsible for client.
- Sent by regular mail and certified/registered mail.
- Includes discussion of firm's file and document retention and destruction policies.
- Firm's policies and procedures for disengagement letters should be in writing, regularly circulated, and explicitly expressed at the orientation of all newly hired attorneys, especially lateral hires.

Note: The firm's policies and procedures should also require that clients be informed in writing of the engagement of third parties' services.

Specific Conflict-of-Interest Areas

Inappropriate relationships with clients—Firm lawyers holding equity interests in, or entering into other commercial relationships with, for-profit business enterprises that are clients of the firm (or that are involved in business transactions with clients of the firm) may have a conflict of interest. The firm should develop and enforce a policy with respect to such client involvement. At a minimum, such a policy should include the following elements:

- Attorneys are not permitted to have commercial relationships with clients of the firm or to be officers or directors of clients of the firm. Such relationships are permitted only with the approval of the managing partner, management committee, or the standing committee charged with overseeing such matters.
- If the firm acts as counsel to the issuer or underwriter of an initial public securities offering, neither the firm nor any partner or employee are permitted to invest in the original IPO allotment.
- If the firm acts as counsel in any form of corporate or asset acquisition, neither the firm nor any partner or employee are permitted to accept any “finders’ fees.”
- If the firm acts as counsel to the issuer or underwriter of any public offering of securities, it may not accept stock in lieu of cash fees.
- If the firm or any partner or employee already owns securities of a company that is about to make an IPO, then the firm may not act as counsel to the issuer or underwriter of the securities.

Representing multiple parties—Firm lawyers may find themselves involved in situations where they are asked to represent more than one party in a legal matter, a situation with strong potential for a conflict of interest. The firm should develop and enforce a policy for such situations, to include the following elements:

- Acceptance of multiple parties is prohibited without review and approval by the risk management partner, general counsel, or the standing committee charged with overseeing such matters.
- Avoid joint representation if there is any possibility that a conflict may arise.
- Disclose your representation to both parties and seek permission from both before accepting the engagement. Do not proceed without permission from both parties.
- Fully disclose to all parties any possible conflicts, their importance, and the lack of confidentiality between parties on matters of joint representation.
- Advise each client to seek independent counsel on the issue of joint representation.
- All parties must give their informed consent, in writing, to joint representation after full disclosure.

Note: To gain informed consent, according to the ABA's Model Rules of Professional Conduct, an attorney "...must make reasonable efforts to ensure that the client or other person possesses information reasonably adequate to make an informed decision" and have it confirmed in writing. Of course, if potential conflicts materialize, joint representation may not be possible, even with informed consent.

Docket Control/Case Inventory

Good caseload management is a critical component of operating an efficient and profitable law firm. It also should result in fewer missed deadlines—a leading source of malpractice suits. It therefore makes good financial sense to institutionalize sound docket control and calendaring procedures. Following are suggested methods firms should consider in managing their docket and scheduling requirements:

- Use one of the many computer-based, automated docket and calendaring systems that are available.
- Employ a docket clerk/administrator to manage a centralized system. Attorneys can complete docket or calendar sheets for the system clerk/administrator to input into the system. Ideally, the system should automatically issue reminders as key dates approach. (Individual attorney diaries should be maintained only as an adjunct to the central calendaring system.)
- Circulate a master calendar firm-wide daily or weekly.

A computerized docket and scheduling system should:

- Employ a master calendar, for each practice group or department, or firm-wide.
- Be integrated across all branch offices.
- Track statute-of-limitation deadlines.
- Be updated daily.
- Be monitored by individuals who have responsibility for ensuring compliance.
- Back up data and store data off site.

Training and Supervision

Proper supervision and training of staff—including keeping up-to-date with new developments in the law, particularly in the firm’s areas of practice—are essential aspects of practice management. Best training and supervision practices include the following.

- A formal training program should specifically address compliance with regulations pertaining to Section 307 of the Public Accounting and Investor Protection Act of 2002 (Sarbanes-Oxley Act). Training should also be offered to new lawyers, including all lateral hires, on practice areas and risk management policies and procedures.
- The firm should have internal continuing legal education (CLE) requirements, including programs on legal ethics and risk management.
- Partners, associates, and counsel/of counsel should be subject to continuous oversight or at least to periodic, formalized performance review by the firm’s practice groups or departments.

Outside Interests

The firm should have policies and procedures with respect to service by any of its attorneys who also serve as officers, directors, or employees of any outside for-profit or not-for-profit business enterprises. These policies and procedures should be in writing, regularly circulated, and explicitly discussed with all newly hired attorneys, including lateral hires. Preferred practices with regard to these policies and procedures include the following:

- Service on outside organizations is not permitted, or service is permitted only with the approval of the risk management partner, general counsel, or a standing committee of the firm charged with overseeing such matters.

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- As a condition of serving as an outside director or officer, the attorney must procure directors and officers (D&O) liability insurance.
 - The attorney is prohibited from providing legal services to the business enterprise.
 - The firm is prohibited from providing legal services to the business enterprise employing a firm attorney. If legal services are provided to the enterprise, the attorney is prohibited from supervising those services.

Suits for Legal Fees

Suits to recover legal fees almost invariably draw countersuits alleging malpractice. For this reason, suits for legal fees should be avoided at all costs. The first goal in this area of practice management should be to avoid fee payment problems from ever occurring. Problems can be minimized in several ways:

- Employ consistent billing and collection procedures.
- Ensure that fee agreements are clearly explained to clients at the outset of the engagement and confirmed in writing. Include an estimate of the total fee, an explanation of additional costs that may be incurred in the course of the matter, and the firm's right to withdraw for nonpayment.
- Manage client expectations so that all parties have a clear understanding of services that will be provided and realistic outcomes.
- Maintain clear, complete, accurate documentation of services rendered and fee calculations.
- Bill frequently and set payment deadlines in order to minimize large outstanding fees.

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- Ensure that fees billed are accurate, complete, and reasonable.
 - Strive for good client relations in every aspect of client contact. A client who has a good relationship with the firm or attorney handling the case is less likely to sue for malpractice.
 - Avoid clients with poor payment histories.

Despite its best efforts, a firm is still likely to face nonpayment situations, so it should have policies and procedures with respect to filing suits over fee collection. One policy might be to simply prohibit such suits and accept a certain percentage of uncollectible fees. If the firm does permit suits over fees, however, several preferred practices are recommended:

- Suits are permitted only with the approval of the risk management partner, general counsel, or a standing committee of the firm charged with overseeing such matters.
- Suits are permitted only after a complete review of the underlying work performed to determine the likelihood and merit of a counterclaim for negligence.
- Suits are permitted only after the relevant statutes of limitation for negligence have expired.

Whether or not a firm allows suits over legal fees, its policies and procedures should be in writing, regularly circulated, and explicitly discussed with all newly hired attorneys, including lateral hires.

Legal Opinions and Audit Responses

The firm should have policies and procedures in place regarding the review and approval of all opinion letters. It should also have clearly defined systems for gathering information and preparing and issuing audit response letters. These policies and procedures should be in writing, regularly

circulated, and explicitly discussed with all newly hired attorneys, including lateral hires.

Practice Group and Matter Management

The firm should have in place effective practice group or departmental management structures in order to:

- Improve oversight of all work in progress for all lawyers in the firm.
- Improve the overall quality of services provided to clients.
- Improve the workload allocation and efficiency of all lawyers in the firm.
- Improve profitability.
- Prevent individual partners (“lone wolves”) or groups of partners (“wolf packs”) from working unsupervised and therefore exposing the firm to potential claims. This is especially important for firms with multiple offices that are thinly staffed.

Money Management and Investment Advice

The firm and its attorneys should never render investment advice to clients or manage their investments. If it or any of its attorneys exercise any discretion or control over any client funds, other than as custodian under the firm’s client trust accounts, then it faces potentially massive liability.

RISK FINANCING AND RISK TRANSFER

Although risks can be mitigated, rarely can they be eliminated. Therefore, a law firm must make decisions, after employing prudent and reasonable risk mitigation techniques, about how to handle its residual risks. The firm's two alternatives are to keep the risk (risk financing) or to transfer the risk (to insurance).

Risk Financing

Law firms may choose to finance malpractice risks in many ways.

After examining their financials, a firm may decide it can afford to absorb the costs of any possible lawsuit. However, given the litigious nature of society, the costs of defending a suit, and the magnitude of jury awards, this is probably an undesirable option for most firms.

Alternatively, a firm may choose to purchase insurance and accept large deductibles or self-insured retentions with the intention of handling small losses themselves and, depending on the insurance, to cover large, potentially catastrophic losses. Or a firm may choose to explore captive options, in which it owns its own "insurance company" (possibly together with other firms). Under this arrangement, it would benefit from the investment income on money put aside to fund losses, and it may also gain tax advantages. However, captives are only suitable for firms with good loss records, strong risk management, and the ability to continue to minimize losses. Captive insurance companies or risk retention groups also typically have smaller capitalization (and thereby less ability to absorb losses) than some commercial insurance companies. Captives and risk retention groups are also often dependent on commercial reinsurance support for financial stability.

Risk Transfer

The vast majority of firms choose to transfer their malpractice risk to an insurance company, via a professional liability insurance policy. Here are some key things to look for when searching for legal malpractice insurance:

- An insurer with expertise in legal malpractice claims, including dedicated specialty claims staff who will handle your claim.
- A highly rated, financially strong insurer that has demonstrated longevity in the market. You want your insurer to be there when you have a claim and to have the financial resources to respond.
- A policy that broadly defines “insured,” as well as key terms such as “professional or legal services,” “loss,” and “claim.”
- A policy that gives the firm the choice of counsel and promptly advances defense costs.
- An insurer with sufficient capacity to offer you the limits you need to cover your firm’s maximum potential loss, including damages and claim expenses.

CONCLUSION

Legal malpractice lawsuits can devastate a law firm. Practice management—and therefore risk management—is critical to the health of a law firm and should be included in every aspect of its business, beginning with the organization and partnership or shareholder agreements and extending to every client contact. Delivery of timely, high-quality legal services and the establishment of centralized policies and procedures, backed by a firm-wide risk management culture, are key factors to preventing professional liability claims.

“Minimizing loss is as much improvement as maximization of profit.”
—Louis Allen



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Form 14-01-0752 (Rev. 2/05)