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LITTLE FISH, BIG PONZI: RECOUPING MADOFF LOSSES THROUGH INSURANCE PROCEEDS

By Jerold Oshinsky, Rachel S. Kronowitz, and Andrea K. Hopkins

The press has been inundated with reports about an enormous ponzi scheme involving billions of dollars lost by investors who relied on Bernard Madoff (“Madoff”). Much already has been written about the Madoff claims, the liabilities, and the federal investigations. But one area of potential recovery for defendants and claimants in Madoff-related cases receiving insufficient focus is insurance coverage issued to financial institutions and professional service providers who supported and advised Madoff. Among other types of insurance that may be available to help defray costs associated with Madoff claims, attention should be specifically focused on fidelity insurance, directors and officers (“D&O”) liability insurance, errors and omissions (“E&O”) or professional liability insurance, and management liability insurance. Claimants with Madoff-related losses are approaching avenues of potential recovery creatively; for example, an ERISA class action was brought last week alleging that Austin Capital Management (“Austin”) failed to conduct adequate due diligence prior to recommending and investing pension funds in Madoff funds (*Pension Fund for Hospital and Health Care Employees v. Austin Capital Management*, E.D. Pa., Feb. 12, 2009). In response, all potential avenues of recovery for defendants like Austin should be pursued.

FIDELITY INSURANCE

The scope of coverage provided by fidelity insurance often is mistakenly thought to be limited to insurance against simple employee theft. But the standard form fidelity insurance policy purchased by many financial institutions, including potential defendants who referred business to Madoff or had other Madoff connections, is much broader. The standard form typically insures against employee fraud or dishonesty—with conditions. The fraud or dishonesty must be committed by the employee with the “manifest intent” to cause a loss to the employer and obtain

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a benefit for the employee (*e.g.*, kickback), or a third person (*e.g.*, business referral) other than compensation for the employee in the normal course of employment. Typical policy language reads:

[This fidelity bond] covers: (A) Loss resulting directly from dishonest or fraudulent acts committed by an Employee acting alone or in collusion with others . . . Such dishonest or fraudulent acts must be committed by the Employee with the manifest intent: (a) to cause the Insured to sustain such loss; and (b) to obtain financial benefit for the Employee or another person or entity.¹

Fidelity policies typically exclude losses relating to loan default, but *not* if the loss occurred due to employee dishonesty. Representative policy language describes the scope of coverage as:

Loss resulting directly from dishonest or fraudulent acts committed by an Employee acting alone or in collusion with others . . . However, if some or all of the Insured's loss results directly or indirectly from Loans, that portion of the loss is not covered unless the Employee was in collusion with one or more parties to the transactions and has received, in connection therewith, a financial benefit with a value of at least \$2,500.²

Therefore, if the facts reveal that a transgressing employee's conduct caused his or her employer to become embroiled in allegations related to Madoff, then fidelity insurance might be a fertile source of recovery to pay investor claims.

Policyholders should note that fidelity policies often contain strict notice requirements. Although the language varies from policy to policy, typical notice provisions might require notice to the insurer of a potential claim as soon as practicable or as soon as the conduct is discovered, but in no event later than sixty (60) days after discovery.

It is agreed that, as a condition precedent to its rights to recover under Insuring Clauses 1, 2, 3, 4, 5, 9(a), 10 or 12, the Assured, shall give written **notice of the discovery of the loss** at the earliest practicable moment and in no event later than sixty (60) days after discovery. The written notice shall provide full particulars including the identity of the person(s) responsible for the loss, the circumstances surrounding the loss, the amount of the loss and any other information which the Assured may so possess . . . It is agreed that, as a condition precedent to its right to recover under Insuring Clauses 6, 9(b), 9(c), 9(d) or 11 of this Bond, the Assured shall give written **notice of any claim made against the Assured** at the earliest practicable moment but in no event later than sixty (60) days following

¹ *Tri City Nat'l Bank v. Fed. Ins. Co.*, 268 Wis. 2d 785, 797, 674 N.W.2d 617, 623 (Wis. Ct. App. 2003).

² Standard Form No. 15 AIG Financial Institution Bond.

the date such claim is made. The written notice shall provide full particulars including the identity of the person(s) responsible for the loss, the circumstances surrounding the loss, the amount of the loss and any other information which the Assured may so possess.³

In addition, the proof of loss requirements are often very specific. Typical language provides:

Within six (6) months after (i) discovery, or (ii) a claim is made or the Assured becomes aware of an error, accidental omission or Theft (whichever event occurs first), or (iii) the Assured has paid the reasonable expenses and attorneys' fees recoverable under Insuring Clause 8, or (iv) the Assured has paid expenses to replace Real Estate Documents recoverable under Insuring Clause 10, the Assured shall furnish to the Underwriters proof of loss duly sworn to by the chief financial officer of the Assured which shall be a narrative with full particulars including but not limited to . . . the Insuring Clause under which the claim is being made, the alleged dishonest or fraudulent conduct . . . the date the Assured discovered the loss and the circumstances surrounding how it was discovered; the amount of the loss; an itemization of the amounts paid out, advanced, withdrawn, taken or otherwise lost; an itemization of the funds or property received from any source whatsoever; the date the loss was sustained; and the circumstances surrounding how it was sustained; and the value of the property lost.⁴

Insurers will resist their obligations to provide coverage if these formal policy requisites are not met.

DIRECTORS AND OFFICERS LIABILITY INSURANCE

D&O insurance is another potentially available path to recovery for Madoff defendants and claimants. In the first instance, in order to preserve a claim for coverage, policyholders and claimants should focus on the following issues: (1) timing and definition of a claim; (2) the fraud and dishonesty exclusions; (3) advancement of defense costs; and (4) the drop-down or "Qualcomm" issue.

1. TIMING AND DEFINITION OF A CLAIM: D&O policies typically require that a claim be made during the policy period against the director or officer, or against the corporation if the policy provides "entity" coverage, and notice be provided to the insurer during the policy or extended reporting period.⁵

³ Standard Form Lloyd's Special Mortgage Bankers Bond (emphasis added).

⁴ *Id.*

⁵ *Am. Special Risk Mgmt. Corp. v. Cahow*, 286 Kan. 1134, 1142, 192 P.3d 614, 621 (Kan. 2008).

A typical “claim” definition in a D&O policy sets forth coverage for the following types of claims:

(1) a written demand for monetary, non-monetary or injunctive relief; (2) a civil, criminal, administrative, regulatory or arbitration proceeding for monetary, nonmonetary or injunctive relief ...; or (3) a civil, criminal, administrative or regulatory investigation of an Insured Person....⁶

The definition of a “claim” or “loss” is often broad enough to include attorneys’ fees incurred in responding to a governmental subpoena or investigation. A typical policy defines “loss” as “any amount which the Insureds are legally obligated to pay for a claim or claims made against them for Wrongful Acts, and shall include . . . defense of legal actions, claims or proceedings.”⁷ Construing such policy language, courts have held that attorney’s fees were “reasonably incurred in ‘defense of ... claims’ under the loss provision of the policy”⁸ and, as a result, they were covered and required to be paid even before a determination of coverage.

2. FRAUD AND DISHONESTY EXCLUSIONS: Most D&O policies contain fraud and dishonesty exclusions. Typical language provides:

This policy excludes coverage for claims “brought about or contributed to by the dishonest, fraudulent, criminal or malicious act or omission of such DIRECTOR or OFFICER if a final adjudication establishes that acts of active and deliberate dishonesty were committed or attempted with actual dishonest purpose and intent and were material to the cause of action so adjudicated.”⁹

These exclusions are the flipside of fidelity insurance which, as described above, expressly covers fraud and dishonesty. But, as noted above, even under the typical D&O exclusion, coverage exists unless and until there has been a negative “final adjudication” of the fraud or dishonesty claim.¹⁰ The key point here is that the insurance company is obligated to pay defense costs, even in *criminal cases*, for potentially covered claims unless and until there has been a final adjudication against the insured that finds that the policyholder acted in a deliberately fraudulent or dishonest manner.

⁶ *AT & T Corp. v. Faraday Capital Ltd.*, 918 A.2d 1104, 1107 (Del. 2007).

⁷ *Polychron v. Crum & Forster Ins. Cos.*, 916 F.2d 461, 462-63 (8th Cir. 1990).

⁸ *Id.*

⁹ *In re Enron Corp. Sec., Derivative & “Erisa” Litig.*, 391 F. Supp. 2d 541, 559 (S.D. Tex. 2005).

¹⁰ The fraud exclusion has traditionally been subject to a “final adjudication” condition that obligates the insurer to fund the criminal and civil defense of directors or officers unless and until the fraud is finally adjudicated in the underlying case.

3. ADVANCEMENT OF DEFENSE COSTS: Typically, D&O policies require insurance companies to “advance” defense costs for a claim that might be covered by the policy; most policies also provide that the cost of defense is included within the limits of the policy. This advancement obligation does not require a prior determination of coverage and is governed by the same potentiality standard that governs the duty to defend. If there is any possibility of coverage, the insurance company must advance defense costs.¹¹

4. QUALCOMM: Finally, policyholders must be mindful of the drop-down issue raised by the specific policy language of certain excess D&O policies. In *Qualcomm*, the court recently held that because the excess policy contained language that required the primary policy to pay its full limits as a pre-condition to the attachment of the excess policy’s obligation, an excess policy was absolved of any liability where the underlying primary policy had not paid its full policy limits.¹²

In contrast, the language of many excess policies require the excess policy to pay after the limit of the primary policy has been paid by either the primary insurance company, the policyholder, or a combination of both. Even some jurisdictions which have addressed the specific *Qualcomm* policy language have come to the opposite and logical conclusion – once the amount of the underlying policy limit has been paid by anyone, the excess policy should be triggered and available to pay claims.¹³ The holdings illustrate the need for policyholders to review carefully the language of their policies. The important lesson here is that policyholders should not accept the *Qualcomm* argument even if they are faced with the same policy language; they should, however, provide for the more acceptable policy language in the future.

ERRORS AND OMISSIONS OR PROFESSIONAL LIABILITY COVERAGE AND MANAGEMENT LIABILITY COVERAGE

Errors and omissions insurance coverage provides broad protection for professionals against liability resulting from negligence, unintentional omissions and professional errors. The scope of coverage of a typical E&O policy states:

The Company shall pay Loss on behalf of the Insureds resulting from any Claim first made against such Insureds and reported to the Company in writing during the Policy Period, or any Extended Reporting Period, for Wrongful Acts

¹¹ See, e.g., *Aetna Cas. & Sur. Co. v. Roe*, 437 Pa. Super. 414, 422, 650 A.2d 94, 98-99 (Pa. Super. Ct. 1994).

¹² *Qualcomm, Inc. v. Certain Underwriters At Lloyds, London*, 161 Cal. App. 4th 184, 193-94, 73 Cal. Rptr. 3d 770, 776-78 (Cal. Ct. App. 2008).

¹³ For example, the Delaware Superior Court interpreted policy language similar to the language at issue in *Qualcomm*, but expressly declined to follow *Qualcomm*’s holding. *HLTH Corp. v. Agric. Excess & Surplus Ins. Co.*, C.A. No. 07C-09-102 RRC, 2008 WL 3413327, at *14 (Del. Super. July 31, 2008). The *HLTH* policy language stated: “Only in the event of exhaustion of the Underlying Limit by reason of the insurers of the Underlying Insurance . . . paying in legal currency loss which, except for the amount thereof, would have been covered hereunder, this policy shall continue in force as primary insurance . . . The risk of uncollectability of any Underlying Insurance . . . is expressly retained by the Insureds...” *Id.*

committed by the Insureds solely in the performance of or failure to perform Insured Services on or after the Prior Acts Date set forth in Item 7 of the Declarations and before the Policy terminates.¹⁴

Madoff-related claims against professional advisors – financial advisors, accountants and other financial service professionals – likely will trigger this valuable coverage. E&O policies protect companies and individuals against claims made by clients for inadequate work or negligent actions; they cover both defense costs and settlements or awards up to the amount of the insurance policy. Registered brokers, dealers, investment advisors and financial planners are often required to carry this coverage. Fund managers also often obtain management liability insurance. These policies typically provide coverage for “any actual or alleged act, error, omission, misstatement, misleading statement or breach of fiduciary duty or other duty committed by any Insured in the performance of, or failure to perform, Professional Services.”¹⁵ Management liability policies work in tandem with the other coverage policies outlined here to help provide seamless coverage for Madofflike claims.

Like D&O coverage, E&O coverage is typically claims made coverage that only responds if a claim is made while the policy is still in force. In order to avoid disputes with insurers, notice of covered claims should be provided to an insurer as soon as practicable. A policyholder may be able to preserve expiring coverage by providing notice of circumstances giving rise to *potential* claims during the policy period. E&O policies may expressly provide for this, stating:

If during the Policy Period an Insured becomes aware of a Wrongful Act **which may subsequently give rise to a Claim**, and during the Policy Period the Insureds: (a) give the Company written notice of such Wrongful Act . . . and (b) request coverage under this Policy . . . then the Company will treat any such subsequently resulting Claim as if it had been made against the Insureds during the Policy Period.¹⁶

Most professional liability policies contain a duty to defend provision, which provides that if any potentially covered claim is made against the insured, the insurer is obligated to defend the claim. Most typical professional liability policies do not include a choice of counsel provision for the policyholder; unless a provision that the policyholder can choose its own counsel is negotiated as part of the underwriting process, the insurer will attempt to control the defense of the claim if the insurer pays defense costs. The policy terms also

¹⁴ Chubb *ProE&O* Policy Specimen.

¹⁵ Standard Form XL Insurance Company Professional Liability Insurance.

¹⁶ Chubb *ProE&O* Policy Specimen (emphasis added).

will determine whether the insurer has a duty to defend an entire claim, even if it includes non-covered allegations against the insured. For example, if a complaint asserts claims of negligence and fraud against a policyholder and the professional liability policy has a fraud exclusion, the insurer is likely to have a duty to defend the entire claim; however the insurer will argue that it will not be obligated to indemnify a policyholder for a portion of a settlement or judgment based on a non-covered allegation.

CONCLUSION

Insurers often resist their coverage obligations whenever confronted with substantial new liability claims – professional liability, corporate governance, asbestos, environmental, pharmaceutical product liability. Insurers can be expected to assert the same resistance here, but the costs of defense and the liability for Madoff claims is likely to be covered by one or more of the various lines of insurance typically purchased by the financial services companies, professional service providers and individuals who may be caught in the web of Madoff-related claims. The most effective means to ensure coverage under these policies is to review the language of the contracts carefully, provide notice early and resolve coverage disputes with insurers promptly.