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INSURANCE PRIMER FOR FINANCIAL SERVICES FIRMS

By *Chidi J. Ogene*

OVERVIEW

The ripple effects of the Madoff, Stanford and other investment scandals continue to extend outward. In addition to the class-action lawsuits against Madoff, Stanford, and others alleged to be directly culpable, an increasing number of professional advisers are being sued. These advisers include brokers, “feeder” hedge funds that invested in Madoff’s fund, and the accountants to the feeder hedge funds.

Given the scale of the alleged frauds and the continued proliferation of lawsuits, many financial services firms should be taking a very hard look at their insurance as an avenue for mitigating potential steep losses. This insurance typically will consist of one or more of the following types of policies: Directors and Officers (“D&O”) insurance; Errors and Omissions (“E&O”) insurance, including professional liability insurance; and Fidelity Policies. These firms may also have purchased more specialized types of insurance.

PRACTICAL TIPS FOR PRESERVING COVERAGE FOR FINANCIAL SERVICES FIRMS

Financial services firms should take the following steps to preserve their insurance coverage, if they have not already done so:

1. *Place their insurance companies on notice.* These policies are almost always “claims-made” policies, meaning they usually provide coverage only when the claim is made during the operative period of the policy and the insurance company is notified in accordance with the policy provisions.

Even if a claim has not yet been made, the policies typically permit the policyholder to notify the insurer of “circumstances” that might eventually give rise to a claim.

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It often is important to provide notice of a claim or circumstances under the existing insurance policy. Many policies have an annual period, in which case coverage will not apply unless the insurer has been notified before the policy period expires. Even if no claim has yet been asserted, providing notice of circumstances operates as a safe harbor to preserve coverage for claims asserted after the expiration of the policy period. Insurers likely will exclude or severely limit coverage for Madoff-type claims going forward, making it all the more important to provide notice of a claim or circumstances under the expiring policies. The notice should be as specific as possible. The policy language usually provides the guidelines.

2. *Read the Policies.* It is important to understand what each type of policy covers. Broadly speaking, D&O and E&O policies cover wrongdoing like negligence, but exclude fraud, dishonesty, or illegal profits. However, even where fraud or dishonesty is alleged, the policies will pay for defending the policyholder against these claims until such conduct is established – *i.e.*, finally adjudicated. In contrast, fidelity policies typically cover fraud and dishonesty claims. But the language of each policy will differ from insurer to insurer, and from financial firm to financial firm. The particular language of the policy will affect such issues as exclusions and the insurer’s obligation to pay defense costs.
3. *Get it in Writing.* Some policies may purport to provide coverage only from the time a written demand is made against the policyholder, or a governmental or private proceeding is formally instituted. The financial firm often incurs substantial costs in advance of written notification or formal initiation of proceedings, such as where the firm retains outside counsel to assist in the investigation and response to an oral inquiry from the government or an aggrieved investor. The insurer then argues that these costs are not covered. To avoid this result, the firm should endeavor to get these oral inquiries reduced to writing, and sent to the firm’s insurers. Also, even in the absence of a formal demand, the policyholder may be able to contend that the correspondence with the claimant rises to the level of a written demand.
4. *Involve the Insurers.* Insurers typically argue that their policies require the policyholders to apprise them of developments with the claim, and in certain circumstances to give the insurer an opportunity to participate in resolving the claim. Insurers often allege that their policyholder failed to meet these obligations, and that the policy provides no coverage as a result. Accordingly, it is important to provide information to the insurer, and to consult with the insurer periodically in the defense and settlement of a claim. If the insurer declines to defend the case or participate in settlement, or otherwise reserves its rights, the firm may be relieved of any obligation to keep the insurer apprised.
5. *Understand the Deductibles/Retentions.* Many policies have deductibles or self-insured retentions (“SIRs”), which may affect the timing as to when the insurer is required to cover the claim. Insurers typically contend that there is a difference between deductibles or SIRs: generally speaking, in the case of a deductible, the insurer will retain responsibility for claims,

but subtract the deductible from the amount it pays. In contrast, in the case of an SIR, the insurer generally contends that it has no responsibility for handling claims until the policyholder pays the SIR amount. Another important issue to consider is whether defense costs apply towards the deductible or SIR: to the extent that they do, the insurers' obligations arise that much sooner.

6. *Be Alert to Potential Conflicts.* Even if the policyholder has done all the right things – read the policies, notified its insurer, and kept the insurer involved during the case – there still is the potential for conflict with the insurer down the road. For instance, the insurer might be paying for the policyholder's defense costs under the terms of the policy. If, however, facts develop to suggest that an exclusion in the policy potentially applies, the insurer-appointed defense counsel may face a conflict of interest. If this happens, the firm will usually be entitled to appoint independent counsel, at the insurer's expense.
7. *Consider Suing.* If the insurer proves intractable in denying coverage for a claim, the policyholder may have no recourse but to sue the insurer. The decision to sue is not made easily, and typically will require input from all the stakeholders: the board of directors, management, the board, and outside counsel. In evaluating whether to sue the insurer, here are a few considerations to bear in mind:
 - Statute of Limitations: Typically, the claim against the insurer will include breach of contract. The statute of limitations for breaches of contract generally is no more than six years (and in many instances shorter), and there often are questions as to what actions cause the limitations period to begin running. If discussions with the insurer are continuing, but significant time has elapsed, the policyholder would be prudent to negotiate a "tolling" agreement with the insurer.
 - Choice of Law: Insurance law varies considerably from state to state. Because insurance policies rarely have a governing law provision, it is important to assess which state's law potentially applies, and then choose the forum likely to adopt the law that is most favorable to the firm. Many states use the Restatement (Second) of Conflicts approach, which applies the law of the state with the most significant relationship to the dispute. In the specific context of insurance policies, the Restatement further provides that the governing law is the local law of the state that the policyholder and the insurer understood to be the principal location of the insured risk. Often, but not always, courts use the policyholder's principal place of business as a proxy for the "principal location of the insured risk," particularly where the insurance policy covers risks located in several states.

Taking these steps will help preserve insurance coverage that is sure to prove valuable in defending claims.