610 Insurance Claims & the Board of Directors: Is There a Conflict of Interest?

Michael Brown
Partner
Ohrenstein & Brown LLP

Suzanne Cruse
General Counsel
Kozy Shack Enterprises, Inc.

Geoffrey W. Heineman
Partner
Ohrenstein & Brown LLP

Ernest J. Newborn II
Senior Vice President & General Counsel
USI Holdings Corporation

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Faculty Biographies

Michael Brown

Michael D. Brown is a founding partner of Ohrenstein & Brown, LLP whose practice spans the litigation, corporate and insurance regulatory arenas. An accomplished litigator and counselor, Mr. Brown is a frequent lecturer for many organizations and has spoken on a variety of topics including claims defense management and litigation management techniques, the regulatory aspects of self-insurance and captive insurance programs, and the prospects for federal regulation of the insurance industry.

Mr. Brown has served as chairman of the subcommittee on Insurance Demutualization of the Association of the Bar of the city of New York and on the boards of directors of several publicly owned companies.

Mr. Brown earned his B.A. at Beloit College and his law degree at New York University School of Law. Mike was a Special assistant attorney general (New York), deputy bureau chief and senior trial attorney.

Suzanne Cruse
General Counsel
Kozy Shack Enterprises, Inc.

Geoffrey W. Heineman

Geoffrey W. Heineman is the managing partner of Ohrenstein & Brown. His practice is concentrated in the area of business litigation with extensive experience litigating securities, directors and officers, RICO, construction, professional liability (including lawyers, agents, brokers, architects and engineers) and intellectual property matters. He also has wide-ranging experience in insurance coverage, with an emphasis on policies issued to directors and officers, accountants, attorneys, other professionals including insurance agents and brokers.

Mr. Heineman is a frequent lecturer to accounting firms on claims defense management and loss prevention techniques.

Mr. Heineman received his B.A. from New York University and his law degree from St. John's University School of Law. He also earned an LL.M. in corporation and securities law from New York University School of Law.

Ernest J. Newborn II

Ernest J. Newborn II is senior vice president, general counsel, and secretary of USI Holdings Corporation, the nation’s ninth largest insurance brokerage and a NASDAQ listed public company. In significant part through the management of the company’s in house lawyers and outside counsel, he has ultimate executive responsibility for the legal health of the company and its subsidiaries and affiliates. As the company’s chief legal officer and corporate secretary, Mr. Newborn is also the company’s senior advisor to the board of directors on governance matters, and the senior management on strategic and operational concerns of the company, including matters involving the company’s acquisition activity, public reporting, material litigation and regulatory matters.

Mr. Newborn has over twenty years of legal experience, including fifteen in the insurance and financial services industry. His insurance career began as associate general counsel for Anthem, Inc., now known as WellPoint, Inc., one of the nation’s leading health benefits companies. Prior to joining USI, Mr. Newborn was vice president, general counsel and corporate secretary at Acordia, Inc., which, at the time of Mr. Newborn’s tenure, was a publicly held insurance brokerage company.

Mr. Newborn also serves on the board of directors and is the chairman of the audit committee of the board of directors of USA Funds, the nation’s leading education and student loan guarantor.

After graduating from Drake University, Mr. Newborn received his law degree from the University of Michigan.

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Insurance Claims & the Board of Directors: Is There a Conflict of Interest?

Description:

In an insurance claim, problems can and do arise when outside counsel, retained by the insurance company, is faced with defending a lawsuit that contains both covered and uncovered causes of action. What is the in-house attorney's role in securing the insured company's rights? How can you successfully manage defense counsel to ensure there is a cooperative relationship with your insurer? Learn the importance of due diligence, severability clauses, and how to avoid conflicts of interest and manage outside counsel's role and responsibilities to both the insured and the insurer.

Hypothetical Cases:

In order to demonstrate the challenges that in-house counsel face in their efforts to insure both their company's interests and those of their directors and officers, we have developed two hypothetical cases. The first one follows a publicly traded company through the underwriting process. In this instance, the in-house counsel is not an active participant in the insurance renewal process. To further complicate the situation, our GC receives a letter from the SEC advising the company that it is the subject of an informal investigation regarding its accounting practices. What impact does this have on the company and its officers?

In the second scenario, we examine the often complex process once a claim has been filed. Our GC deals with a reservation of rights and insured vs insured exclusions. There is multiple defense counsel involved. Who is protected and at what cost? Each fact pattern was developed from actual cases managed by members of the panel and each panelist will share additional "war stories" that underline the need for pro-active management of the underwriting and claims process by in-house counsel.

Panelists:

Michael Brown
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Case 1: Underwriting

In April 2003, ABC, Inc. ("ABC"), a publicly traded company (although 60% of the company was purportedly owned by the management team) in the business of financing medical equipment and receivables contacted its insurance broker regarding renewal of its Directors & Officers insurance coverage for the 2003-2004 policy period. ABC had been insured by the same insurer since 1990. However, in an effort to obtain a lower premium quotation, ABC asked its broker to inquire of other insurers. ABC, through its Chief Operating Officer Mr. Oblivious, represented in an application for Directors & Officers insurance to Acme Insurance Company that in the past 5 years it had not been involved in any litigation, administrative proceeding, or investigation. Mr. Oblivious further represented that ABC had never submitted a claim or notice of circumstance under its prior directors & officers' coverage and that no loss payments had been made on its behalf. Finally, the application represented that no person proposed for coverage was aware of any or circumstance, alleged or otherwise, that might give rise to a claim. Unfortunately, Mr. Oblivious failed to sufficiently poll the other officers of ABC to confirm that in fact no one was aware of any issues that warranted disclosure to Acme. In fact, the Chief Executive Officer, Mr. Greedy, and the Chief Financial Officer, Mr. Spineless, were engaged in a number of questionable activities. Mr. Greedy and Mr. Spineless had for years been double-pledging collateral, improperly including as assets receivables that would never be collected, and moving impaired accounts around the books in order to inflate ABC's revenues. Rather than speak with each senior officer personally, Mr. Oblivious simply circulated an email asking if anyone knew of any facts or circumstances that should be disclosed to Acme in the application for insurance. Everyone responded that they did not.

The Acme application, signed in Pennsylvania, states under Section 10 False Information that under Pennsylvania law any person who knowingly and with intent to defraud any insurance company or other person files an application for insurance or statement of claim containing any materially false information or conceals for the purpose of misleading, information concerning any fact material thereto commits a fraudulent insurance act, which is a crime and subjects such persons to criminal and civil penalties. The Acme application is silent as to the severability of the representations, in other words, whether the statements by Mr. Oblivious can be imputed to other

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officers who may be innocent of any wrongdoing and had no knowledge of the activities of Mr. Greedy and Mr. Spineless.

The Acme application additionally contains a declaration by the signor that to the best of his knowledge and belief the statements set forth in the application are true, that the application and its attachments are the basis of the contract should a policy be issued, shall be deemed a part of the policy, and most importantly that if the information in application materially changes between the date of the application and the inception of the policy the signor will immediately report the change in writing to Acme. Acme then has the right to withdraw or modify any outstanding quotations or agreements to bind coverage.

Acme quoted an aggregate limit of liability of $10,000,000, subject to a $250,000 deductible for Insuring Clause B, for a premium of $375,000. Acme agreed to provide severability with respect to the signing of the application and all exclusions, final adjudication for the criminal and fraudulent acts exclusion, the definition of a claim including written demands for monetary damages and regulatory or investigative proceedings and the advancement of defense costs, among other things.

Because Acme had not yet issued the policy, ABC, through its broker, repeatedly requested that the binder period be extended. During this time, the broker also obtained a $5 million excess policy from another insurer. It was also during this period that ABC's accountant withdrew from its representation of ABC and refused to sign off on its financial reports to the SEC. Shortly thereafter, ABC received a letter from the SEC advising the company that it was the subject of an informal investigation regarding its accounting practices.

ABC, at the time the policy was bound had market cap of $135 million and a share price of approximately $9.

The policy was finally issued to ABC in August 2003 subject to a reservation of rights in which Acme stated that it would rescind the policy in the event facts developed which indicated ABC failed to disclose material adverse information in the application or during the binder period due to the fact that ABC and two of its officers had been sued for allegedly violating securities laws. Approximately one month later ABC filed for voluntary bankruptcy protection.

Case 2: Claims Management

In June 2001, ABC Company ("ABC") provided its insurer, Acme Insurance Company ("Acme") with notice of circumstances of a number of potential claims against it arising out of state regulatory inquiries in which it was alleged ABC engaged in market manipulation of the natural gas and electrical power markets. ABC ultimately settled the state's claims, admitting no liability, and seeking no insurance coverage for the settlement given the fact that the policy expressly excluded coverage for regulatory investigations. Approximately one year later, ABC was sued by its shareholders for allegedly manipulating the energy markets and engaging in deceptive accounting practices. ABC placed Acme on notice of these claims and asserted that they were subject to coverage under its 2001-2002 policy because they related back to the original notices of circumstance provided in June 2001.

Acme accepted notice of the claims and began its coverage investigation. ABC also sought Acme's consent to the retention of defense counsel. While rarely an issue of contention between and insurer and its insured, given that a large number of directors and officers were named in these claims and had arguably adverse interests, it was necessary to retain several different defense attorneys. ABC and Acme shared the concern that such a large number of different defense lawyers would erode the available insurance monies too rapidly. ABC retained "coverage counsel" at its own cost to assist in the coordination and management of all of the defense attorneys. Shortly thereafter, Acme informed ABC that it was reserving its rights to deny coverage on a number of grounds including fraud, late notice, personal profit, and fines and penalties. Acme also reserved its rights to rescind the coverage in its entirety given the fact that the financial statements on which it based its issuance of the policy were allegedly misstated. Thereafter, the numerous complaints were consolidated. Acme continued to provide coverage subject to a reservation of rights. In 2003, another lawsuit was commenced against ABC by the former president of a company that had been acquired by ABC in 2000. That lawsuit alleged that the merger was the result of fraudulent inducement and that ABC had been wrongfully misstating its oil and gas reserves for years. Because these allegations were substantially connected to the allegations already asserted and consolidated, all of the matters were consolidated under this single case. This case, however, raised the same issues with regard to insurance coverage, and in fact possibly provided Acme with greater grounds on which to deny coverage by potentially implicated the Insured v. Insured exclusion.

Key Points:

- GCs need to participate in the application and renewal process. GCs play a critical role in insuring the company has the best coverage possible. Process should not be left to the financial officers, insurers and brokers.
  - The Board needs to understand what the D&O policy does and doesn't do, and how the company's advancement/indemnification provisions intersect with D&O coverage. It is the GC's job to communicate the board's priorities in connection with D&O insurance purchases.
  - In privately held companies that do not have a Risk Manager, GC is closest to asses risks in contracts, human resources and procurement and product liability and will be able to determine whether certain exclusions in policies must be removed.
  - Sarbanes-Oxley requirements and ongoing internal strategic initiatives (whether acquisitions, divestitures or restructurings) all have potential impact on D&O coverage buying decisions, and priorities must be evaluated and weighed by GC as part of overall insurance purchase decision.

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- Lack of precision in the area of policy drafting could have serious coverage implications and the GC needs to get involved to make sure there is no failure of expectations.

- Cash flow: it's very frustrating for insureds to be expected to pay substantial D&O premiums long before policies are drafted and issued, but then to wait months and months for D&O insurers to reimburse unchallenged expenses when a claim is made. GC has to explain to management why this occurs. This is a major credibility challenge for an industry that considers itself a "service business."

- Importance of policy reviews when policy is often drafted months after binding and errors or mischief can occur.
  - Be aware of your coverage during the binder period.

- GCs should retain their own outside counsel even if there are costs associated with this decision. Costs can be saved by working with outside counsel. With a deductible, the GC is in the best position to gather facts and draft a position statement. Outside counsel can finalize and submit. General Counsel can keep the insurance company advised of the status of the case. General Counsel is usually in the best position to know when to proceed with litigation and when to settle. Without input from the GC, the company may pay litigation fees that double the amount of a settlement.

- D&O insurer claims reputations are very important. Broker GCs talk to each other frequently, and are part of the same industry working groups. If a D&O insurer is adopting a very aggressive claims strategy, this type of information makes its way around, and GCs owe it to their boards and management to factor that information into their D&O purchasing decisions.

- GC needs to insure that the carrier's form is used as a jumping off point from which coverage enhancements should be negotiated.

  - The days when D&O purchasers simply rolled over on their renewals are long gone. Just as the brokers we employ expect to be grilled by our clients on cutting edge developments in exposure and coverage, we expect our brokers and carriers to be knowledgeable about current issues, and to share that information with us -- without GCs having to ask for it. We have to be informed purchasers of this very expensive and complex insurance contract. We expect our partners on the brokerage and carrier side to work with us to achieve a level of knowledge where we can make informed purchasing decisions.
  - Policies are not in set forms, ask questions and request custom clauses.
  - Reservation of rights letters that overreach deserve a written response. For example, disparate treatment vs. disparate impact.

- Key Policy Wording Considerations:
  - Definition of a Claim.
  - Personal Conduct Exclusion.
  - Severability of Knowledge.

- GC needs to insure that the D&O insurance application is accurate and complete and that appropriate steps have been taken to provide necessary comfort.
  - Due diligence is critical. Interview each director or officer that would be covered by a D&O policy. Directors and officers have a fiduciary duty to disclose any potential conflict. If conflict is not disclosed, what are the liabilities of the company and its officers? Review severability clauses.
  - Importance of the Insured Representation Clause within the policy.
    - Duty to update

The Do's and Don'ts for General Counsel When Acquiring Insurance Policies:

√	DO remain involved in the process even if there is a dedicated Risk Manager assigned to acquire insurance coverage.
√	DO review various quotes and policy forms from competing insurers when acquiring coverage as not all policies are created equal. Again, include yourself in this review even if there is a dedicated Risk Manager assigned the task.
√	DO request to see several representative polices, even from the same insurer.
√	DO conduct private, individual, face-to-face discussions with senior and/or executive officers regarding any potential issues prior to completion and submission of the application for coverage.
X	DON'T rely on a basic survey (by email or otherwise) of the other officers to uncover information which should be disclosed in the application.
√	DO disclose in the application any potential circumstances uncovered while polling the other officers.
√	DO disclose in the application any potential circumstances known to you, even if you believe no claim will ever arise. Feel free to state your opinion that no claim is likely, but nonetheless disclose the existence of the possibility.
√	DO review all binders and binder extension carefully to be sure all terms and conditions negotiated are correctly represented.
√	DO request modification and revision to boilerplate policy language where appropriate. As long as the intent of both parties are properly memorialized this can be done even after the policy has been issued but is easiest when negotiated prior to the issuance of the binder.

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- [√] DO disclose to the insurer any change in facts or circumstances disclosed in the application.
- [√] DO request severability with respect to the signor of the application and the other officers and directors.
- [√] DO review your policy and become comfortable with its coverage when it is issued, BEFORE any claim arises.

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