

*We are pleased to share this latest issue of the Wiggin and Dana Insurance Practice Group Newsletter. We circulate this newsletter by e-mail periodically to bring to the attention of our colleagues in the insurance industry reports on recent developments, cases and legislative/regulatory actions of interest, and happenings at Wiggin and Dana. We welcome your comments and questions.*

## WIGGIN AND DANA INSURANCE PRACTICE GROUP

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## WIGGIN AND DANA LLP ANNOUNCES THE FORMATION OF ITS PRIVACY AND INFORMATION SECURITY PRACTICE GROUP

Wiggin and Dana lawyers have been helping clients with their data protection and security issues for several years. To formalize its work across several industries, Wiggin and Dana is pleased to announce the launch of its Privacy and Information Security Practice, which integrates the extensive privacy work that the firm has been performing across a broad range of disciplines, including services for the insurance industry. For additional information, visit [www.wiggin.com](http://www.wiggin.com).

## WIGGIN AND DANA'S MEMBERSHIP IN THE INTERNATIONAL ASSOCIATION OF PRIVACY PROFESSIONALS

The International Association of Privacy Professionals has accepted Wiggin and Dana as a corporate member. Additionally, several Wiggin and Dana lawyers are in the process of becoming Certified Information Privacy Professionals. The CIPP designation indicates the mastery of a specialized principles-based framework and knowledge base in information privacy.

## PUBLICATIONS OF INTEREST

The American Bar Association, Tort Trial and Insurance Section, Insurance Coverage Litigation Committee has announced the availability of *The Reference Handbook on The Comprehensive General Liability Policy*. This new publication is a comprehensive work of over 800 pages addressing all aspects of the CGL policy. Several current and former Wiggin and Dana Associates, including Alison Weir, Michael Kenny, Richard Ramsay, Rachel Priester and Aaron Singer assisted with Chapter 9 on Principal Exclusions. The Reference Handbook is now available for order at [www.ababooks.org](http://www.ababooks.org).

Conning Insurance Research and Consulting recently released a new in-depth study on the Lloyd's market. The report is called *Lloyd's in the 21<sup>st</sup> Century: After the Precipice*. According to Conning, this "first in-depth study of Lloyd's in a decade finds an institution transformed from its troubled former self to a market that is modern and relevant globally. Capital composition, membership standards, governance, controls, and processes have been overhauled, tightened, and modernized. This study reviews the recent developments at Lloyd's, examines the current challenges for the market, and extracts insights from the Lloyd's model of value to U.S. property-casualty insurers in their own strategic planning. We review the performance of Lloyd's,

## ATTORNEY NOTES

**Wiggin and Dana Lawyer  
Named to Who's Who Legal**

Wiggin and Dana is pleased to announce that Joe Grasso, Partner and Co-Chair of the firm's Insurance Practice Group, was named to the 2010 Who's Who Legal publication for Shipping and Maritime law. Since 1996 Who's Who Legal has identified the foremost legal practitioners in 31 areas of business law, featuring over 10,000 of the world's leading private practice lawyers in over 100 countries. It is impossible to buy entry into this publication. For more information about Who's Who Legal, please visit <http://www.whoswholegal.com>.

**Alison Weir** was elected to the Maritime Law Association of the United States, which seeks to advance reforms in the Maritime Law of the United States, to facilitate the administration of justice, and to promote uniformity in its enactment and interpretation.

**Tim Diemand and Michael Menapace** participated in the ARIAS U.S. reinsurance meeting in New York City from November 4-5. The theme of the 2010 Fall conference was Arbitration Without Borders: Lessons We Can Learn from International Arbitration.

**Michael Menapace** participated in Insurance Day, a day-long educational seminar for ocean marine underwriters, claims handlers, adjusters, and other personnel, which is jointly sponsored by the American Institute of Marine Underwriters, the American Marine Insurance Forum, the Association of Average Adjusters of the U.S., the Marine and Insurance Claim Association, and the Marine-Claims Recovery Forum.

benchmarking its results against other global markets." For additional information on the study, <http://www.conning.com/viewpublications-article.aspx?id=4684>.

## WHEN WORLDS COLLIDE: THE BATTLE FOR D&O INSURANCE PROCEEDS IN BANKRUPTCY

*By Sharyn B. Zuch and Michael Menapace*

*A VERSION OF THE FOLLOWING ARTICLE WAS PUBLISHED IN THE OCTOBER 2010 ISSUE OF THE AMERICAN BANKRUPTCY INSTITUTE JOURNAL.*

### I. SETTING THE STAGE FOR THE FIGHT

Directors and officers of large companies expect their benefits include insurance to protect them from third-party claims arising from actions they take performing their corporate duties. This coverage, known as directors and officers ("D&O") insurance, indemnifies directors and officers and pays defense costs in actions brought against them in their corporate capacities. Directors and officers rely on this coverage when making hard decisions and taking risks that they believe will ultimately benefit the corporation. However, if the company files for bankruptcy, or is placed into a receivership, they may be surprised to find themselves battling for their D&O benefits with a trustee or receiver who contends that the proceeds belong to the debtor's estate. Moreover, the D&O insurer can become embroiled in the fight because it does not know whom to pay. How can this happen?

This article examines the increasingly common conflict over D&O proceeds between estate fiduciaries and directors and officers. These fights may arise more frequently in high-stakes financial fraud cases with criminal cases pending against the directors and officers in addition to securities violations alleged against the company.<sup>121</sup> While most companies purchase D&O coverage with sufficiently high limits, when a company collapses due to alleged financial fraud such as a Ponzi scheme, the resulting creditors' claims may exceed the policy limits and the company's other unencumbered assets. This sets the stage for a battle between the estate representative and the directors and officers over D&O proceeds.

Such a drama recently played out between the receiver and the alleged Ponzi scheme masterminds in the *Stanford Financial Group* case pending in the federal district court in Dallas.<sup>121</sup> In February 2009, The Securities and Exchange Commission ("SEC") seized the assets of Stanford Financial Group ("Stanford") and its affiliates. Prosecutors charged R. Allen Stanford and some of Stanford's directors and officers, including Laura Pendergest-Holt, the chief investment officer, with facilitating a massive Ponzi scheme. Initially, the individual insureds ultimately gained access to the D&O coverage to fight the criminal charges after months of uncertainty and a hard-fought battle with the Stanford receiver for access to the proceeds of three D&O policies. However, in October 2010, after a review by the Fifth Circuit Court of Appeals, the court granted the insurers' motion to vacate the preliminary injunction that had ordered them to pay defense costs and expenses. Citing the guilty plea entered by Stanford CFO, the court found that the insurers had proved a substantial likelihood that a preponderance of the evidence would show that the policy's money laundering exclusion applies.<sup>131</sup>

Historically, courts have been sympathetic to the notion that the directors and officers rely on the existence of the D&O coverage and have understood that companies may have difficulty in attracting independent directors without generous D&O coverage. Indeed, courts have generally respected D&O policy language requiring that directors' and officers' defense costs get paid first, as specified in priority of payment provisions. For instance, in the *Enron* case, the debtors'

## ATTORNEY NOTES

**Sabrina Houlton** attended the Connecticut Privacy Forum, which is a gathering of privacy professionals and lawyers from the New England area with presentations on a variety of privacy issues confronted by companies in the insurance, financial, and higher education industries.

**Michael Menapace** was a panelist for an Insurance Law program sponsored by the Connecticut Bar Association's Young Lawyers Section.

**Joe Grasso** recently attended in the Fort Lauderdale Mariner's Club Seminar and the Annual Fall Meeting of the Maritime Law Association in Houston, Texas. Joe also presented the Annual Legal Update at the American Institute of Marine Underwriters Annual General Meeting in New York City.

interest in the D&O policy was limited by its clear language and the court upheld the priority of payment provision, which favored payment of the directors' and officers' defense costs.<sup>141</sup>

Courts addressing this priority of payment issue usually look first to the policy language to resolve the dispute between the insureds and the trustee or receiver. However, many D&O policies lack clearly worded priority of payment provisions or, in some cases, lack one entirely. In these instances, the courts have been left to carve up the policy limits based on the Bankruptcy Code and general rules of equity. On occasion, these principles have led to some peculiar results, and it is expected that bankruptcy trustees and receivers in high profile cases will become more aggressive and creative in seeking to recover D&O proceeds in the future.

## II. TYPES OF D&amp;O COVERAGE: A, B, AND C SIDE

Current D&O policies covering for-profit entities and their directors and officers typically provide three kinds of coverage against third-party claims made during the policy period. Side A coverage is conventional direct-liability coverage which pays directors' and officers' defense and indemnity costs if the company has not agreed to indemnify them. Side B coverage is indirect indemnification which pays the company for the defense and indemnity of its directors and officers if the company has agreed to indemnify them. Side C coverage, which is relatively new, is direct entity coverage that pays the insured company for its own defense and indemnity costs when a securities claim is made directly against it.

While a company may purchase a single D&O policy, most will purchase a D&O program, called an insurance tower, which consists of multiple policies, with stacked limits. For example, a company may have a self-insured retention (or a deductible) for the first \$1 million of defense and indemnity costs. Insurer #1 may then provide \$4 million of coverage in excess of the \$1 million retention, Insurer #2 may provide the next \$10 million in excess of the first \$5 million (\$1 million retention and the \$4 million from Insurer #1), and Insurers #3 and #4 may each provide 50 percent of next \$20 million defense and indemnity costs above \$15 million, for a total policy limit of \$35 million.<sup>151</sup> The structure of these insurance towers can be much more sophisticated and the limits can, and often do, go much higher. The important point in this fact pattern is that the potential liabilities resulting from fraudulent financial activities are likely to be much higher than the typical limits of D&O insurance that the company would purchase.

Assume a hypothetical company's \$50 million Ponzi scheme has collapsed. The directors, officers and the company have all been sued by investors for \$50 million in damages for securities fraud and there are also criminal charges pending against the directors and officers. The company has no real assets, and the directors and officers have incurred \$5 million in attorney's fees. The \$35 million of insurance limits described above are clearly insufficient to pay both the directors' and officers' indemnity and defense costs and the claims against company. If our hypothetical company ends up in bankruptcy, the trustee's compensation under §§ 326 and 330 of the Bankruptcy Code will be based upon the amount of money disbursed to parties in interest in the case. It is therefore easy to see that the trustee will be incentivized to fight mightily to have the policy limits included as assets of the bankruptcy estate.

## III. INSURANCE POLICIES ARE PROPERTY OF THE ESTATE; PROCEEDS MAY OR MAY NOT BE

It is Black Letter Law that insurance policies are property of the estate under § 541 of the Bankruptcy Code. See *e.g. MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89 (2d Cir. 1988); *In re Louisiana World Exposition, Inc. v. Fed. Ins. Co. (In re La. World Exposition, Inc.)*, 832 F.2d 1391 (5th Cir. 1987). Therefore, the automatic stay applies to any action to obtain possession or control of D&O policies. However, the issue of whether D&O proceeds are property of the estate is a question about which the courts have not achieved a consensus. Even the methods of analysis have not been uniform. The inquiries have been fact-specific and seem to turn on the issues of how immediate is the directors' and officers' need for the coverage compared to how

#### ABOUT WIGGIN AND DANA'S INSURANCE PRACTICE GROUP

Highly regarded and deeply experienced, the Wiggin and Dana Insurance Practice Group provides international, national and regional insurers, reinsurers, brokers, other professionals and industry trade groups with effective and efficient representation. Our group members regularly advise clients in connection with coverage issues, defense and monitoring of complex claims, regulatory proceedings, policy wordings, internal business practices, and state and federal investigations. We also defend clients faced with individual lawsuits and class actions – both at trial and on appeal; and represent clients in insurance and reinsurance arbitrations. We have broad experience in many substantive areas, including property, commercial general liability, inland and ocean marine, reinsurance, E&O, D&O, and other professional liability environmental, and aviation. A more detailed description of the Insurance Practice Group, and biographies of our attorneys appear at [www.wiggin.com](http://www.wiggin.com).

remote or speculative is the likelihood that the debtor will actually face third party actions and submit a claim for coverage.

At one end of the spectrum are the cases such as *In re Adelpia Communications Corp.*, 298 B.R. 49 (S.D.N.Y. 2003), which held that Adelpia's D&O proceeds, urgently needed by the company's former CEO and other executives to defend themselves in their civil and criminal corporate fraud cases, were not property of the estate. The debtors had "[n]o cognizable equitable and legal interest" in the proceeds since they had not made any payments for which they were entitled to indemnification, nor had they even committed to making such payments using their entity coverage. *Id.* at 53. The court analogized the debtors' claim to the D&O proceeds to a car owner's claim that he has a present right to the proceeds from his collision policy just because he might crash into someone the next day. *Id.*

The *Lehman Brothers* court similarly resolved the conflict concerning a suit against Lehman's directors and officers. The debtors moved for an order to modify the automatic stay to fund a \$1.6 million settlement in the Openwave litigation from D&O policy limits of \$250 million. The policies had no side C coverage. Although they had not yet asserted any claims against the Lehman officers and directors, three creditors objected to the lift stay motion, on grounds that the settlement would deplete the policy limits otherwise available to them. The court overruled the objections and granted the motion to allow the insurers to fund the settlement from the D&O limits, finding that the objections were premature and "predicated on a great deal of speculation."<sup>61</sup> See also, *In re La. World Exposition, Inc.*, 832 F.2d at 1401 (holding that the proceeds of a D&O policy, which had no C side coverage, belonged only to the executives); *In re World Health Alternatives, Inc.*, 369 B.R. 805, 811 (Bankr. D. Del. 2007) (finding that D&O proceeds were not property of the estate and the directors and officers were entitled to use D&O A side coverage to fund the settlement of a securities fraud case where debtor had no B side indemnification claim); *Ochs v. Lipson (In re First Cent. Fin. Corp.)*, 238 B. R. 9, 10 (Bankr. E.D.N.Y. 1999) (concluding that D&O proceeds were not estate property because no securities claim had been brought against the debtor or were even threatened, stating "[i]f entity coverage is hypothetical it cannot be used by the trustee to lever himself into a position of first entitlement" to the proceeds).

At the other end of the spectrum are cases holding that the estate does have an interest in the D&O proceeds and that they are property of the estate. For instance, the court in *In re Cybermedica, Inc.*, 280 B.R. 12, 15 (Bankr. D. Mass. 2002) held that the D&O proceeds were property of the estate because "the estate is worth more with it than without it." See also *Homsy v. Floyd (In re Vitek, Inc.)*, 51 F.3d 530, 538 (5th Cir. 1995) (reinstating the bankruptcy court's order authorizing the bankruptcy trustee to use all D&O proceeds to settle mass tort litigation against the debtor to the detriment if its coinsured officers).

Importantly, even courts finding D&O proceeds to be property of the estate attempt to balance the directors' and officers' immediate needs to have their defense costs paid against the estate's need for the benefits. The *Cybermedica* court, for example, lifted the automatic stay to give two of the company's directors the right to seek payment of their defense costs in a suit brought against them by the chapter 7 trustee, finding that the directors "may suffer substantial and irreparable harm" without access to such benefits "now." *Id.* In overruling the trustee's objections, the court reasoned that the harm to the estate was speculative - the D&O policy had no side C coverage and there were no pending indemnification claims against the debtor implicating the side B coverage. *Id.* Similarly, in *In re Arter & Hadden, L.L.P.*, 335 B.R. 666, 674 (Bankr. N.D. Ohio 2005), the court concluded that the D&O proceeds were property of the estate, but it lifted the stay anyway because the directors and officers of the debtor law firm had been sued by its bankruptcy trustee and could "suffer substantial and irreparable harm" without access to the firm's D&O proceeds for their defense costs.

**ABOUT WIGGIN AND DANA LLP**

Having celebrated our 75th year in 2009, Wiggin and Dana is a full service firm with more than 130 attorneys serving clients domestically and abroad from offices in Connecticut, New York and Philadelphia. For more information on the firm, visit our website at [www.wiggin.com](http://www.wiggin.com).

*Please send us the names and e-mail addresses of colleagues who would like to receive this publication. If you do not want to continue to receive a copy of this publication, please contact [bjacobson@wiggin.com](mailto:bjacobson@wiggin.com).*

Other cases have attempted to divide fairly the D&O coverage between the directors and officers and the estate. An unconventional apportionment calculation was used in at least one case where, in the absence of a clear language in the policy, the court relied on general equitable principles to carve up the D&O policy limits. *In re National Century Enterprises, Inc.*, 2005 Bankr. Lexis 1052 (Bankr. S.D. Ohio Jan. 10, 2005), was a perfect storm of an accounting and financial fraud case. There was \$5 million in D&O coverage, \$2.6 billion in allowed claims and defense costs of nearly \$4 million. In the absence of a priority of payment provision, the bankruptcy court allocated 70 percent of the D&O proceeds to the directors and officers for their defense costs and 30% to the entity for payment to creditors. Lacking guidance from the policies, the court looked to the intent of the D&O policies, which were purchased primarily for the benefit of the directors and officers, and decided that a simple proration would be inequitable because it would leave the directors and officers with “virtually nothing for their defense costs.” Instead, the court adopted a *per capita* method to divvy up the proceeds, giving \$500,000 to each of the directors and officers. *Id.* at \*29-35 (relying in part on the vacated bankruptcy court decision in the *Adelphia* case, which had found the D&O policy to be property of the estate but partially lifted the automatic stay to allow payment of \$300,000 in defense costs for each director or officer).

Another court skirted the issue of whether the proceeds are property of the estate in ruling for the directors and officers. In the *Stanford* receivership case<sup>[21]</sup> mentioned above, both sides cited bankruptcy cases for guidance. The relevant issue was whether the district court’s order restricting the use of receivership assets prohibited the D&O carrier from disbursing funds to pay the defense costs for several of Stanford’s officers and directors, whom the SEC alleged were running a \$7 billion Ponzi scheme. The court held that even if the proceeds were property of the estate (an issue the court declined to resolve), it was exercising its equitable discretion “in the interest of fairness” to permit D&O proceeds to be used to pay for the directors’ and officers’ criminal defense costs. The court found that the potential harm to R. Allen Stanford and the other officers, who faced multiple charges for conspiracy, fraud and obstruction of justice, was “real and immediate,” while the receiver’s claim to the coverage “is presently speculative.” *Id.* at pp. 7-8. The *Stanford* court found it noteworthy that the receiver had not tendered a single claim against the debtors to the insurer for a defense. *Id.* at p. 7. As discussed above, this decision is now moot in practical terms because the court has since found that the D&O policy’s money laundering exception applies and, therefore, the insurer is not obligated to pay the insureds’ defense and indemnity costs.

#### **IV. HOW DIRECTORS AND OFFICERS CAN AVOID THE BATTLE IN THE FUTURE AND HOW INSURERS CAN AVOID BEING CAUGHT IN THE MIDDLE**

As a starting point, directors and officers should be certain that the corporation’s bylaws include a duty to indemnify them to the full extent permitted under applicable state law. Next, directors and officers should ascertain that their company’s D&O policies contain clear, unambiguous priority of payment provisions that subordinate the entity’s coverage to their own, since the courts that have addressed the issues discussed in this article have usually started their analysis with a review of the terms of D&O policy.

Unfortunately, existing policies contain a wide variety of wordings on the priority of payment issue. Some do not address any priority of payment rules at all, which is the worst scenario for insureds and insurers alike.<sup>[21]</sup> In light of this fact, it may be tempting to structure D&O programs with separate liability limits for the side A, B and C coverages. For example, a program could provide limits of \$15 million for side A and B coverage and provide a separate \$20 million for side C coverage. This structure is, however, inefficient for insureds. If the directors and officers are sued but the company is not, the directors and officers would not have access to the \$20 limits reserved exclusively for the defense and indemnity of the company. Instead, a clear priority of payment provision with a single policy limit is best.

Some policies acknowledge the potential conflict between the directors and officers and the company, but provide limited or unclear wording. For example, one policy currently in use states:

In the event of bankruptcy of the Company, the Insurer shall first pay . . . Loss on behalf of the Directors and Officers under Insuring Agreement A. until all Claims against the Directors and Officers are resolved, and only then pay Loss on behalf of the Company under Insuring Agreements B. and C.

This language may be adequate in some cases. However, assuming that there is no side A coverage available for the directors and officers (because the company has agreed to indemnify them), if the company and the directors and officers are all sued for securities fraud, both side B and C coverage could be involved. Under this language, there is no priority of payment specified between the side B and side C coverage, leaving the court to interpret the insureds' and insurer's intention. In such a case, how will the bankruptcy court carve up the proceeds if the trustee seeks them for the benefit of the estate? The answer may depend on a number of factors including whether any claims have been asserted against the debtor, and if not, whether they any claims have been or threatened or are purely speculative, the size of any claims against the company, the amount of the directors' and officers' defense costs already incurred and the perceived immediacy of the directors' and officers' need for the proceeds versus the trustee's.

There are better examples of priority-of-payment provisions that offer directors and officers more certainty that their defense costs will be paid even in the event of a bankruptcy filing by their company.<sup>121</sup> Comprehensive priority-of-payment provisions define the scenario under which the provision is triggered, address the priority between side A versus C and B versus C coverage, and state that the insurance was procured for the benefit of the directors and officers.

In addition to demanding that a company's D&O policies contain clear priority-of-payment provisions, directors and officers should seek policies stating that, in the event of a bankruptcy: (a) the insurer is not relieved of its obligations to all insureds, and (b) that the corporation waives and releases its rights to the automatic stay as to the proceeds, as well as waiving the right to seek a Bankruptcy Code § 105 injunction to stop the payment of the D&O proceeds to the directors and officers. Finally, directors and officers might request that their corporations purchase D&O policies without side C coverage because a number of the reported decisions have held that where there is no such coverage, the proceeds cannot be property of the estate. The company should then consider buying separate coverage that would respond if the company was faced with a suit alleging securities fraud.

Without a doubt, the best solution to conflicting claims on the D&O proceeds is a clear priority-of-payment provisions stating which insureds are entitled to policy proceeds and when they are entitled to them *vis-à-vis* other insureds. With clear language, courts should be expected to honor the parties' intent even when faced with a trustee's competing claim for D&O proceeds.

<sup>121</sup> While indemnification for criminal activities is almost always excluded from D&O coverage, the insurer has a duty to defend unless there is a finding that an insured engaged in criminal activity. Coverage is rarely excluded on this basis since most suits settle before such a finding.

<sup>122</sup> See *Sec. & Exchange Comm'n v. Stanford Int'l Bank, Ltd.*, Case No. 3:09-CV-298-N (N. D. Tex. Oct. 9, 2009) [Docket No.831].

<sup>123</sup> See *Pendergest-Holt v. Certain Underwriters at Lloyd's of London*, No. 09-3712 (S.D. Tex. Oct. 20, 2010) [Docket No. 352 (opinion)].

<sup>124</sup> See *In re Enron Corp.*, Case No. 01-16034 (Bankr. S.D.N.Y. Apr. 11, 2002) [Docket No. 3278].

<sup>125</sup> Another characteristic of most D&O policies is that they are subject to a single aggregate limit, which makes the battle for the proceeds a zero sum game—every dollar paid to the directors' and officers' lawyers for their defense costs or settlement of suits (A or B side coverage) reduces the amount that might otherwise be available for the bankruptcy trustee or receiver to use in the settlement of securities fraud claims brought against the estate (C side coverage).

<sup>126</sup> See *In re Lehman Bros. Holdings, Inc., et al.*, Case No. 08-13555 (Bankr. S.D.N.Y. Dec. 16, 2009) [Docket No.6297] and Transcript [Docket No. 9812] pp. 69-70.

<sup>127</sup> See *Sec. & Exchange Comm'n v. Stanford Int'l Bank, Ltd.*, Case No. 3:09-CV-298-N (N. D. Tex. Oct. 9, 2009) [Docket No.831].

<sup>iii</sup>Generally, when faced with a claim, the insurer is not concerned with whom it must pay, but insurers certainly are concerned with paying the “wrong” party and then being liable for additional payments to another. The benefit of clear language to insurers is predictability.

<sup>iiii</sup>For instance, this is a much clearer priority of payment provision:

[S]olely with respect to any Claim made on or after a liquidation or reorganization proceeding is commenced (whether voluntarily or involuntarily) under Title 11 of the United States Code, as amended, or any similar state, local or foreign law (“Bankruptcy Law”) by or against the Parent Company:

[S]olely with respect to any Claim made on or after a liquidation or reorganization proceeding is commenced (whether voluntarily or involuntarily) under Title 11 of the United States Code, as amended, or any similar state, local or foreign law (“Bankruptcy Law”) by or against the Parent Company:

- (1) it is understood and agreed that if Loss, including Defense Expenses, shall be payable under more than one of the INSURING AGREEMENTS, then the Insurer shall . . . pay such Loss as follows:
  - (a) first, the Insurer shall pay that Loss, if any, which the Insurer may be liable to pay on behalf of the Insured Persons under INSURING AGREEMENT (A);
  - (b) second, the Insurer shall pay that Loss, if any, which the Insurer may be liable to pay on behalf of the Company under INSURING AGREEMENT (B); and
  - (c) third, the Insurer shall make such other payments which the Insurer may be liable to make under INSURING AGREEMENT (C) or otherwise.

## FROM THE COURTS

**Money Laundering Exclusion Precludes D&O Coverage in the Stanford Financial Dispute.** *Pendergest-Holt v. Certain Underwriters at Lloyds of London*, 4-09-CV-03712 (S.D. Tex. Oct. 13, 2010). The SEC initiated an action against various individuals associated with the Stanford Financial Group on February 2009. A group of insurers initially agreed, under reservation of rights, to pay defense costs for individuals, but denied coverage in August 2009 after one Stanford executive pleaded guilty to conspiracy to commit wire, mail and securities fraud. The insurers cited the Money Laundering Exclusion as the reason for its denial. Originally, the federal district court granted a motion for preliminary injunction, which forced the insurers to continue to cover defense costs to the individuals. The Fifth Circuit Court of Appeals remanded the case on the coverage question after disagreeing with the trial court’s reasoning. After a hearing on remand, the court vacated the preliminary injunction, held that the Money Laundering Exclusion applied because: (a) the individuals knew, suspected, or reasonably should have known or suspected that the investment details provided to them were not an accurate portrayal of Stanford International Bank Limited’s investment performance; and (b) the insurers had proven a substantial likelihood that a preponderance of the evidence would establish that Allen Stanford knowingly committed acts of money laundering, as defined in the D&O policy.

**First Circuit Requires Trial Court to Allocate D&O Proceeds Between Insureds.** *Genzyme Corp. v. Fed. Ins. Co.*, No. 09-2485 (1st Cir. Oct. 13, 2010). Genzyme Corp., a Massachusetts biotech firm had three classes of stock registered with the SEC that it decided to convert to a single stock class. Shareholder suits followed the announcement and Genzyme paid a settlement of \$64 million to one group of shareholders. Genzyme then tendered a \$10 million policy limit claim to its D&O carrier, which insurer refused and claimed the settlement payment was uninsurable. In a subsequent coverage action, the trial court decided the settlement was uninsurable as a matter of public policy. The First Circuit Court of Appeals reversed the trial court and held that public policy did not prohibit payment to only one group of shareholders and that the policy “bump-up” exclusion barred coverage only to the extent a claim was made against the corporate insured and did not apply to claims against the directors and officers. The appellate court remanded the case to the trial court for the daunting task of determining how the settlement payment was allocated between claims against the corporation and the individual insureds.

**Second Circuit Holds that Cedants May Not Rely on Follow the Fortunes Doctrine After Agreement Time Limitations.** *Arrowood Surplus Lines Ins. Co. v. Westport Ins. Co.*, No. 10-397 (2d Cir. Sept. 17, 2010). Arrowood claimed that it was reinsured by Westport for a general

liability policy it sold to Equity Residential, a real estate investment trust. Arrowood said that Westport terminated the reinsurance contract in 2000 causing Arrowood to cancel a number of policies it had issued. However, in 2006, Equity named Arrowood as a defendant in a suit in the Northern District of Illinois, which suit Arrowood settled by paying \$4.1 million. Arrowood then billed Westport more than \$6.7 million for the settlement and litigation expenses. After Westport refused to pay, Arrowood filed suit in 2008 in the District of Connecticut. In the suit, Arrowood argued that the follow the fortunes clause applied. The appellate court held that the additional periods of insurance coverage that Arrowood extended to Equity fell outside the reinsurance agreements time limitations and therefore the settlement was not subject to the follow the fortunes provision. The court stated, "in any event, our precedent holds that a 'follow the fortunes' provision cannot expand the express limits of coverage imposed by a reinsurance agreement."

**Third Circuit Holds that Reinsurance Treaties Did Not Clearly Waive Removal Provision and Vacatur Standards.** *Ario v. Underwriting Members of Syndicate 53 at Lloyds for the 1998 Year Account*, No. 09-2989 and 09-2991 (3d Cir. Aug. 18, 2010). Pursuant to an arbitration concerning whether the cedants had properly underwritten the insurance business applicable to the reinsurance placement materials, the arbitration panel rescinded three of the four treaties at issue. Joel Ario, as liquidator of Legion Insurance Company filed a suit to confirm in part and vacate in part the arbitration award. Reinsurers removed the action to federal district court pursuant to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, as implemented by the Federal Arbitration Act. The Reinsurers filed a motion to confirm the arbitration award. Ario argued that the case should be remanded to Pennsylvania state court because the parties had adopted the Pennsylvania Uniform Arbitration Act to govern the arbitration and, thus, the Convention and FAA did not apply. The federal court rejected this argument. The court then rejected Ario's argument that the PUAAs vacatur standards applied and denied a motion to vacate the arbitration award, applying the standards of the FAA. The Third Circuit agreed. The appellate court held that parties may opt out of the removal provisions of the Convention, but the treaties at issue did not clearly and unambiguously contain such language. Similarly, the appellate court notes that the PUAAs, instead of the FAA, might plausibly apply because the arbitration clause in the treaties did not evidence "clear intent" to apply the PUAAs vacatur standards. Applying the FAA vacatur standards, the appellate court affirmed the trial court's decision.

**District Court Finds Reinsurer Was Not an Indispensable Party and Denies Insurer's Motion to Vacate Arbitration Award.** *First Automotive Serv. Corp. v. First Colonial Ins. Co.*, 3:07-cv-682 (M.D. Fla. June 16, 2010). Insurer Northbrook removed a case brought by an insured to federal court and moved to compel arbitration. After the arbitration, the insured plaintiffs moved to vacate the award by arguing that Northbrook concealed the fact that First Colonial Insurance Company reinsured Northbrook 100% and First Colonial was, therefore, an indispensable party and that First Colonial's presence in the original lawsuit would have destroyed diversity/proper removal. The court had little sympathy for this argument and noted that the plaintiffs knew throughout the arbitration proceeding that First Colonial reinsured Northbrook and never objected to its absence. The court also noted that First Colonial had no direct liability to plaintiffs based merely on the fact that it reinsured Northbrook 100%. The court also upheld the panel's award of attorneys' fees and stated that manifest disregard of the law is no longer viable post *Hall Street*, adding to the split among federal courts concerning the impact of *Hall Street* on the doctrine of manifest disregard of the law.

**STOLI Scheme May Be Challenged After Life Insurance Policy's Incontestability Period.** *Settlement Funding, LLC v. AXA Equitable Life Ins. Co.*, 09-CV-8685 (S.D.N.Y. Sept. 29, 2010). The Plaintiff did not contest that the life insurance policy at issue was obtained with a forged signature and contained misrepresentations as to the insured's actual income and net worth. The Plaintiff did argue that AXA bargained away the right to challenge the validity of the insurance

policy pursuant to an incontestability clause. In this case, AXA challenged the validity of the policy more than two years after it issued the policy. The court noted that New York courts have long recognized the important function of incontestability clauses; however, it also said that while it is a “high bar, the incontestability clause is not sacrosanct.” The court recognized the abuses involving life insurance policies lacking an insurable interest in recent years and the substantial record before it pointing to the existence of an improperly procured policy. The court granted AXA’s motion for summary judgment to the extent it seeks to dismiss the Plaintiff’s claims for breach of contract, bad faith denial of coverage, and other tort actions under Ohio law.

**Letter From the EPA Seeking Cooperation Constitutes a Claim.** *Ash Grove Cement Co. v. Liberty Mut. Ins. Co.*, No. 09-239 (D. Ore. Oct. 2010). An Oregon district court recently held that under a liability policy issued to Ash Grove Cement Company a letter from the EPA seeking the insured’s cooperation in investigating a Superfund site constituted a claim giving rise to the insurers’ duty to defend. The EPA has sent out approximately 70 letters to potentially responsible parties that might be liable under CERCLA for costs the EPA had and would incur for actions taken at the Portland Harbor Superfund Site. The court stated: “The general purpose of the policies at issue here was to provide Ash Grove with insurance coverage for liabilities and damages that Ash Grove incurred because of property damage. The policies neither defined ‘suit’ nor limited its meaning through exclusions.” The judge noted that a reasonable insured could interpret the EPA letter as a claim under the policies and that the letter was equivalent to a “suit seeking damages.”

## FROM THE REGULATORS

**NAIC Market Conduct Annual Statement Project Grows to 34 Jurisdictions.** The National Association of Insurance Commissioners (NAIC) announced on October 19, 2010 that 34 jurisdictions have signed a Terms of Use Agreement to collect Market Conduct Annual Statement (MCAS) data. Through the agreement, states will use a new automated collection tool to collect MCAS data, which will be centrally stored at the NAIC. For additional information, [http://www.naic.org/Releases/2010\\_docs/mcas\\_grows\\_to\\_34\\_jurisdictions.htm](http://www.naic.org/Releases/2010_docs/mcas_grows_to_34_jurisdictions.htm).

**NAIC Issues Draft Bulletin Regarding Stranger-Owned Annuity Transactions.** The NAIC has issued a bulletin to help insurers limit their potential exposure to stranger-owned annuity transactions. The draft bulletin includes certain safeguards that the NAIC recommends insurers follow. Typically, stranger-owned annuity transactions are those in which a stranger to the agent or investor pays a nominal fee or the use of the individual’s identity as the measuring life on an investment-oriented annuity. The suggested safeguards are designed so that insurers can detect STOA transaction. Additional information from the NAIC Life and Annuities Committee, including a download of the draft bulletin, may be found at [http://www.naic.org/committees\\_a.htm](http://www.naic.org/committees_a.htm).

### Connecticut

As previously reported, the Connecticut Insurance Department has issued a Bulletin concerning data breaches. Pursuant to Bulletin IC-25, all licensees and registrants of the Department are required to notify the Department of any information security incident affecting Connecticut residents within five calendar days after the incident is identified. More information concerning Bulletin IC-25 may be found at [http://www.ct.gov/cid/lib/cid/Bulletin\\_IC\\_25\\_Data\\_Breach\\_Notification.pdf](http://www.ct.gov/cid/lib/cid/Bulletin_IC_25_Data_Breach_Notification.pdf).

On November 8, 2010, the Connecticut Insurance Commissioner entered into an agreement with Health Net of Connecticut that required Health Net to pay \$375,000 for information

security lapses for what the Insurance Department considered to be failures to safeguard the personal information of its members from misuse by third parties. More information may be found at <http://www.ct.gov/cid/cwp/view.asp?a=1269&tQ=427650>.

Unrelated to the November 8, 2010 agreement, Health Net has announced it will lay off 750 workers in Connecticut as part of its plan to stop offering health insurance in the Northeast.

Also unrelated to the above, Insurance Commissioner Thomas Sullivan has resigned effective November 15, 2010. PricewaterhouseCoopers announced that Commissioner Sullivan has joined its Financial Services Regulatory team in its Hartford, Connecticut office.

#### **Massachusetts**

The Massachusetts Division of Insurance has amended its surplus lines regulations for the approval of alien unauthorized insurers. The previous scheme, which required alien insurers to maintain a trusted surplus of \$20 million in the U.S. and annually file financial information following U.S. accounting rules, effectively made it prohibitive for alien insurers to obtain surplus line eligibility in Massachusetts. For a description of the new requirements and application information, [http://www.mass.gov/Eoca/docs/doi/Companies/forms/alien\\_unauth\\_app.pdf](http://www.mass.gov/Eoca/docs/doi/Companies/forms/alien_unauth_app.pdf).

#### **New York**

The New York Insurance Department now has the authority to review rates for health insurance before they become effective. The new “prior approval” provisions replace the previous “file and use” laws. In addition, insurers seeking to increase rates must notify their customers, providing those customers with an opportunity to comment to the Department. For further information, <http://www.ins.state.ny.us/press/2010/p1010211.htm>.

#### **California**

Pursuant to AB 1708, effective January 1, 2011, California will have new minimum capital and surplus requirements for surplus lines insurers applying for eligibility. The new requirement will increase the current minimum of \$15 million to \$45 million with at least \$25 million of the surplus consisting of cash. For those surplus lines insurers already eligible, their surplus must be at least \$30 million on January 1, 2011 and they will have until December 31, 2013 to increase their capital and surplus to \$45 million.

The California Office of Administrative Law has approved the State’s Department of Insurance plans to repeal certain privacy regulations. This is largely seen as a victory of insurance agents and brokers. Specifically, California Code of Regulations Section 2689.8(c)(3) is repealed. That provision required agents and brokers to annually mail privacy policies to all customers, and to provide an “opt out” form that, if returned by the customer, prevented broker-agents from shopping on renewal to find better policies from other insurance companies. The repeal was required by the 2004 enactment of Financial Code Section 4056.5(b), which expressly permits broker-agents to use nonpublic personal information without obtaining prior customer consent to shop on renewal.