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You Recommended Madoff — Are You Covered?

Law360, New York (January 26, 2009) -- Filing a complaint is easy. And when lawyers are chasing \$50 billion in losses, an enormous amount of lawsuits will follow. Who are the most obvious targets? It will undoubtedly be the Madoff “feeder” funds and other referral sources including brokerage firms, accountants, lawyers, investment managers and advisors.

Whether your organization is a “feeder fund” or investment advisor, the next question becomes: will your directors and officers (“D&O”) or professional liability (“E&O”) insurance policy protect you from these actions?

There are other policies that may provide protection including (without limitation): Financial Institutions (fidelity) Bonds, fiduciary insurance, CGL policies, SIPC “coverage”, General Partners Liability coverage, etc.

But these two policies, D&O and Professional Liability are your most likely sources of coverage protection.

Will Your D&O And Professional Liability Policies Provide Coverage?

Yes — but not without a fight. Both D&O and E&O (Errors & Omissions) insurance are available to the corporation targeted by government agencies or private claimants for Madoff-related losses.

D&O insurance typically covers the corporate policyholder (where entity coverage is present) and the corporation’s out-of-pocket costs in indemnifying and defending its directors and officers for alleged wrongful acts in carrying out their corporate responsibilities.

D&O insurance also covers the directors and officers directly. Similarly, standard form E&O insurance policies protect the corporation and its various employees and affiliates, such as securities brokers and dealers working for investment banks, for loss arising

from their alleged wrongful or negligent acts committed in their capacities as managers, representatives or agents of the corporation.

From the outset, it is important for you to provide timely notice of a claim to the insurance companies. Notice of claim is an obligation the insured or policyholder must complete before seeking coverage.

Most D&O and E&O policies put a specific time limitation on how late notice can be provided after the claim is filed, while others require notice “as soon as practicable.”

Government investigations into a company’s alleged “improper” investment practices or accounting irregularities are also covered under many of these policies, which include “investigations by any governmental entity into possible violation of law” in the policy’s definition of “claim.”

The insurance policies normally cover “defense costs” incurred from responding to a government or regulatory examination as well. The definition of “loss” will also include coverage for settlements and judgments arising from the underlying claim.

Insurance Company “Defenses”

Given the enormous dollar amounts involved, don’t be surprised that our friendly insurer is going to throw every defense it can (viable or not) including:

- The Fraud Exclusion: Most D&O (and E&O) policies exclude claims based upon fraud or dishonesty.

Generally speaking, there are two types of fraud and dishonesty exclusions: exclusions which require a final adjudication showing fraud or dishonesty and those that do not (e.g. where the policy says it excludes any claims where there is fraud or dishonesty “in fact”).

The former is far preferable than the latter. The exclusion cannot be used by the insurance company as a defense unless and until there is a final adjudication of active and deliberate dishonesty that is material to the claim.

Thus, settlements are fully covered because there was no “final adjudication”. In re Donald Shelden & Co. Inc., 186 B.R. 364, 369 70 (S.D.N.Y. 1995). This is exceedingly important to you because 95 percent of all claims are settled before trial.

In addition, the insurance company cannot re-litigate the underlying case (which they will want to do). See, e.g. City of Idaho Falls v. Home Indemn. Co., 888 P.2d 383 (Idaho 1995); (Windt, Insurance Claims and Disputes 4th § 6:31 (reasoning that after settlement “[t]he actual merit of each of the plaintiff’s claims against the insured is not directly ‘relevant’”).

At this point the fraud involved appears to involve only Madoff himself, not his “feeder funds” or others. However, the insurance companies will invariably attempt to assert this defense.

But remember, until a final determination is reached, you are entitled to the advancement of legal costs incurred in defending against such claims. *Federal Ins. Co. v. Kozlowski*, 792 N.Y.S.2d 397, 404 (App. Div. 2005).

- **The Personal Profit Exclusion:** This exclusion appears more troublesome. The typical exclusion precludes coverage for loss “based upon, arising from or in consequence of ... an Insured having gained any profit, remuneration or advantage to which such Insured is not legally entitled, if a judgment or final adjudication in any proceeding establishes the gaining of such remuneration or advantage.”

This provision contains the much preferred final adjudication modifier as compared to the “in fact” condition. Nevertheless, an issue remains since many of the complaints already filed have claimed that the feeder funds inappropriately charged management fees and other compensation. This area will be exploited as much as possible by the insurance companies.

- **Rescission:** Many of the ongoing investigations could yield a finding that there were numerous “red flags” regarding Madoff’s operation, some of which were (allegedly) “known” by your company and should have been disclosed in the policy application.

The insurance company may assert that the failure to disclose such occurrences provides grounds for policy rescission. It is important to note that the burden to prove a rescission case is a heavy one and falls on the insurance company.

The insurer must show that any misrepresentation was material to the decision to issue coverage and the misrepresentation was in fact made by the policyholder. *Home Ins. Co. of Ill. (New Hampshire) v. Spectrum Information Tech.*, 930 F.Supp. 825, 843 (E.D.N.Y. 1996) (holding the insurance company did not carry its burden and may not rescind the policy). Remember: most rescission actions are unsuccessful.

There will be other defenses, depending on the exact policy language – often esoteric and often wrong.

Defense Costs

Probably the most important coverage for your firm is defense costs. The typical D&O or E&O policy will provide for advancement of defense costs while your firm is defending the claims that have been brought against it.

Given the high cost of lawyers, advancement of defense costs — as they are incurred (as compared to at the end of the litigation; that may take years) — is very important to

you. However, some insurers will attempt to disregard the “as incurred” language and forestall you from obtaining reimbursement for years. Don’t let them.

An insurance company cannot escape its duty to advance defense costs while you are defending a claim by merely contesting coverage. *Fed. Ins. Co. v. Kozlowski*, 792 N.Y.S.2d 397 (App. Div. 2005).

In *Kozlowski*, the insurance company argued that a coverage dispute over the application of an exclusion excused the insurance company from its duty to advance defense costs. In rejecting this argument, the court stated:

"This court has recognized that under a directors and officers liability policy calling for the reimbursement of defense expenses as in *Gon and Okada* 'insurers are required to make contemporaneous interim advances of defense expenses where coverage is disputed, subject to recoupment in the event it is ultimately determined no coverage was afforded.'"

Id. at 403 (quoting *Nat'l Union Fire Ins. Co. of Pittsburgh, PA v. Ambassador Group Inc.*, 556 N.Y.S.2d 549, 553 (App. Div. 1990).

If the insurance company arguments were legitimate, the D&O policy itself would be “rendered a nullity,” and the coverage it supposedly provided would be completely illusory. See *United States v. Weissman* (No. 5294 C.R. 760 CSH, 1997 WL 539774 (S.D.N.Y., Aug. 28, 1997).

Furthermore, a policyholder may seek a ruling on the duty of an insurance company to provide defense costs even if the total amount of liability for those defense costs is not yet ascertainable. See *General Accident Insurance Co. of America v. Allen* (692 A.2d 1089 (Pa. Sup. Ct., 1997).

Directors and officers should receive the fair protection and compensation they are entitled to under the D&O policies. See *In re Adelphia Communications Corp.* (285 B.R. 580 (Bankr. S.D.N.Y., 2002)

Conclusion: Seek Help

If your corporation faces investigations or litigations created by its involvement in the Madoff “industry”, it should immediately consult with an insurance expert to assess what insurance policies triggered and to protect your coverage. Your insurance policies are assets your company paid for. Use them. The insurance companies are not going to volunteer payment.

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