ANDERSON KILL
POLICYHOLDER ADVISOR
The Policyholder Law Firm
Volume 22 Number 5 www.andersonkill.com November/December 2013

Coverage *Quelled* by Extreme Exhaustion Arguments: The Cautionary Tale of the *Quellos* Case

By William G. Passannante and Joshua Gold

William G. Passannante Joshua Gold

Companies that have purchased towers of excess D&O insurance take warning: Washington is the latest state to hold that settling a claim with your primary D&O insurance company may negate excess coverage on grounds that the primary policy was not "exhausted."

The case, *Quellos Group LLC v. Federal Insurance Company et al.*, No. 68478–7–I (Court of Appeals, Washington, Div. One, November 12, 2013), should prompt directors and officers to ask: Has our broker made sure that our tower of D&O insurance is as seamless as claimed — and proof against extreme "exhaustion" arguments?

Bad Facts Can Make For Some Tough Results

Quellos Group was a Seattle-based investment management company. Beginning in 1999, former officers and employees developed a new tax shelter strategy called the Personally Optimized Investment Transaction, or POINT, that gave clients the opportunity to offset capital gains with losses. Admittedly, the unfavorable and unflattering factual pattern of this case was not conducive to public policy arguments in favor of policyholders generally. The *Quellos* decision summarizes the POINT scheme as follows:

> Using circular transactions and offsetting payments that cancelled each other out, these offshore corporations created a paper portfolio of over $9 billion in U.S. high tech stocks that appeared to suffer price drops and generated the fake capital losses used in the POINT transactions. The fees charged by Quellos depended upon the amount of tax loss generated in each transaction for the taxpayer who bought the shelter; the more money the taxpayer "lost" from the transaction, the more Quellos charged for the scheme.

Quellos, slip op. at 2.

The opinion states that in total, the POINT transactions shielded $2 billion in capital gains from federal taxes and generated $65 million in fees for Quellos. The officers "pleaded guilty to conspiracy to defraud the IRS of $240 million in taxes." *Quellos*, slip op. at 7.

> "[. . .] settling a claim with your primary D&O insurance company **may negate excess coverage** on grounds that the primary policy was not 'exhausted.'"

For 2004–2005, Quellos purchased layers of directors and officers liability insurance, including a primary-level investment management insurance policy with a $10 million liability limit subject to a $2.5 million self-insured retention, from American International Specialty Lines Insurance Company (AISLIC). Quellos also purchased $10 million first-layer excess insurance from Federal Insurance Company, and $20 million second-level excess coverage from Indian Harbor Insurance Company.

When the IRS and federal prosecutors began closing in on the firm in 2006, Quellos sought reimbursement from the primary and first- and

"The Cautionary Tale of the Quellos Case" continued on next page

"The Cautionary Tale of the Quellos Case" continued from p1

second-level excess insurance companies for $35 million in settlement costs, and $45 million in defense costs and other costs incurred in connection with multiple government investigations. Pursuant to a settlement agreement, AISLIC paid Quellos just under $5 million of the $10 million policy limit for 2004–2005, as well as other amounts for policies in other years. AISLIC subsequently did not agree to make any additional payments on the 2004–2005 policy. *Quellos*, slip op. at 9.

Federal and Indian Harbor then refused to pay "on the grounds that the underlying insurance limits had not been exhausted." *Quellos*, slip op. at 8.

The Excess Policies

Federal's $10 million excess policy states: "Coverage hereunder shall attach only after the insurers of the Underlying Insurance shall have paid in legal currency the full amount of the Underlying Limit for such Policy Period." Indian Harbor's $20 million second-level excess policy was subject to the terms and limits of the Federal policy. With regard to the Indian Harbor policy, the opinion notes, "The record also shows that an amendment was available from Indian Harbor that allowed the insured as well as the underlying insurer to pay the full amount of the underlying policy limits to trigger excess coverage." *Quellos*, slip op. at 18.

That is, Indian Harbor had a policy on the shelf that might have provided real insurance but instead sold Quellos a policy with a gaping coverage hole. Policyholders might also wonder why Quellos's broker did not insist on the amendment. Policyholders and their brokers should also take note that it's now vital to insist that excess D&O policies stipulate the policyholder's right to make up any shortfall in the underlying policy payout without surrendering excess coverage on exhaustion grounds.

The *Quellos* court held, "Because the exhaustion language in the Federal and Indian Harbor excess insurance policies is clear and unambiguous, we must enforce it as written, and affirm summary judgment dismissal of the lawsuit against Federal and Indian Harbor." *Quellos*, slip op. at 20.

The court unfortunately rejected Quellos's argument that exhaustion was only a condition under the policies and that, as with "timely notice requirements," the insurance company should have to show prejudice as grounds for denying coverage. This argument should carry weight on public policy grounds. The *Quellos* decision is contrary to the long line of cases favoring compromise in insurance litigation rather than forcing parties to ultimate judgment, and contrary as well to the reasonable expectations of directors and officers who rely upon insurance to provide coverage.

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Until recently, it had been accepted for decades that settling a primary insurance claim would not compromise excess coverage. Now, thanks to a string of decisions, D&O insurance policyholders must make sure that excess policies are not booby-trapped with unduly restrictive exhaustion clauses which may permit insurance companies to make improper, extreme arguments that policyholders forfeit coverage for valid insurance claims.

William G. Passannante is co-chair of Anderson Kill's Insurance Recovery Group and a shareholder in the firm's New York office. A leading lawyer for policyholders in the area of insurance coverage, Mr. Passannante has appeared in cases throughout the country and has represented policyholders in litigation and trial in major precedent-setting cases.
(212) 278-1328 **wpassannante@andersonkill.com**

Joshua Gold is a shareholder in Anderson Kill's New York office. Mr. Gold has extensive experience in insurance coverage analysis, consulting and litigation, with an emphasis on directors' and officers' insurance, errors and omissions insurance, online and high-tech liability and property insurance coverage issues and offshore market insurance products.
(212) 278-1886 **jgold@andersonkill.com**

Signs Your Insurance Company is Leaving You TWISTING IN THE WIND (And How You Can Protect Against It)

By David A. Shaneyfelt and Ted Mechtenberg

"There is no coverage for this claim under your policy." These words can fill a policyholder with dread. Could you have seen these words coming? Could you have *prevented* their coming? Possibly. Here are some signs to look for — and some counter-strategies to ward off a coverage denial.

Huge Potential Liability

Brace yourself if you are facing a large claim. The larger the claim, the more incentive the insurance company has to avoid paying it.

Counter-Strategy: Be on guard at the outset — don't assume that every request for information is intended to help you. Communicate with the insurance company only through counsel. Your communications will be privileged and you can treat requests for information with the same degree of business interests your insurance company will be treating its communications with you.

The Delayed Response

You notify your insurance company of a claim. No response. You have litigation deadlines due. Did the insurance company receive your notice? Are its personnel disorganized? Are they planning a negative response? All three are open questions.

Counter-Strategy: Confirm your notice was received. Call and talk to a live person. Get a name and contact information. Send your notice again and again, if necessary, keeping track of your submissions, and include reminders about looming deadlines. Do not let a litigation deadline lapse. Get counsel involved to manage the initial litigation response. Advise the insurance company of your intentions. Tell them that if you do not hear from them by a certain date, you will assume they agree with your plan. Then execute your plan. If you fear a negative response is forthcoming, anticipate it by stating your position in advance, or explain why further investigation is necessary to confirm coverage. If the company refuses you this opportunity, this could be powerful evidence in a bad faith action later.

The Pointed Investigation

When the claims handlers say, "Please provide us with all facts when you first learned of the events giving rise to this claim," assume they are looking to disclaim coverage on grounds the claim preceded the policy period or that your application for insurance was deficient. "Please provide us with information regarding similar claims made against you" signals that they are looking to disclaim coverage on grounds the claim is interrelated to other excluded claims. "Please tell us what actions you have taken to settle this matter before the claim was filed" suggests they are looking to disclaim coverage on grounds you compromised your defense of the case.

Counter-Strategy: Answer the questions honestly, but carefully. Realize that such questions are designed to build a case against coverage. Answer questions to build a case for coverage.

The Detailed Reservation of Rights Letter

Your insurance company cannot accept your defense and abandon you later without having given you fair notice of that possibility. They therefore typically send a letter at the outset saying they will accept your defense now, but are reserving the right to not pay for it, or for certain damages, later. This "reservation of rights" letter can be highly detailed and will be used to justify their exit strategy later.

Counter-Strategy: Pay close attention to this letter. Read your policy and your claim; know exactly what claims and damages they believe are covered or not covered. If you think the non-covered claims have merit, be concerned, because your insurance company will be sure to magnify the strength of those claims later — when they remind you they will not be paying for them. You will want to magnify the strength of the covered claims instead. Have counsel determine whether your insurance-appointed counsel has the ability to marshal proof of the case away from covered claims and toward non-covered claims. If so, most states give you a right to independent counsel.

"Twisting in the Wind" continued on next page

"Twisting in the Wind" continued from p3

Defense Counsel Says: "I Don't Do Coverage Work"

If you ask insurance-appointed counsel about your coverage rights, and they say they don't have anything to do with coverage — watch out. They most emphatically do have everything to do with coverage, whether they admit it or not. Depending on how they do their job, you can find yourself without coverage as the case develops.

Counter-Strategy: Ask your counsel about your coverage rights. Sometimes you will get a fair, albeit guarded, response. More often, you will get deflection. If so, retain independent counsel immediately and determine how vulnerable you are to loss of coverage. Again, depending on how vulnerable you are, most states give you the right to demand that your insurance company pay for your independent counsel, who will defend you against the claim and help protect against the loss of coverage rights.

The Warning In Advance Of Mediation

Your insurance company has been defending your claim. Your defense counsel arranges for mediation and says you need to attend. Your insurance company then reminds you of the reservation of rights letter and adds that because this claim seeks damages not covered by this policy, you will need to fund any settlement reached at mediation.

Counter-Strategy: This is a declaration of war. Get coverage counsel immediately. Call the mediator and explain the new complexity. Be sure the mediator has a background in insurance coverage; if not, demand one that does. Present a strong case for coverage back to the insurance company. Consider using the mediator to work with the plaintiff on the claim. Can the claim be amended to confirm coverage? Is personal bankruptcy an option to threaten the plaintiff (or the insurance company)? Would the plaintiff rather take your coverage rights and agree to collect only against your insurance company? In the end, you may have to cut the best deal you can, in a three-way negotiation between you, the plaintiff and the insurance company. If you cannot, consider your options for litigating your coverage rights against the insurance company.

Conclusion

While you cannot control what your insurance company will actually do, you can look for signs of what they might do. Knowing those signs will help you protect against the potential loss of important rights and interests.

David A. Shaneyfelt is a shareholder in Anderson Kill's Ventura, CA, office. Mr. Shaneyfelt concentrates his practice in the area of insurance recovery, exclusively on behalf of policyholders. He is an experienced litigator, focusing on insurance policy benefits for wage and hour class actions, director and officer insurance, public entity liability, professional malpractice and reinsurance.
(805) 288-1300 **dshaneyfelt@andersonkill.com**

Ted Mechtenberg is an attorney in Anderson Kill's Ventura, CA, office. Mr. Mechtenberg's practice focuses on insurance recovery, exclusively on behalf of policyholders.
(805) 288-1300 **tmechtenberg@andersonkill.com**

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