

QFDCC QUARTERLY



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Steven E. Goldman

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AND BEYOND
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Cite as: 53 FED’N DEF. & CORP. COUNS.Q. ____ (2002).

The Federation of Defense & Corporate Counsel Quarterly (USPS 189-180) (ISBN 0887-0942) is published quarterly for \$60.00 per year by the Federation of Defense & Corporate Counsel, Inc., 11812-A North 56th Street, Tampa, FL 33617. Periodicals postage paid at Springfield, Illinois and additional mailing offices. POSTMASTER: Send address changes to the Executive Director, 11812-A North 56th Street, Tampa, FL 33617.

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FEDERATION OF DEFENSE & CORPORATE COUNSEL

2003 WINTER MEETING

Sunday, February 23 –

Sunday, March 2



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Awards of Attorneys' Fees in American Marine Insurance Law

Steven E. Goldman

I.

INTRODUCTION

When any insurance company or underwriter becomes involved in a coverage dispute with an insured, outside counsel is going to be asked to provide an opinion as to the likely outcome of the litigation. The likelihood of success in such a contest must be the first consideration in reaching any determination concerning how to proceed on a questionable claim for coverage.

However, simply winning or losing cannot be the sole determinant in the decision as to whether a claim will be paid, or whether coverage is going to be denied. In addition, counsel will certainly be asked to provide some analysis of the extent of exposure for damages in the event that the judicial decision is against the insurer. In such a case, exposure for damages might well comprehend items such as claims for emotional distress, commercial losses flowing from failure or delay in receiving policy proceeds, prejudgment interest and the potential of punitive damages in the event of a determination of bad faith in the denial of the claim.

In a number of states, legislatures eager to discourage insurance companies from denying claims have enacted statutes that in some cases permit, and in other cases require, that courts make awards of attorneys' fees in situations in which the insured prevails in a coverage litigation. Those statutory awards of attorneys' fees can have the effect of dramatically increasing the insurer's exposure well in excess of the policy limits that were the original subject of the dispute.

Insurance companies offering coverage for non-marine property and liability risks, and for non-marine transportation risks such as aviation and trucking, have for long had to contend with this additional potential exposure in every situation where a denial of coverage and commencement of litigation is being contemplated. At the present time, however, there is a raging controversy concerning whether marine insurance companies and underwriters should be subject to these state law provisions awarding attorneys' fees to prevailing insureds. That controversy is the subject of this article, which will examine the jurisprudence and the arguments made therein.

Recent decisions by the United States Court of Appeals for the Second Circuit and the United States Court of Appeals for the Eleventh Circuit, respectively, have enunciated two different positions on this subject. The unfortunate fact that these decisions stand in direct



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conflict with each other, reaching different and irreconcilable positions, in turn casts into stark relief the chaotic predicament confronted by marine insurers seeking guidance from their counsel. How reliable is the answer to the question of whether potential exposure for attorneys' fees of the insured must also be weighed as a consequence of losing a coverage contest?

II. HISTORICAL PERSPECTIVE

Like other living things, the law continues to evolve and develop, often along lines that even scholars might have been reluctant to predict. In the American law and practice of marine insurance, the jurisprudence was for quite a long time characterized by a marked and conscious tendency to maintain basic harmony with the laws and practices in the United Kingdom. Justice Oliver Wendell Holmes referenced this basic fact nearly one hundred years ago when he noted that "it is desirable, if there is no injustice that the maritime law of this country and of England should agree."¹

A federal judiciary that saw uniformity in this particular field of law as a value to be continually reaffirmed enforced this remarkable harmony and continuity. A common normative regime, existing across the entire United States, familiar and recognizable in other English-speaking jurisdictions, was encouraged by the historic dominance of the great marine insurance market that grew up and developed in London. Underwriters seeking predictability and foreseeability in order to allow for a rational basis for setting premium rates were well served by this state of affairs.

When Great Britain codified into law in 1906 a range of practices and precedents, it must have seemed that a paradigm had been enacted that would provide for a continuation

¹ *Eliza Lines*, 199 U.S. 119, 128 (1905).

of the harmony in marine insurance that had been fostered by the federal courts in the United States.²

Instead, what has taken place in the second half of the Twentieth Century has been an evolution quite different from what might have been expected. Rather than fostering uniformity, the federal courts have presided over a growing diversification, as decisions have been issued that have dethroned previous marine insurance doctrines and practices once considered well entrenched and authoritative. Where previously there existed an established body of federal case law recognized as authoritative in every court, state and federal, recent decades have witnessed a growing willingness on the part of these same courts to refer instead to state statutes as the basis for deciding a marine insurance coverage case.

With fifty state legislatures enacting statutes, the inevitable result has been utterly predictable. Marine insurance companies and the attorneys representing them can no longer look across a vast field of common law and practices, confident of being able to predict the outcome of a coverage dispute regardless of whether a particular case arose in New York, Florida, Texas or California

This departure from uniformity in the law of marine insurance as a primary value in the federal courts traces its beginnings to the case of *Wilburn Boat Co. v. Fireman's Fund Insurance Co.*³ Decided in 1955, this seminal case continues, even after half a century, to roil the waters of marine insurance and to vex underwriters and attorneys alike.

Reversing two centuries of case law from courts in the United States and the United Kingdom, the Supreme Court's majority decision in *Wilburn Boat* rejected application of the strict or "literal performance rule" where a marine policy's Private Pleasure Warranty had been breached by the insured. The insured had been carrying passengers for hire on its vessel. The Hull & Machinery insurer denied the claim when the vessel was destroyed by fire. It no doubt relied upon advice of counsel to the effect that the "literal performance rule" recognized by federal maritime law would void coverage despite the apparent lack of any causal connection between the breach of warranty and the fire.

Having concluded in the face of overwhelming case law to the contrary that there was in fact no well established federal law or rule dealing with the consequences of a breach of a Private Pleasure Warranty, the majority opinion in *Wilburn Boat* went on to state that "[t]herefore, the scope and validity of the policy provisions here involved and the consequences of breaching them can only be determined by State law"⁴ Thus began the

² British Marine Insurance Act, 6 Edw. 7, C. 41, sec. 33.

³ 348 U.S. 310 (1955).

⁴ *Id.* at 316.

introduction of varieties of state law into marine insurance jurisprudence, a field which previously had been noteworthy for the degree of harmony across the entire nation.⁵

In the wake of *Wilburn Boat*, and despite sometimes-harsh criticism from scholars and commentators,⁶ the federal circuit and district courts have struggled to adhere to its stated requirements, and to themselves create predictable rules for decision.⁷ However, in compliance with the Supreme Court's mandate, the case law developed over the past five decades has been marked by increasingly frequent reference to state law. This has occurred in novel areas where previously there had been virtually no dispute but that principles of federal

⁵ The dissenting opinion filed by Justice Reed strongly protested the majority's departure from what certainly seemed to have been an established and well entrenched federal rule of maritime law shared with the UK on this subject of the effect of a breach of a warranty in a policy of marine insurance, stating:

Our admiralty laws, like our common law, come from England. As a matter of American judicial policy, we tend to keep our marine insurance laws in harmony with those of England. Before our Revolution, the rule of strict compliance with marine insurance warranties had been established as the law of England. That rule persists. While no case of this court has been cited or found that says specifically that the rule of strict compliance is to be applied in admiralty and maritime cases, that presumption has been consistently adopted as the basis of reasoning from our earliest days. Other courts have been more specific. No case holds to the contrary.

Id. at 325 (citations omitted).

⁶ The Supreme Court's decision has been characterized as "persistently problematic," *see*, ALEX L. PARKS & EDWARD V. CATTEL, JR., *THE LAW OF TUG, TOW AND PILOTAGE*, (2d ed. 1982); "an anomaly," *see*, Nicholas J. Healy, *The Hull Policy: Warranties, Representations, Disclosures and Conditions* 41 *TUL. L. REV.* 245 (1967); "chaos," *see*, GRANT GILMORE & CHARLES L. BLACK, JR., *THE LAW OF ADMIRALTY* (2d ed. 1957).

⁷ The decision in *Steelmet, Inc. v. Caribe Towing Corp.*, 779 F.2d 1485 (11th Cir. 1986), states quite succinctly the type of analytical exercise that the courts see themselves as bound to pursue whenever an issue arises in a marine insurance case:

One must identify the state law involved and determine whether there is an admiralty principle with which the state law conflicts, and, if there is no such admiralty principle, consideration must be given to whether such an admiralty rule should be fashioned. If none is to be fashioned, the state rule should be followed.

Id. at 1488.

maritime law constituted entrenched, binding and authoritative precedent.⁸ In cases dealing with the most common and indeed the most traditional areas of marine insurance disputes, such as those involving breach of policy warranties, or failure to disclose facts during the application process, decisions have been issued from American courts that make a conspicuous salute to *Wilburn Boat's* innocuous sounding holding that in the absence of a specific and controlling rule, the interpretation or construction of a marine insurance contract is to be determined by state law.

It is within this context of the intrusion of state statutory enactments into what previously had been an exclusive preserve of an older, common law of federal admiralty rules that the issue of attorneys' fees in marine insurance coverage litigation should be understood.

III.

STATE STATUTES & CASES AWARDING ATTORNEYS' FEES

The controversy over awards of attorneys' fees has developed against the background of the enactment by a number of state legislatures of statutes that seek to penalize first party insurers when there is a wrongful denial of coverage.⁹ Florida's provision is typical of many of these statutes, providing:

Upon the rendition of a judgment or decree by any of the courts of this state against an insurer and in favor of any named or omnibus insured or the named beneficiary under a policy or contract executed by the insurer, the trial court or, in the event of an appeal in which the insured or beneficiary prevails, the appellate court shall adjudge or decree against the insurer and in favor of the insured or beneficiary a reasonable sum as fees or compensation for the insured's or beneficiary's attorney prosecuting the suit in which the recovery is had.¹⁰

⁸ Perhaps the most familiar and well established principle in all of marine insurance law is that such policies are *uberimmae fidei*, i.e., that they are contracts of "utmost good faith," requiring that the insured make full disclosure of all material facts and permitting rescission of the policy in the event of even an innocent failure to comply with this admittedly harsh but historic and essential protection. In the case of *Albany Ins. Co. v. Anh Thi Kieu*, 927 F.2d 882 (5th Cir. 1991), a panel of the 5th Circuit Court of Appeals relied upon *Wilburn Boat* to retreat from this doctrine of *uberimmae fidei*, permitting federal and state courts in Texas and Louisiana to refer to state law in both of those jurisdictions in order to resolve cases of alleged failure to disclose material facts. Under both Texas and Louisiana statutes, only evidence of fraudulent misrepresentation by the insured will support rescission of the policy.

⁹ For a review of the statutory enactments see, Note, *State Attorney Fee Shifting Statutes: Are We Quietly Repealing the American Rule?*, 47 LAW & CONTEMP. PROBS. 321 (1984).

¹⁰ FLA. STAT. ch. 627.428(1) (2002).

Federal and state courts in Florida have agreed that the attorneys' fee statute is punitive in nature, constituting "a penalty against an insurer who wrongfully refuses to pay a legitimate claim."¹¹ The manifest aim of the statute is recognized as being to "discourage contesting of valid claims of insureds against insurance companies,"¹² and also to "reimburse successful insureds reasonably for their outlays for attorney's fees when they are compelled to defend or to sue to enforce their contracts."¹³ There is no requirement in the statute of any demonstration of bad faith or other misconduct on the part of the insurance company. Attorneys' fees are awarded to an insured or a beneficiary merely upon the rendition of a judgment by a court in Florida.

Florida's statute may be contrasted with that of the state of Virginia, which states:

Notwithstanding any provision of the law to the contrary, in any civil case in which an insured individual sues his insurer to determine what coverage, if any, exists under his present policy or bond or the extent to which his insurer is liable for compensating a covered loss, the individual insured shall be entitled to recover from the insurer costs and attorneys' fees as the court may award. However, these costs and attorneys' fees shall not be awarded unless the court determines that the insurer, not acting in good faith, has either denied coverage or failed or refused to make payment to the insured under the policy.¹⁴

The Virginia provision would not sanction an award of attorneys' fees where the insurer commences a declaratory judgment action, casting the insured in the role of the defendant in a coverage action. Nor would the statute permit an award in the absence of a finding by the court that the insurer had acted in bad faith.¹⁵ Whereas statutes like Florida's threaten an insurer with liability for attorneys' fees as a punitive sanction that results from an adverse decision, Virginia's provision requires evidence to support a finding of actual bad faith.¹⁶

In a number of jurisdictions, the courts have stepped in even in the absence of any direction from the state legislature and have independently crafted rules calling for the same type of awards of attorneys' fees in the event that an insured prevails in a coverage dispute with its insurer. In Washington State, for example, the state courts have created a

¹¹ *Great Southwest Fire Ins. Co. v. DeWitt*, 458 So. 2d 398, 400 (Fla. Dist. Ct. App. 1984).

¹² *Ins. Co. of N. Am. v. Lexow*, 937 F.2d 569, 573 (11th Cir. 1991).

¹³ *Id.*

¹⁴ VA. CODE ANN. § 38.2-209 (Michie 2002).

¹⁵ *See Joseph P. Bornstein, Ltd. v. Nat'l Union Fire Ins. Co.*, 828 F.2d 242 (4th Cir. 1987).

¹⁶ *See Rush v. Hartford Mut. Ins. Co.*, 652 F. Supp. 1432 (W.D. Va. 1987).

regime under which “an award of fees is required in any legal action where the insurer compels the insured to assume the burden of legal action, to obtain the full benefit of his insurance contract.”¹⁷ Whether suit is commenced by the insured, or by the insurer bringing a declaratory judgment action, fees are awarded whenever an insurer unsuccessfully denies coverage.¹⁸

IV. INITIAL DECISIONS

It is remarkable that the number of reported cases dealing with the applicability of these state provisions, whether statutory or judicially crafted, in the context of marine insurance coverage litigation is as scarce as it in fact turns out to be.¹⁹ More significant, however, is the fact that no particular universally accepted rule emerged to provide a beacon for an industry that thrives upon predictability, and within a legal tradition that had consistently affirmed the strong interest in harmony and uniformity across national and international systems.

One of the earliest cases to address the subject came in 1986 in *INA of Texas v. Richard*.²⁰ The marine insurer had rejected coverage for the vessel’s loss and, invoking federal admiralty jurisdiction, had commenced a declaratory judgment action in the federal district court in Houston. The parties had actually agreed to settle their coverage dispute, submitting to the trial judge cross-motions for summary judgment on the question of whether attorneys’ fees could be recovered by the insured. The insured appealed the trial judge’s simple order, without opinion, granting summary judgment to the marine insurer.

The Fifth Circuit asserted that its decision would be guided by the “polestar of *Wilburn Boat* . . . and its progeny.”²¹ Guided by the “axiomatic” principle that state law would control marine insurance issues in the absence of some specific and controlling federal rule, the panel of judges in the *Richard* case stated:

Having held that state law controls the interpretation of marine insurance policies, it would defy both logic and sound policy were we to hold that the applicability of

¹⁷ *Olympic Steamship Co. v. Centennial Ins. Co.*, 811 P.2d 673, 681 (Wash. 1991).

¹⁸ *See Fluke Corp. v. Hartford Accid. & Indem. Co.*, 7 P.3d 825 (Wash. Ct. App. 2000), *rev. granted*, 22 P.3d 802 (Wash. 2001).

¹⁹ Professor David W. Robertson also notes this “relative scarcity” of marine cases in the section of his broad article dealing with the general issue of attorneys’ fees in all varieties of admiralty and maritime litigation in the United States. *See* David W. Robertson, *Court-Awarded Attorneys’ Fees in Maritime Cases: The “American Rule” in Admiralty*, 27 J. MAR. LAW & COMM. 507, 561 (1996).

²⁰ 800 F.2d 1379 (5th Cir. 1986).

²¹ *Id.* at 1380.

attorney's fees *vel non* must be determined by reference to uniform federal law. As a polyglot of differing state laws respecting the substance of marine insurance policies is permissible, we can think of no reason, nor has one been advanced, why a unitary and uniform federal rule respecting attorney's fees in marine insurance cases is required.²²

In the wake of the "polestar" decision from the Supreme Court in the *Wilburn Boat* case, a panel of judges in the Fifth Circuit could ignore a centuries old tradition and rule not only that "[t]here is no specific and controlling federal rule of law relating to attorney's fees in marine insurance litigation," but could justify their holding by asserting that no rationale or justification existed for any such rule!²³

Other courts and other judges were not quick to conform to or to accept the holding in the *Richard* case that no specific or controlling federal rule of law could be found relating to attorneys' fees in maritime and admiralty litigation.

In the case of *Pace v. Insurance Co. of North America*,²⁴ the First Circuit Court of Appeals addressed the issue of whether a Rhode Island statute, quite similar to the Virginia statute previously discussed, conflicted with a controlling federal admiralty rule against such provisions.²⁵ The state statute provided for punitive damages as well as attorneys' fees, and the appellate court very hesitantly held that such a state law could be given effect. Characterizing its holding as "tentative,"²⁶ the court stated that jurisdiction in the case was based upon diversity rather than upon admiralty jurisdiction, and noted that *Wilburn Boat* encouraged use of state law to supplement federal principles. Since there was no established federal principle in conflict with state bad faith law doctrines, the First Circuit saw no absolute bar to permitting an award of damages against a marine insurer for violation of a state law aimed at such specific practices.

Several years later, in the case of *Southworth Machinery Co. v. F/V Corey Pride*,²⁷ the First Circuit addressed the issue of whether a Massachusetts statute could be the basis for an award of attorneys' fees in an action for damages caused by a defective engine on a

²² *Id.* at 1381.

²³ The panel does cite to a number of earlier decisions supporting reliance upon state law to answer the questions of whether attorneys' fees lie in the context of a marine insurance dispute. *See* *Am. E. Dev. Corp. v. Everglades Marine, Inc.*, 608 F.2d 123 (5th Cir. 1979); *Offshore Logistics Servs., Inc. v. Arkwright-Boston Mfrs. Mut. Ins. Co.*, 639 F.2d 1142 (5th Cir. 1981); *Eagle Leasing Co. v. Hartford Fire Ins. Co.*, 540 F.2d 1257 (5th Cir. 1976), *cert. denied*, 431 U.S. 967 (1977); *Solomon v. Warren*, 540 F.2d 777 (5th Cir. 1976); *Stuyvesant Ins. Co. v. Nardelli*, 286 F.2d 600 (5th Cir. 1961); *Gulf Oil Corp. v. Mobile Drilling Barge or Vessel*, 442 F. Supp. 1 (E.D. La. 1975), *aff'd per curiam*, 565 F.2d 958 (5th Cir. 1978).

²⁴ 838 F.2d 572 (1st Cir. 1988).

²⁵ R.I. GEN. LAWS § 9-1-33 (2002).

²⁶ *Pace*, 838 F.2d at 579.

²⁷ 994 F.2d 37 (1st Cir. 1993).

fishing trawler.²⁸ The district court rejected the claim for attorneys' fees because "such an award would conflict with federal maritime law under which the parties pay their own fees absent bad faith or oppressive litigation tactics."²⁹ The appellate court noted that state law may be relied upon to "supplement federal maritime law but may not directly contradict it."³⁰

In reaching its decision affirming the district court's denial of any award of attorneys' fees, the appellate court reasoned that cases permitting such awards, such as *Pace*, could be distinguished because these dealt with matters not the subjects of traditional maritime law.

State statutes providing for attorney's fees may sometimes be given effect in admiralty cases, notably, where the attorney's fees are awarded incident to a dispute that is not normally a subject of maritime law. For example, in *Pace* . . . we held that maritime law did not preempt a Rhode Island cause of action allowing recovery of damages and attorney's fees for an insurer's bad faith refusal to pay or settle claims; the refusal to settle claims is normally left untouched by maritime law.³¹

Clearly, the stated position of the First Circuit seems to be that unless there is a demonstration of bad faith, a marine insurer need not be concerned that an award of attorneys' fees under a state provision will be made against it after an adverse judgement in a coverage dispute. Otherwise, established principles of federal admiralty law would apply and at least in the First Circuit, these are recognized as prohibiting awards of attorneys' fees even in the face of state statutes.

Based upon the holding in *Southworth*, district courts within the First Circuit have continued to rule that attorneys' fees will not be awarded in admiralty actions, because to do so would contradict established and uniform principles of federal admiralty law.³²

In the case of *Sosebee v. Rath*,³³ the Third Circuit determined that there was now a federal maritime law rule holding that attorneys' fees could be awarded only where a defendant was shown to have acted in bad faith. In a case involving a provision from the civil

²⁸ MASS. GEN. LAWS ch. 93A, § 11 (2002).

²⁹ *Southworth Machinery*, 994 F.2d at 41.

³⁰ *Id.*

³¹ *Id.* (citation omitted).

³² See *Clarendon Am. Ins. Co. v. Fernandez*, 1999 A.M.C. 2885 (D. P.R.); *Jefferson Ins. Co. v. Maine Offshore Boats, Inc.*, 2001 A.M.C. 2171 (D. Me.).

³³ 893 F.2d 54 (3d Cir. 1990).

code of the United States Virgin Islands awarding attorneys' fees to successful litigants,³⁴ the appellate court ruled that any such statute conflicted with an admiralty law rule against such awards absent bad faith. More critically, the Third Circuit panel stated quite explicitly that its aim was to encourage the old tradition of a uniform maritime law and practice:

There is a strong interest in maintaining uniformity in maritime law. This interest would be undermined if the availability of attorneys' fees depended upon where the plaintiff filed suit. Therefore, when a case arises under the federal maritime law, as this case does, a local statute awarding attorneys' fees should not be applied.³⁵

Despite the fact that it admittedly did not deal with a marine insurance policy or a coverage dispute, there is no reason whatever to believe that the Third Circuit's holding would not extend there. Conceptually, there is no distinction between such cases and any other variety of maritime litigation, and the strongly stated rationale of uniformity in cases arising under the federal admiralty law remains vital.

V. AFFIRMING HARMONY — THE SECOND CIRCUIT DECISION

By the time the Court of Appeals for the Second Circuit took up *American National Fire Insurance Co. v. Kenealy*,³⁶ the only decision from a federal appellate court that favored application of a state attorneys' fees statutes in marine insurance coverage litigation was *INA of Texas v. Richard*.³⁷ Both the First and the Third Circuits had issued decisions prohibiting the application of state attorneys' fees statutes, and there was a strong argument to be made to the effect that the federal courts should encourage nationwide uniformity by explicitly recognizing a federal admiralty rule for the subject.

Kenealy was initiated by the marine insurer filing a declaratory judgment action in the Southern District of New York, seeking a ruling that it could not be liable for the loss of an insured vessel that took place beyond the policy's navigational limits. Both parties appealed the decision of the district court, the insurer asking for a reversal of the judgment determining that there was in fact coverage for the loss, and the insured seeking a reversal of the district court's denial of any award of attorneys' fees.

³⁴ V.I. CODE. ANN. § 541 (1967).

³⁵ *Sosebee*, 893 F.2d at 56 (citation omitted).

³⁶ 72 F.3d 264 (2d Cir. 1995).

³⁷ 800 F.2d 1379 (5th Cir. 1986).

Judge Calabresi's opinion on the attorneys' fee issue was brief and direct, reciting a line of earlier cases in which he discerned an emerging consensus on the existence of "a settled federal admiralty rule."³⁸ With the holding in the case of *Ingersoll Milling Machine Co. v. M/V Bodena*,³⁹ the Second Circuit had reached a "general rule . . . that the award of fees and expenses in admiralty actions is discretionary with the district judge upon a finding of bad faith. And this would seem to settle the matter."⁴⁰

The ruling rejected any suggestion that attorneys' fees should be awarded where the marine insurance company had been the one to initiate the unsuccessful coverage litigation by commencing a declaratory judgment action:

While *Ingersoll* did not specifically examine cases brought by insurance companies, it stated the federal prohibition against attorneys' fees in admiralty suits in the broadest of terms. It did not temper its holding by suggesting that a different rule would apply if the insurance company brought the action. We believe that our holding in *Ingersoll* suffices to "establish" a federal admiralty rule, which now must be followed instead of state law.⁴¹

Unless there was a demonstration of bad faith, federal admiralty law would not permit marine insurers to be subjected to the various and widely differing regimes set up by the states for awarding attorneys' fees in coverage litigation. Judge Calabresi cited the earlier rulings of the First Circuit in *Southworth* and from the Third Circuit in *Sosebee* in support of the consensus for the existence of an established federal admiralty rule on this subject. He stated, "the First and Third Circuits . . . have reached the same results as *Ingersoll* We agree with *Southworth* and *Sosebee*, and see no reason . . . to limit *Ingersoll*."⁴²

VI.

AFFIRMING DISHARMONY — THE ELEVENTH CIRCUIT DECISION

Courts in the Eleventh Circuit seemed to be in firm agreement with the emerging federal admiralty rule on attorneys' fees right up until the very surprising decision during the summer of 2000 rejecting the existence of any such rule in *All Underwriters v. Weisberg*.⁴³ Indeed, it is unavoidable to describe the latter decision as shocking in light of the existing

³⁸ *Kenealy*, 72 F.3d at 270 (citing *Purilan Ins. Co. v. Eagle Steamship Co.*, 779 F.2d 866 (2d Cir. 1985)).

³⁹ 829 F.2d 293 (2d Cir. 1987), *cert. denied sub nom.* J.E. Bernard & Co. v. *Ingersoll Milling Mach. Co.*, 484 U.S. 1042 (1988).

⁴⁰ *Kenealy*, 72 F.3d at 270 (citations omitted).

⁴¹ *Id.*

⁴² *Id.* at 271.

⁴³ 222 F.3d 1309 (11th Cir. 2000).

case law from the district courts within the circuit. There the Florida statute providing for attorneys' fees had been described as violative of the treasured value of uniformity in federal admiralty law, and its application to marine insurance expressly rejected.

In *Underwriters v. On The Loose Travel*,⁴⁴ and then again in *La Reunion Francaise, S.A. v. Florida Yacht Charters*,⁴⁵ the federal district court in Miami had issued decisions consistent with the consensus that had emerged among the First, Second and Third Circuits. The district court judges were manifestly prepared to recognize the existence of "a well-settled federal maritime rule that attorneys' fees are not recoverable absent federal statutory authorization or a showing of bad faith in the conduct of litigation."⁴⁶

Somewhat earlier, the same federal district court in Miami had confronted the issue from a somewhat different perspective. However, it had still reached the same conclusion that a federal admiralty law rule existed which would prohibit application of state law awards of attorneys' fees to a prevailing insured in a marine insurance litigation. In *Garan, Inc. v. M/V Aivik*,⁴⁷ the marine insurer moved to strike an offer of judgment⁴⁸ that was filed under Florida's state statute, arguing that such an award was in conflict with the established federal maritime rule. Deciding in favor of the existence of the federal maritime law rule, the district court was influenced by the fact that the case was before it on the basis of section 1333 of title 28 of the United States Code, admiralty jurisdiction. It distinguished other cases in which the state provision had been permitted to apply where jurisdiction was founded on diversity. However, separate and apart from jurisdiction, the district court was clearly convinced that the case law over the previous decade had resulted in the creation or the recognition of a federal maritime law rule requiring its deference:

The Florida statute conflicts with the American rule set forth in federal common law, as the Florida substantive rule impermissibly imposes an additional obligation on the parties in direct conflict with longstanding federal maritime common law.

While Defendant argues that courts have increasingly applied state law as a supplement to the federal maritime law, such applications are only valid when federal statutory or common law is silent on the issue. The federal law regarding

⁴⁴ 1999 A.M.C. 1742 (S.D. Fla.).

⁴⁵ 2000 A.M.C. 1953 (S.D. Fla.).

⁴⁶ *On The Loose Travel*, 1999 A.M.C. at 1744.

⁴⁷ 1995 A.M.C. 2657 (S.D. Fla.).

⁴⁸ FLA. STAT. ch. 768.79 (2002) states, in pertinent part:

In any civil action for damages filed in the courts of this state, if a defendant files an offer of judgment which is not accepted by the plaintiff within 30 days, the defendant shall be entitled to recover reasonable costs and attorney's fees incurred by her or him or on defendant's behalf . . . from the date of filing of the offer if the judgment is one of no liability or the judgment obtained by the plaintiff is at least 25 percent less than such offer.

the award of attorneys' fees in the maritime context is clear and directs each side to pay its own fees.⁴⁹

In view of the district court case law which adhered to and which commented approvingly on the authorities from the First, Second and Third Circuits, the ruling of the Eleventh Circuit in the *Weisberg* case seemed to come as a bolt from the blue to marine insurers and underwriters. The decision reversed the existing consensus among the district court judges regarding the existence of an established federal rule. In addition, it also rejected the goal of achieving any degree of uniformity on the issue.

This case that has now roiled the waters of maritime law had the most quotidian of beginnings, arising out of Lloyd's Underwriters' rejection of a claim for the sinking of a thirty-two foot motor vessel insured under a Hull & Machinery policy for an agreed value of \$50,000. Asserting material misrepresentation in the application, Underwriters' counsel commenced a declaratory judgment action in the federal district court in Miami, invoking admiralty jurisdiction. Counsel for the assureds responded with an answer and a counterclaim, including in the latter a demand for an award of attorneys' fees under the Florida statutes.⁵⁰ At a preliminary stage in the litigation, the demand for attorneys' fees was the subject of a motion to strike, which was granted by the district court. After a denial of Underwriters' summary judgment motion, the parties agreed to a settlement of the coverage dispute by which the full agreed value of the policy was paid to the assureds, reserving the assureds' right to appeal the district court's denial of attorneys' fees.

Giving a very strong indication of precisely where it intended to go, the Eleventh Circuit panel first reached the preliminary conclusion that the Florida attorneys' fee statute was substantive law, rather than merely procedural law. Therefore, it would be binding upon a federal court in Florida in any case brought on the basis of diversity jurisdiction. Having thereby cleared the decks, the panel addressed the heart of the case: whether there was an existing and applicable federal admiralty law rule on the subject, or any reason to require or justify one.

Omitting any reference whatsoever to the district court holdings in cases such as *Underwriters v. On The Loose Travel*,⁵¹ *La Reunion Francaise, S.A. v. Florida Yacht Charters*,⁵² or *Garan, Inc. v. M/V Aivik*,⁵³ the panel stated that "[t]his circuit has awarded attorneys' fees pursuant to [the Florida statute] in a number of marine insurance contract disputes."⁵⁴ The opinion cited to several rather venerable decisions, the most recent of which

⁴⁹ *Garan*, 1995 A.M.C. at 2661.

⁵⁰ See FLA. STAT. ch. 627.428(1) (2002).

⁵¹ See 1999 A.M.C. 1742 (S.D. Fla.).

⁵² See 2000 A.M.C. 1953 (S.D. Fla.).

⁵³ See 1995 A.M.C. 2657 (S.D. Fla.).

⁵⁴ *All Underwriters v. Weisberg*, 222 F.3d 1309, 1313 (11th Cir. 2000).

was from 1988, as support for this very suspect statement, and while noting that in none of these had the court dealt with the issue of whether an established federal maritime rule existed, the ruling stated:

Nonetheless, because these cases consistently applied state law to decide whether or not attorneys' fees lie in the context of a marine insurance dispute, they strongly support, if not implicitly hold, that there exists no specific and controlling federal law relating to attorneys' fees in marine insurance litigation.⁵⁵

In one of the cases cited by the panel, *Windward Traders, Ltd. v. Fred S. James & Co.*,⁵⁶ neither the court nor any of the parties had ever even raised the issue of whether application of the Florida statute was barred by an existing federal admiralty rule. Both the court and the parties had stipulated to the use of Florida state substantive law to decide the issues in the litigation.

In two other cases cited by the panel, *Steelmet, Inc. v. Caribe Towing Corp.*⁵⁷ and *Blasser Brothers, Inc. v. Northern Pan American Line*,⁵⁸ awards of attorneys' fees had indeed been permitted. However, in *Garan, Inc. v. M/V Aivik*,⁵⁹ a mere five years earlier, the court had explicitly rejected these same two cases as authority for a departure from the existence of an established federal admiralty rule, noting:

Defendants' reliance on *Steelmet* . . . and *Blasser Brothers* . . . is misplaced. In both of those cases, attorneys' fees were awarded only in third party actions on insurance contracts between insured shippers and their insurers. There, the Courts had previously recognized the ability of states to regulate rights under insurance policies issued within their domain.⁶⁰

Recognizing that a conflict existed on the question of attorneys' fees in marine insurance litigation, and having decided to reject the case law from its lower courts, the Eleventh Circuit panel defined its task as a choice between following the decision reached by the Fifth Circuit in the *Richard* case,⁶¹ or following that reached by the Second Circuit in *Kenealy*.⁶² Manifestly having already determined what course they wished to pursue, the

⁵⁵ *Id.*

⁵⁶ 855 F.2d 814 (11th Cir. 1988).

⁵⁷ 842 F.2d 1237 (11th Cir. 1988).

⁵⁸ 628 F.2d 376 (5th Cir. 1980).

⁵⁹ See 1995 A.M.C. 2657 (S.D. Fla.).

⁶⁰ *Id.* at 2661.

⁶¹ 800 F.2d 1379 (5th Cir. 1986).

⁶² 72 F.3d 264 (2d Cir. 1995).

Eleventh Circuit panel sought to justify and defend their refusal to follow the Second Circuit in finding an emerging federal admiralty rule of law, and instead criticized *Kenealy* as having been wrongly decided.⁶³

To do so, the Eleventh Circuit panel had to conclude that the Second Circuit decision in *Ingersoll Milling Machinery Co. v. M/V Bodena*⁶⁴ had not in fact provided for a “general rule . . . that the award of fees and expenses in admiralty actions is discretionary with the district judge upon a finding of bad faith” as Judge Calabresi had stated in *Kenealy*.⁶⁵ This dismissal of the *Kenealy* court’s interpretation of *Ingersoll* as having settled the matter of a federal admiralty rule on the issue of attorneys’ fees was accomplished virtually without argument.

The Eleventh Circuit panel also had to take exception with the *Kenealy* decision’s understanding of the holding by the First Circuit in *Southworth Machinery Co. v. F/V Corey Pride*,⁶⁶ and the holding by the Third Circuit in *Sosebee v. Rath*.⁶⁷ This was accomplished by noting simply that neither *Southworth* nor *Sosebee* involved denials of coverage under marine insurance policies. The Eleventh Circuit panel was thereby able to ignore the very strong language in both of these cases that would otherwise very clearly support the existence of an established and universally applied federal admiralty rule prohibiting reference to state law provisions requiring attorneys’ fees. To do so, the Eleventh Circuit panel stated, “the cases relied upon by *Kenealy* do not support the *Kenealy* court’s proposition that they reached the same conclusion as *Ingersoll*.”⁶⁸

However, as we have seen, lower courts in the First Circuit have very recently expressed their strong disagreement with the Eleventh Circuit’s reading of *Southworth* and *Sosebee*. Those courts have granted motions seeking to strike demands for attorneys’ fees in marine insurance actions as being contrary to established and uniform principles of federal admiralty law.⁶⁹

⁶³ The Eleventh Circuit panel derived intellectual support for this position from the Robertson article, *supra* note 19, in which the author had opined that the federal admiralty rule approved by the Second Circuit in the *Kenealy* decision was in fact nothing more than the so-called “American Rule” which generally provides that each side in any litigation should pay its own fees and costs in the absence of some statutory rule to the contrary. The “American Rule” being merely procedural, the author had argued that *Kenealy* therefore “rests on a conceptual error,” and was to that extent “wrongly decided.” *Id.* at 563-66.

⁶⁴ 829 F.2d 293 (2d Cir. 1987), *cert. denied sub nom.* J.E. Bernard & Co. v. Ingersoll Milling Mach. Co., 484 U.S. 1042 (1988).

⁶⁵ *Id.* at 309.

⁶⁶ 994 F.2d 37 (1st Cir. 1993).

⁶⁷ 893 F.2d 54 (3d Cir. 1990).

⁶⁸ *All Underwriters v. Weisberg*, 222 F.3d 1309, 1314 (11th Cir. 2000).

⁶⁹ *See Clarendon Am. Ins. Co. v. Fernandez*, 1999 A.M.C. 2885 (D. P.R.); *Jefferson Ins. Co. v. Maine Offshore Boats, Inc.*, 2001 A.M.C. 2171 (D. Me.).

The Eleventh Circuit decision in the *Weisberg* case is certainly subject, therefore, to criticism on the basis of its having strained to reach a preordained result. The ruling ignored lower court precedents from the district court in Miami and elsewhere, and it exaggerated the extent to which its own precedents from over a decade earlier provided any authority for permitting the state attorneys' fee statute to operate in the context of marine insurance litigation.

Most critically, however, the decision is utterly astounding for its glib and facile dismissal of the chance to avail itself of an opportunity to encourage uniformity by agreeing with the *Kenealy* decision. Previous decisions rejecting state law attorneys' fee provisions have recognized that "a strong interest exists in maintaining uniformity in maritime law,"⁷⁰ and have noted that this strong interest "would be undermined if the availability of attorneys' fees depended upon where the plaintiff filed suit."⁷¹

Where the goals of international harmony, and national uniformity, had once been explicitly announced in marine insurance decisions from the federal bench across the United States, the Eleventh Circuit's decision in *Weisberg* seems to announce a completely different policy: "*Underwriters* does not provide any reason, nor have we found one to require a unitary and uniform federal rule respecting attorney's fees in marine insurance litigation."⁷²

VII. PROGNOSTICATING THE FUTURE

The Eleventh Circuit has recently reaffirmed its *Weisberg* holding in the case of *Fireman's Fund Insurance Co. v. Tropical Shipping*.⁷³ Therefore, it must now be considered as settled law that state and federal courts in Florida resolving marine insurance coverage disputes "may award attorneys' fees pursuant to [the Florida statute] against an insurer in a marine insurance contract case."⁷⁴

Presumably, courts in the Fifth Circuit will continue to be bound by the holding in *INA of Texas v. Richard*⁷⁵ that the Eleventh Circuit evidently deemed to be so persuasive in *Weisberg*. No decisions on this subject have been forthcoming in quite some time, and it might perhaps be safest for the astute and cautious underwriter to simply presume that attorneys' fees will almost certainly continue to be awarded in Texas and Louisiana. The

⁷⁰ *Garan, Inc. v. M/V Aivik*, 1995 A.M.C. 2657, 2661 (S.D. Fla.).

⁷¹ *Sosebee v. Rath*, 893 F.2d 54, 56 (3d Cir. 1990).

⁷² *All Underwriters v. Weisberg*, 222 F.3d 1309, 1314-15 (11th Cir. 2000).

⁷³ 254 F.3d 987 (11th Cir. 2001).

⁷⁴ *Id.* at 1009 (citing *Weisberg*).

⁷⁵ 800 F.2d 1379 (5th Cir. 1986).

Fifth Circuit has not been reluctant to confound and amaze by abruptly reversing centuries of decisions supporting a uniform and established federal admiralty rule that a policy of marine insurance is subject to the doctrine of “utmost good faith,” or *uberimae fidei*.⁷⁶ If state law can be permitted to intrude into a field of marine insurance law and practice previously understood as being so manifestly federal, then it can only be reasonably expected that attorneys’ fee awards will continue to be determined by reference to state provisions.

Courts in New York and throughout the Second Circuit will continue to rule that attorneys’ fees may be awarded in marine insurance coverage litigation only where there is some demonstration of bad faith, or perhaps a breach of the obligation of utmost good faith in handling the claim.⁷⁷

At least two courts in the First Circuit have demonstrated quite recently that they understand there to exist a federal admiralty rule prohibiting awards of attorneys’ fees under state law or practice in marine insurance coverage litigation, other than in situations involving bad faith.⁷⁸

No decision has been reported out of the Third Circuit since *Sosebee v. Rath*.⁷⁹ However, it appears reasonable to expect courts in that jurisdiction to continue to feel bound by the strong language of the appellate court’s ruling emphasizing the powerful and continuing interest in application nationwide of a uniform federal rule. That rule seeks to avoid the pitfall of having a significant element of a damage award be contingent upon the plaintiff’s selection of a particular forum in which to commence a suit.

An intermediate state appellate court in Washington State has recently embraced the reasoning of the Eleventh Circuit in *Weisberg*, rejecting the *Kenealy* case and its “notion” that a uniform federal admiralty rule exists prohibiting awards of attorneys’ fees unless there is a finding of bad faith.⁸⁰ The court even suggests that in the event it were to engage in some test involving balancing of the competing federal interest in uniformity of maritime law versus the state interest in protecting its citizen-insureds who are compelled to resort to litigation in order to establish coverage, the “harmony and uniformity of maritime law does not mandate preemption of the attorney fees determination.”⁸¹

⁷⁶ See, e.g., *Albany Insurance Co. v. Anh Thi Kieu*, 927 F.2d 882 (5th Cir 1991).

⁷⁷ See, e.g., *New York Marine & Gen. Ins. Co. v. Tradeline*, 2000 A.M.C. 2139 (S.D.N.Y.).

⁷⁸ See *Clarendon Am. Ins. Co. v. Fernandez*, 1999 A.M.C. 2885 (D. P.R.); *Jefferson Ins. Co. v. Maine Offshore Boats, Inc.*, 2001 A.M.C. 2171 (D. Me.).

⁷⁹ 893 F.2d 54 (3d Cir. 1990).

⁸⁰ *Axess Int’l, Ltd. v. Intercargo Ins. Co.*, 30 P.3d 1 (Wash. Ct. App. 2001).

⁸¹ *Id.* at 8.

The United States Court of Appeals for the Ninth Circuit, overseeing the entire West Coast of the country and the great and growing ports located there, has yet to rule on this subject.

VIII. CONCLUSION

By following the holding in the *Wilburn Boat* case to its logical conclusion, certain courts have been instrumental in creating a chaotic situation where just a short time ago national uniformity and international legal harmony had been the rule. Now, in a case in which a policy warranty has been breached by the insured, the outcome of litigation might well be dependent upon whether the policy was delivered in New York or in Florida. In a case in which the evidence supports the conclusion that an unintentional but material misrepresentation was made by the insured during the application process, the outcome of litigation might well be dependent upon whether the policy was delivered in California or in Texas. With the Eleventh Circuit's decision in *Weisberg*, the uncertainty that has been imported into these areas of substantive marine insurance law has now been introduced into the question of whether a punitive award of attorneys' fees can also be visited upon a marine insurer unlucky enough to have guessed wrong on which law would apply and on how a coverage litigation would likely turn out. As the Third Circuit noted with concern in the *Sosebee* case, marine insurers and underwriters now confront a situation in which the availability of attorneys' fees as an element of damages can depend upon where a plaintiff files its lawsuit. Even without evidence of bad faith or improper handling of a claim, courts in the Fifth Circuit, Eleventh Circuit and Washington State will now impose attorneys' fees. Whereas, courts in the First Circuit, Second Circuit, Third Circuit, and Fourth Circuit will make such an award to a prevailing insured pursuant to a state statute only where the marine insurer can be shown to have acted in bad faith. There is no definitive decision as yet from the Ninth Circuit, or from the remaining federal appellate courts which, situated for the most part far from major seaports, should not be expected to take up cases involving significant marine insurance issues.

Short of willingness by the Supreme Court to take up the issue and resolve this conflict between the circuits, this sad and unfortunate situation will continue to prevail. In light of the fact that the last marine insurance case taken up for review by the Supreme Court was almost fifty years ago in *Wilburn Boat*, it must be considered highly unlikely that the Court will view the need for resolution of this dispute with any degree of urgency. It is instead rather likely that the situation involving awards of attorneys' fees in marine insurance coverage litigation will be allowed to continue as it has, unsettled and with every case before every court presenting the issue anew as ever hopeful attorneys press their cases asking for damages.

The results in the future will be various, as they have been in the past. For some courts, motivated by the historic value placed upon international harmony and nationwide uniformity, the ruling of the Second Circuit in the *Kenealy* case will continue to be persuasive and

awards of attorneys' fees will not be permitted. In other courts, unconvinced of the need for, or even the desirability of a common law and practice in marine insurance, and unwilling to concede that marine insurers might be influenced to alter their business practices in locales that permit attorneys' fees,⁸² the ruling of the Eleventh Circuit in *Weisberg* will continue to constitute a polestar. Difficult and unpleasant as it might be to continue to navigate in such treacherous waters, marine insurers and underwriters wishing to do business in the domestic United States market will find that there is no other choice.

⁸² See, e.g., the comment of the Washington State Court of Appeals in *Axess*, in which it stated its belief that “[i]t is highly unlikely a fee award in Washington would alter the business practices of insurers” *Id.*

Future FDCC Meeting Sites

2003

WINTER

Sunday, February 23 – Sunday, March 2

The Westin Mission Hills Resort
Rancho Mirage, California

ANNUAL

Saturday, July 26 – Saturday, August 2

Fairmont Le Manoir Richelieu
La Malbaie, Quebec, Canada

2004

WINTER

Sunday, March 7 – Sunday, March 14

The Orchid at Mauna Lani
Hawaii

ANNUAL

Sunday, July 25 – Sunday, August 1

Hyatt Chesapeake
Chesapeake, Maryland

Insurance, Reinsurance and Self-Insured Retentions: The Basics And Beyond[†]

Thomas F. Segalla

I. INTRODUCTION

The concepts of reinsurance, self-insured retention and additional insured status have often been considered to be illusive terms. Poor performance¹ or significant loss² can and often does result in a more keen awareness of these concepts and a tightening of the belt by the insurance industry. In such circumstances insurance and reinsurance carriers will often reevaluate the way they do business and change the focus of available coverages. For example, it has been reported that “recent natural catastrophe losses, including the huge storm and flood losses that have hit European insurers during the last two years, are promoting reinsurers to reassess the terms of catastrophe coverage.”³

Insurance and reinsurance companies become more introspective and specific when determining the nature and extent of coverage, the way they communicate, the way they deny coverage, and what they expect from each other. As a result there has been a growth of “alternative markets” to place insurance. These are alternatives to the traditional form of insurance and generally include “large self-insureds, associations, groups, pools, state funds, risk retention groups, captives, and risk purchasing groups.”⁴

[†] Submitted by the author on behalf of the FDCC Insurance Coverage Section.

¹ Lisa S. Howard, *U.S. Reinsurer Results Worsen*, NATIONAL UNDERWRITER, PROPERTY & CASUALTY/RISK & BENEFITS MANAGEMENT EDITION, Apr. 2, 2001 at 1.

² Carolyn Aldred, *Reinsurer Seeks More Precise ‘Event’ Definition*, BUS. INS., March 26, 2001 at 1.

³ *Id.*

⁴ M. Patricia Casey, *The Relationship Between Alternative Markets and Reinsurers: The Reinsurance Perspective*, 28 THE BRIEF 26 (Summer 1999).



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Of course, any time you add additional parties to the traditional insurance process more disputes tend to develop. It is recognized that coverage disputes were once almost non-existent in the reinsurance field.⁵ When these disputes become a recurring theme, the claims professional and practitioner involved in the traditional insurance field, as well as the field of reinsurance and alternative markets, must not only revisit the basics, but must consider the impact of the present environment on those basics.⁶

This article will explore the applicable basic principles in reinsurance and self-insured retention situations and highlight some of the more recent developments in these areas of law and practice.

⁵ Milton Thurm, *Allocation and Other Reinsurance Issues*, (unpublished manuscript on file with author).

⁶ Edward J. Ozog et al., *The Unresolved Conflict Between Traditional Principles of Reinsurance and Enforcement of the Terms of the Contractual Undertaking*, 35 TORT & INS. L.J. 91 (1999); Larry P. Schiffer, *New Risks for the New Economy—What Does it Mean for Reinsurers?*, MEALEY'S LITIG. REP.: REINSURANCE, Vol 11, No 9, Feb. 8, 2001.

II. REINSURANCE

A. *The Basic Arrangement*

Reinsurance is best conceptualized as “insurance of insurance companies.”⁷ Stated another way, “the insurance of one insurer (the ‘reinsured’) by another (the ‘reinsurer’) by means of which the reinsured is indemnified for loss under insurance policies issued by the reinsured to the public.”⁸ In order to fully understand reinsurance, there are certain basic definitions⁹ that must be considered:

- primary insurer - the company that writes the insurance for and has the relationship with the policyholder/insured.
- reinsurer - provides protection for the reinsured/cedant.
- retrocessionaire - provides a second layer of reinsurance (i.e. reinsurer buys insurance). In this situation the reinsurer can be referred to as a “cedant.”
- retention - the portion of the risk that the ceding insurer retains or assumes.

In addition to these basic concepts, reinsurance involves various plans and underwriting methods.

1. Reinsurance Plans¹⁰

Each of the following plans impact how the premiums are treated.

a. *Proportional Plans*

- (1) Quota share/co-insurance. Under this type of plan the loss or risk is shared proportionately. In the life insurance/reinsurance field these are two specific types of plans. Usually a fixed percentage.
 - yearly renewable term
 - modified coinsurance
- (2) Surplus share. The face amount of the policy or the policy limit depending on the type of insurance is shared on a quota basis.

⁷ HENRY T. KRAMER, *The Nature of Reinsurance*, in REINSURANCE 1, 5 (R. Strain, ed. 1980) at 5; BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES §15.01 (10th ed. 2000).

⁸ *Id.*

⁹ Thomas G. Kabele, *Reinsurance Problems in Personal Accident, Workers Compensation and Other Lines of Business*, MEALEY’S LITIG. REP.: REINSURANCE, Vol 11, No 7, August 17, 2000.

¹⁰ *Id.* This article provides an excellent technical discussion of basic definitions, plans and underwriting concepts; see also OSTRAGER & NEWMAN, *supra* note 7, at §§15.02[a],[b] & [c].

b. *Non-Proportional Plans*

- (1) Stop Loss/Excess Loss. The reinsurer on a particular loss pays an amount above the attachment point.
- (2) Stop Loss Aggregate. An aggregate attachment point is defined and the reinsurer pays the claims over that amount.
- (3) Loss Trigger/Franchise. If losses exceed the trigger point which is set, the insurer pays all claims down to a particular amount.
- (4) Horizontal Excess of Loss. This plan contemplates the adding of additional reinsurers.

c. *Fronting Arrangements*

- (1) Licensed/Unlicensed. This is a reinsurance device used by a company not qualified or licensed to do business in a particular state. The licensed insurer issues a policy with the understanding that another party will pay under the policy.¹¹

2. Reinsurance Contracts¹²

There are basically two types of reinsurance contracts written by the underwriters:

a. *Treaty Reinsurance*

Under the pure treaty contract, the reinsured cedes a block of business on an ongoing basis to the reinsurer. In such situations there could be more than one reinsurer each taking a specific amount or percentage of the total liability. Such a sharing could be open and automatic or secretive and blind.¹³

b. *Facultative Reinsurance*

This type of reinsurance deals with a specified risk insured by a particular policy or group of policies. The reinsurer individually underwrites the specific risk.¹⁴ There is a semi-automatic or automatic variation that allows the reinsurer to cancel whole or part of the risk.¹⁵

¹¹ OSTRAGER & NEWMAN, *supra* note 7, at §15.03[c]; *see also* Robert M. Hall, *Enforcing Net Retention Clauses In Reinsurance Contracts*, MEALEY'S LITIG. REP.: REINSURANCE, Vol 11, No 15, December 14, 2000.

¹² *Id.* at §15.03; Kabele, *supra* note 9.

¹³ *In re Midland Ins. Co.*, 590 N.E.2d 1186, 1188 (N.Y. 1992); *Old Reliable Fire Ins. Co. v. Castle Reins. Co.*, 665 F.2d 239, 241 (8th Cir. 1981).

¹⁴ *Unigard Sec. Ins. Co. v. North River Ins. Co.*, 4 F.3d 1049, 1054 (2d Cir. 1993).

¹⁵ *Compagnie de Reassurance d'île de France v. New England Reins. Corp.*, 57 F.3d 56, 64-65, 74-76 (1st Cir. 1995).

B. *Interpretation of Arrangement*

1. Rules of construction

Most claims professionals and practitioners are familiar with the concept that ambiguous provisions contained in an insurance policy are generally interpreted in favor of the insured and against to the insurer. Courts have made it “clear” that when interpreting the reinsurance arrangement, these traditional principles are not applied when two insurers negotiate the certificates and treaties.¹⁶ However some courts, even in the reinsurance context, have held that “where an ambiguity exists in a standard-form contract supplied by one of the parties, the well established *contra proferentum* principle requires that the ambiguity be construed against that party.”¹⁷

In addition, a principle that appears to be unique to the interpretation of reinsurance arrangement is that the courts, in interpreting the arrangement, will look to industry usage and practices and all communications and documentation utilized by the cedant and reinsurer.¹⁸ Specifically the courts will look to the course of dealing between the parties. As one court noted: “[f]acultative reinsurance agreements are not integrated agreements. It is generally recognized that the insurance agreement consists of the communications exchanged between the parties, as well as the facultative reinsurance certificates.”¹⁹

Consequently, all the correspondence and communication between the cedant and reinsurers are critically important in determining the terms of reinsurance arrangement. The court in *Donaldson* made it clear that the exchange of correspondence between the parties can create a binding agreement and the issuance of a certificate of assurance is unnecessary.²⁰ The communication and documents generated between the parties and all submissions, requests, binders, facultative notes and certificates will be reviewed in an attempt to clarify the arrangement.²¹ Even the “exchange of telephone calls or telefax” can constitute an agreement.²² The courts in reviewing the applicable evidence will use it for

¹⁶ William C. Hoffman, “*Custom and Usage*” in *Reinsurance Contracts 1997-1999 Recent Developments and Outlook*, MEALEY’S LITIG. REP.: REINSURANCE, Vol 10, No 19, February 10, 2000; *Loblaw, Inc. v. Employer’s Liab. Assur. Corp.*, 446 N.Y.S. 2d 743, 745 (App. Div. 1981), *aff’d*, 442 N.E.2d 438, (N.Y. 1982); *Great Am. Ins. Co. v. Fireman’s Fund Ins. Co.*, 481 F.2d 948, 954 (2d Cir. 1973).

¹⁷ *Westchester Resco Co. v. New England Reins. Corp.*, 818 F.2d 2, 4 (2d Cir. 1987); *see also*, *Travelers Ins. Co. v. Central Nat’l Ins. Co.*, 733 F. Supp. 522, 528 (D.Conn. 1990) (where the court held against the reinsurer because it drafted the agreement); OSTRAGER & NEWMAN, *supra* note 7, at §15.03[b].

¹⁸ *United Fire & Casualty Co. v. Arkwright Mut. Ins. Co.*, 53 F. Supp. 2d 632 (S.D.N.Y. 1999).

¹⁹ *Id.* at 28; *see also* *Donaldson v. United Community Ins. Co.*, 741 So. 2d 676 (La. Ct. App. 1999); *see generally*, COUCH ON INSURANCE 3d §13:17; *see also* Hoffman, *supra* note 16.

²⁰ *Donaldson*, 741 So. 2d 676.

²¹ *Id.*

²² *Sumitomo Marine & Fire Ins. Co. v. Cologne Reinsurance Co.*, 552 N.E.2d 139, 142 (N.Y. 1990).

the purpose of “clarifying, but not contradicting or changing the terms.”²³ Therefore, it is important that representatives of the primary insurer, reinsurer, retrocessionaire, Lloyds syndicate member, reinsurance manager, primary managing general underwriter and broker be aware that their activities will be judged based upon a course of dealing and industry practices. They should be further made aware that those activities could be used to “clarify” the reinsurance relationship.

2. Enforcement of Terms

Once the terms of the arrangement have been defined, the courts will consider basically the following two concepts in determining how and in whose favor the specific terms of the agreement will be enforced.

a. *Follow the Fortunes Doctrine*

Historically, the follow the fortunes doctrine was referred to as a loss settlement clause. However, most jurisdictions refer to clauses of this nature as the follow the fortune doctrine and defined it as follows:

A loss settlement clause, in the absence of a provision to the contrary, binds the reinsurer to pay its share of the reinsured’s settlement of losses under an original insurance unless:

1. The loss is beyond the scope of the insurance as a matter of law; or
2. The loss, in the case of a reinsurance coextensive with underlying insurance, is beyond the scope of the underlying insurance as a matter of law; or
3. The settlement was fraudulent, collusive, in bad faith or otherwise dishonest; or
4. The reinsured failed to take all businesslike steps reasonably necessary to properly and carefully investigate and ascertain the amount of the loss.²⁴

Succinctly stated, a follow the fortune clause requires reinsurers to pay their share of a loss settlement made by the insured if the loss settled was, with respect to liability and damages, reasonably within the scope of the reinsurance arrangement. That is, payments need be made if the loss is covered by the original policy and the reinsurance contract, subject of course, to the foregoing defense. As one court has noted, a loss would be without reinsurance if it was not contemplated by the original insurance policy or if it was expressly excluded by the term of the certificate of reinsurance.²⁵

²³ United Fire & Casualty Co. v. Arkwright Mut. Ins. Co., 53 F. Supp. 2d 632 (S.D.N.Y. 1999); *see also*, Ozog et al., *supra* note 6.

²⁴ Ozog et al., *supra* note 6 (citing William C. Hoffman, *Common Law of Reinsurance Law Settlement Clauses*, 28 TORT & INS. L.J. 659, 677 (1993)).

²⁵ North River Ins. Co. v. CIGNA Reins. Co. 52 F.3d 1194 (3d Cir. 1995); *see also*, Bellefonte Reins. Co. v. Aetna Cas. & Sur. Co., 903 F.2d 910 (2d Cir. 1990).

Another court recently held that in order to avoid its obligation under a follow the fortune clause, the reinsurer must prove that “the reinsured’s gross negligence or bad faith, or that the settlement was not even arguably within the scope of the reinsurance coverage.”²⁶ The follow the fortunes clause does not rewrite the terms of the arrangement. The majority of courts have supported such a conclusion.²⁷

Also of significance is the fact that the courts have held that a follow the fortune clause will not be implied into the insurance contract and there must be an express provision²⁸ that is similar to the following:

The liability of the reinsurer . . . shall follow that of the company, subjected in all respects to all the terms, conditions and limits of the company’s policy(ies), except when otherwise specifically provided herein or designated as non-concurrent reinsurance in the declarations²⁹

Closely related to a follow the fortune clause is a follow the form clause. It generally provides: “concurrency between the policy of reinsurance and the reinsured policy is presumed, such that a policy of reinsurance will be construed as offering the same terms, conditions and scope of coverage as exists in the reinsured policy. That is, it exists in the absence of explicit language in the policy of reinsurance to the contrary.”³⁰

b. “*Uberrimae fidei*”

This duty, of utmost good faith, has been described as “a mutual duty each party owes the other. The duty exists with respect to any action necessary or desirable in order to place and maintain both parties within a fair and equitable bargain.”³¹ It is recognized that “. . . a reinsurer’s obligation to indemnify its cedant pursuant to the follow the fortunes doctrine is conditioned on the good faith exercised by the cedant in its dealing with the reinsurers.”³² While there are a varying number of standards applied by the courts, one commentator provides an interesting spectrum and defines three potential standards:³³

²⁶ Hartford Accid. & Indemn. Co. v. Columbia Cas. Co., 98 F. Supp. 2d 251 (D. Conn. 2000).

²⁷ See Am. Ins. Co. v. N. Am. Co. for Prop. & Cas. Ins., 697 F.2d 79 (2d Cir. 1982) (holding that despite a follow the fortune clause, the reinsurer is only liable for a loss of the kind reinsured).

²⁸ Michigan Twp. Participating Plan v. Federal Ins. Co., 592 N.W.2d 760 (Mich. Ct. App. 1999); Int’l Surplus Lines Ins. Co. v. Certain Underwriters at Lloyd’s of London, 868 F. Supp. 917 (S.D. Ohio 1994); see generally, Hoffman, *supra* note 16.

²⁹ OSTRAGER & NEWMAN, *supra* note 7, at §16.01[d].

³⁰ *Id.*

³¹ Kramer, *supra* note 7, at 9; see generally, M. Patricia Casey, *The Relationship Between Alternative Markets and Reinsurers: The Reinsurance Perspective*, 28 THE BRIEF 26 (Summer 1999).

³² Ozog et al., *supra* note 6; see also, Kabele, *supra* note 9.

³³ Kabele, *supra* note 9.

- (1) Highest — cedant subordinates its interests to that of the other party.
- (2) Middle — treat your interests as you would treat others.
- (3) Lowest — watch out for yourself first, do not conceal and act unfairly.

The type of underwriting, that is the retention amount, could affect the standard to be applied. The doctrine has recently been raised in the context of the cedants failure to disclose critical information or the making of various misrepresentations about the risk or its own insolvency.³⁴

It is also recognized that the reinsurer owes the cedant a duty of good faith and fair dealing. Recently, in *Commercial Union Insurance v. Seven Province Insurance Co.*,³⁵ the First Circuit Court of Appeals held that the reinsurer's conduct, consisting of rising multiple, shifting defenses (many unsubstantiated) in a lengthy pattern of foot-dragging and stringing Commercial Union along, with the intent of pressuring Commercial Union to compromise its claims,³⁶ constituted a violation of the Unfair Trade Practices Act.

C. *Other Obligations of Parties*

The typical reinsurance arrangement involves the underlying insured, the reinsured and reinsurer. In order to understand the reinsurance relationship, an understanding of the obligation among and between these parties is necessary.

1. Obligations of Reinsured to Reinsurer

Over and above the doctrines and duties discussed above, the reinsured is required to do the following:

a. *Notice of Claim*

Most reinsurance arrangements require that the reinsured provide the reinsurer with prompt notice.³⁷ The courts have not precisely defined what is considered prompt notice and what should trigger the notice. The courts have indicated that the timeliness of the

³⁴ *Compagnie de Reassurance d'ile de France v. New England Reins. Corp.*, 57 F.3d 56, 64-65, 74-76 (1st Cir. 1995); *Michigan Nat'l Bank – Oakland v. Am. Centennial Ins. Co.*, 674 N.E.2d 313 (N.Y. 1996); see *Allendale Mut. Ins. Co. v. Excess Ins. Co.*, 992 F. Supp. 278, 283 (S.D.N.Y. 1998) (for the general statement of the law; however, note that the complaint was dismissed on jurisdictional grounds at 62 F. Supp.2d 116 (S.D.N.Y. 1999)); see also *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.*, 9 F. Supp. 2d 49 (D. Mass. 1998).

³⁵ 217 F.3d 33 (1st Cir. 2000), *cert. denied*, 531 U.S. 1146 (2001).

³⁶ *Id.*

³⁷ *Zenith Ins. Co., v. Employers Ins. Co.*, 141 F.3d 300 (7th Cir. 1998); *Christiania Gen. Ins. Corp. v. Great Am. Ins. Co.*, 979 F.2d 268 (2d Cir. 1992).

³⁸ For a general discussion of late notice, see OSTRAGER & NEWMAN, *supra* note 7, at §16.02.

notice is judged by an objective standard³⁸ and that custom and usage in the reinsurance industry judge the nature and reasonableness of the notice.³⁹ The traditional view was that the reinsurer was not required to show prejudice in order to prevail on a late notice claim.⁴⁰ However, the recent majority view requires that the reinsurer show that it has been prejudicial.⁴¹ Courts have held that there must be some “tangible economic injury” to the reinsurer.⁴² Similarly, courts have decided that a cedant’s bad faith can be a substitute for the prejudice requirement - - simple negligence is not enough.

b. *Underwriting and Claims Handling*

It is consistently recognized that the cedant must exhibit competent underwriting and claims handling and specifically that it must act “honestly and [has] taken all proper and businesslike steps” in investigating and resolving the claim.⁴³ It appears most courts require more than the mere negligence in the handling of a claim in order for the reinsurer to rescind the agreement. For example, the Third Circuit Court of Appeals requires that the “misadjustment” be as a result of gross negligence or reckless conduct.⁴⁴

The reinsurer under the follow the fortunes doctrine “cannot second guess the good faith liability determinations made by its reinsured, or the reinsured’s good faith decision to waive defenses to which it may be entitled.”⁴⁵ However, what happens if the reinsurer becomes involved in defending the loss or in the claims handling process. In *Venetsanos v. Zucker, Facher & Zucker*⁴⁶ the court held:

We recognize and endorse the general rule that an original insured does not enjoy a right of direct action against a true reinsurer. It is settled that an ordinary treaty of reinsurance merely indemnifies the primary insurer against loss rather than against liability.⁴⁷

³⁹ *Id.* at §16.02[a].

⁴⁰ *Id.* at §16.02[b]; *Unigard Sec. Ins. Co. v. N. River Ins. Co.*, 762 F. Supp. 566, 592 (S.D.N.Y. 1991), *certified questioned answered*, 594 N.E.2d 571 (N.Y. 1992); *aff’d in part, rev’d in part*, 4 F.3d 1049 (2d Cir. 1993).

⁴¹ *Unigard*, 4 F.3d at 1069.

⁴² *Id.*

⁴³ OSTRAGER & NEWMAN, *supra* note 7, at §15.04[a]; *see generally*, *Ins. Co. of Africa v. Scor (U.K.) Reins. Co.*, [1985] 1 Lloyd’s Rep. 312 (Ct. App. 1984); *Am. Marine Ins. Group v. Neptunia Ins. Co.*, 775 F. Supp. 703, 708 (S.D.N.Y. 1991), *aff’d*, 961 F.2d 372 (2d Cir. 1992).

⁴⁴ *N. River Ins. Co. v. CIGNA Reins. Co.*, 52 F.3d 1194 (3d Cir. 1995).

⁴⁵ *Christiania Gen. Ins. Corp. v. Great Am. Ins. Co.*, 979 F.2d 268, 280 (2d Cir. 1992).

⁴⁶ 638 A.2d 1333 (N.J. Super. Ct. App. Div. 1994).

⁴⁷ *Id.* at 1339 (citations omitted).

The general rule changes when:

. . . the conduct of the reinsurer demonstrates that it takes charge of and manages the defense of suits against the original insured, the reinsurer may be held to be a 'privy' to the action. In such case, . . . the insured [has] been allowed to proceed directly against the reinsurer.⁴⁸

The extent of the reinsurer's involvement that will trigger the change of the general rule is difficult to predict and one commentator has noted that "[a]t some level of involvement, reinsurers share the cedant's obligation to the insured handle claims in a fair and efficient fashion. The point at which this takes place, however, is not yet clear."⁴⁹

2. Obligations of Reinsurer to Reinsured

Generally, the obligations of reinsurer are defined and governed by the reinsurance arrangement. Specifically, the reinsurer arrangement is one of indemnity and the reinsurer owes nothing to the reinsured until the claim has been paid.⁵⁰ In *International Surplus Lines Insurance Co. v. Fireman's Fund Insurance Co.*,⁵¹ the court held that the burden of proof is on the reinsured to establish that the reinsurer is liable under the reinsurance contract. Once the reinsured has met its burden of proof, the burden shifts to the reinsurer to show there is an exception or defense to coverage.⁵²

Traditionally under an indemnity agreement, the reinsurer in addition to the amount of loss is required to pay the reinsured a proportional share of expenses incurred by the reinsured and related to the defense and claim handling of the underlying claim.⁵³ Recently, in *TIG Premier Insurance Co. v. Hartford Accident & Indemnity Co.*⁵⁴ the court considered this issue of whether a reinsured under a facultative reinsurance agreement was entitled to recover expenses in addition to the limits. The court, in distinguishing two New York cases and deciding the issue under California law, held there were questions of fact as to whether the meaning of the certificate could be used to include the reimbursement of expenses.⁵⁵

⁴⁸ *Id.*; see also, *Keightley v. Republic Ins. Co.*, 946 S.W.2d 124 (Tex. Ct. App. 1997) (opinion was subsequently withdrawn by stipulation of the parties at a rehearing).

⁴⁹ Robert M. Hall, *Reinsurance Coverage of Excess of Policy Limits and Extra Contractual Obligations*, MEALEY'S LITIG. REP.: REINSURANCE, Vol 11, No 16, December 28, 2000.

⁵⁰ See generally, OSTRAGER & NEWMAN, *supra* note 7, at §15.04[b].

⁵¹ No. 88C320, 1992 U.S. Dist. LEXIS 1022 (N.D. Ill. 1992), *aff'd*, 998 F.2d 504 (7th Cir. 1993).

⁵² *Id.*; see also, *Charman v. Guardian Royal Exchange Assurance* [1992] 2 Lloyd's Rep. 607.

⁵³ OSTRAGER & NEWMAN, *supra* note 7, at §15.04[b].

⁵⁴ 35 F. Supp. 2d 348 (S.D.N.Y. 1999).

⁵⁵ *Id.* at 351. Compare, *Unigard Sec. Ins. Co. v. North River Ins. Co.*, 4 F.3d 1049, 1071 (2d Cir. 1993) and *Bellefonte Reins. Co. v. Aetna Cas. & Sur. Co.*, 903 F.2d 910, 911 (2d Cir. 1990).

3. Liability of Reinsurer to Policyholder

Courts have traditionally held that “an insured does not have a direct right of action against a reinsurer, since the reinsurance contract is only one of underwriting to the original insurer.”⁵⁶ The basis for such holdings is that privity of contract exists only between the reinsurer and the reinsured.

There is no privity between the reinsurer and the original insured/policyholder. Specifically, it has been stated:

[A] contract of reinsurance being one between the reinsurer and the insurer/reinsured, absent language in the policy indicating the reinsurer’s intent to be directly liable to the insured, the reinsurer has no obligation to the original insured which cannot claim the status of third party beneficiary of the reinsurance contract.⁵⁷

It is recognized that the contract can be drafted to operate in favor of the insured and provide by a “cut through” clause that the original insured has a direct action.⁵⁸ Also, the course of dealing or custom and practice can alter the general rule. This is especially true where the reinsurer becomes involved in the claims process.⁵⁹

D. *Discovery Issues*

Several courts have recently treated the issue of whether the communications between the reinsured and reinsurer are protected as extrinsic evidence, privilege or work product. Further, the courts have been filled with discovery challenges between reinsureds and reinsurers.⁶⁰ A complete discussion of this issue is beyond the scope of this article; however, it should be noted that most jurisdictions subscribe to the “common interest doctrine” that permits parties who possess common legal interests to share and exchange attorney-client privilege information without that information losing its protected stakes.⁶¹ The doctrine also applies to the reinsurance arrangement.⁶²

⁵⁶ *Klockner Stadler Hurter v. Ins. Co. of Pa.*, 785 F. Supp. 1130, 1133 (S.D.N.Y. 1990).

⁵⁷ *Michigan Nat’l Bank – Oakland v. Am. Centennial Ins. Co.*, 611 N.Y.S.2d 506, 511-12 (App. Div. 1994), *aff’d*, 674 N.E.2d 313 (N.Y. 1996); *see also*, *Litho Color, Inc. v. Pacific Employers Ins. Co.*, 991 P.2d 638 (Wash. 1999); *Gannon Trucking v. Aon Corp.* No. BC199481 (Cal. Super. April 4, 2000).

⁵⁸ *Bruckner-Mitchell, Inc. v. Sun Indem. Co.*, 82 F.2d 434, 444 (D.C. Cir. 1936).

⁵⁹ *Klockner Stadler Hurter v. Ins. Co. of Pa.*, 785 F. Supp. 1130, 1134 (S.D.N.Y. 1990); *see also*, OSTRAGER & NEWMAN, *supra* note 7, at 15.04[d].

⁶⁰ For an excellent discussion of these discovery issues, see Ellen K. Burrows & John H. O’Leary, *Discovery and Privilege: Protecting Reinsurance Communication in an Uncertain Legal Landscape*, MEALEY’S LITIG. REP.: REINSURANCE, Vol 10, No 12, Oct. 28, 1999.

⁶¹ *Id.*; *see also* James M. Fischer, *The Attorney-Client Privilege Meets the Common Interest Arrangement: Protecting Confidences While Exchanging Information for Mutual Gain*, 16 REV. LITIG. 631, 646 (1997).

⁶² *Minn. School Boards Ass’n Ins. Trust v. Employers Ins. Co.*, 183 F.R.D. 627 (N.D. Ill. 1999); *Nat’l Union Fire Ins. Co. v. Stauffer Chem. Co.*, 558 A.2d 1091 (Del. Super. Ct. 1989); *Durham Indus., Inc. v. N. River Ins. Co.*, No. 79 Civ. 1705 (RWS), 1980 U.S. Dist. LEXIS 15154 (S.D.N.Y. Nov. 21, 1980).

A claimant in a bad faith action against its insurer will seek disclosure of communications between the reinsured and reinsurer. Two recent cases supply some guidance in this area. In *Young v. Liberty Mutual Insurance Co.*,⁶³ a bad faith claimant sought communication between the reinsured and reinsurer pertaining to reserve information. In noting that the information requested was extrinsic evidence, the court allowed discovery because it might aid in interpreting the meaning of the terms in the CGL policies.⁶⁴ The reinsured sought to protect communications with its reinsurer in the case of *Front Royal Insurance Co. v. Gold Players, Inc.*⁶⁵ In holding that the documents were created in the ordinary course of business under the contractual obligation between the insurer and reinsurer and not prepared in anticipation of litigation, the court ruled they were not protected under the work product doctrine.⁶⁶

E. Allocation

The disputes that arise between the reinsured and reinsurer over the allocation payments have generally been in environmental and mass tort litigation. The case of *Commercial Union Insurance Co. v. Seven Provinces Insurance Co.*⁶⁷ raises the key issues that must be addressed when seeking to determine whether the allocation method selected is proper. In the typical case the reinsured will settle the past and future claims and in arriving at a settlement figure will choose to settle for commercial reasons. That figure will not necessarily be based on actual liability and may not involve each policy period. As one commentator noted:

Reinsurers may object . . . that the reinsured has singled out policy years in which the reinsurance retention was lowest, or that the reinsured's settlement artificially minimized the number of occurrences, all in order to reduce retained loss and maximize the indemnity payment from reinsurers.⁶⁸

In determining whether the allocation is enforceable, the courts will look at "whether the allocation of the settlement to reinsurers was rational, reasonable, fair and transparent with regard to liability and calculation of damages, as well as, to whether the particular portion of the losses allocated are reasonably shown to be within the scope of reinsurance."⁶⁹

⁶³ No. 3:96-CV-1189 (EBB), 1999 U.S. Dist. LEXIS 6987 (D. Conn. Feb. 16, 1999).

⁶⁴ *Id.*

⁶⁵ 187 F.R.D. 252 (W.D. Va. 1999).

⁶⁶ *Id.*

⁶⁷ 9 F. Supp. 2d 49, 64 (D. Mass. 1998), *aff'd*, 217 F.3d 33 (1st Cir. 2000), *cert. denied*, 531 U.S. 1136 (2001).

⁶⁸ Hoffman, *supra* note 16.

⁶⁹ *Id.*

F. *The Future*

One merely has to review the areas in the reinsurance field that have been recently addressed by the courts to determine what future issues will form the basis of challenges to the traditional reinsurance concepts.

1. Is there a fiduciary duty between the cedant and reinsurer?⁷⁰
2. Can the reinsured sue the reinsurer's assignee under an assumption agreement?⁷¹
3. Does the reinsurer have the right to setoff in the liquidation of the reinsured?⁷²
4. Do the policyholder and accident victims have a direct action against the reinsurer?⁷³
5. Can reinsurer's conduct be considered Unfair Trade Practice?⁷⁴
6. Can a reinsurer be liable for bad faith to the underlying insured?⁷⁵

It is recommended that the claims professional review these key case developments and updates to determine what is around the corner. This will allow them to adjust to the ever-changing climate of reinsurance.

III.

SELF INSURED RETENTION/DEDUCTIBLE AND OTHER PLANS

A. *Generally*

The number of entities choosing some sort of insurance "out-of-the box" has significantly increased in the last twenty years.⁷⁶ It is generally recognized that such an increase has been determined to be a direct response to a reduction in limits, changes to commercial insurance policy coverage and an increase in premiums.⁷⁷ "Unavailability" and

⁷⁰ See *United States v. Brennan*, 183 F.3d 139 (2d Cir. 1999).

⁷¹ See *Nationwide Mut. Ins. Co. v. Home Ins. Co.*, 150 F.3d 545 (6th Cir 1998).

⁷² See *Comm'r of Ins. v. Munich Am. Reins. Co.*, 706 N.E. 2d 694 (Mass. 1999).

⁷³ See *Donaldson v. United Community Ins. Co.*, 741 So. 2d 676 (La. Ct. App. 1999).

⁷⁴ See *Commercial Union Ins. Co. v. Seven Provinces Ins. Co.*, 217 F.3d 33 (1st Cir. 2000), *cert. denied*, 531 U.S. 1136 (2001).

⁷⁵ See *Litho Color, Inc. v. Public Employer's Ins. Co.*, 991 P.2d 638 (Wash. Ct. App. 1999).

⁷⁶ Rory A. Goode, *Self-Insurance as Insurance in Liability Policy "Other Insurance" Provisions*, 56 WASH. & LEE L. REV. 1245, 1251 (1999).

⁷⁷ See generally, George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L. J. 1521, 1526-27 (1987).

“unaffordability” can do wonders for creative risk managers.⁷⁸ Consequently, not only has there been a rise in the use of traditional self-insurance retention programs, there has been a development in a hybrid of these types of insurance arrangements.⁷⁹ These arrangements combine some sort of self-insurance retention where the company retains a portion of the risk with traditional insurance — primary, and excess insurance, umbrella insurance. The claims professional and practitioner should be aware, however, that courts and commentators often use these terms interchangeably and this can result in inconsistent interpretations. As one commentator noted: “courts frequently treat deductible and self-insured retentions as interchangeable terms, so descriptions of policies at issue in decided cases may characterize these policies inaccurately.”⁸⁰

While this portion of the article will concentrate on self-insurance retention plans and deductibles, the individuals and entities involved in this area of insurance practice must be aware of certain standard definitions.⁸¹

- *Pure self-insurance.* This is the complete absence of any type of insurance. The entity is considered “bare.” As a practical matter, most companies cannot afford to face catastrophic losses and significant litigation that can result in serious financial loss and bankruptcy; therefore, this is not usually used.
- *Self-insured retention.* Under this concept an entity agrees to be responsible for all the amount of the claim up to a specified sum and thereafter various layers of insurance become involved.
- *Fronting Policies.* Under this plan there is a complete retention of the risk by the entity. The obligations of the insurer come into play when the entity is unable to pay a loss sustained by a third party. Up until that point the insured fulfills the function of an insurer — adjust the loss and agrees to pay the insured for any payment it makes. These policies are required by many states in order for the “self-insured” to meet governmental insurance requirements.
- *Retrospective Rated Policies.* Program of this nature operated based on the insured’s loss history. Based upon the insured’s claims experience during the prior year, the insurance company “retrospectively” sets the premium charged. This can

⁷⁸ Goode, *supra* note 76, at 1251.

⁷⁹ *Id.*

⁸⁰ William T. Barker, *Combining Insurance and Self-Insurance: Issues For Handling Insurance and The Decision To Settle*, 61 DEF. COUNS. J. 352 (1994).

⁸¹ For a general discussion of these plans see Goode, *supra* note 76, at 1254-58; *see also*, Douglas R. Richmond, *Issues and Problems in “Other Insurance,” Multiple Insurance and Self-Insurance*, 22 PEPP. L. REV. 1373 (1995); James M. Fischer, *The Presence of Insurance and the Legal Allocation of Risk*, 2 CONN. INS. L.J. 1 (1996).

result in either a rebate to the insured where the actual losses are less than the estimation or an additional premium if the losses exceed the estimation made by the insurer.

As noted below, depending on the plan that is chosen, there are some critical implications to the coverages that may be available to insureds and precisely what portion of the risk will be the responsibility of one or more insurance companies. The availability of other “primary insurance” (i.e. standard forms of insurance); “excess insurance” (i.e. insurance immediately over primary covers which can be several levels); “umbrella insurance” (i.e. excess above specific primary coverage and supplement coverage for other risks not covered by the primary) and “reinsurance” (i.e. insurance for all or part of the cedant/reinsured’s primary coverage) will determine who will pay what.

B. *Differences.*

What are the differences between a self-insurance retention and a deductible?⁸² The analysis given by the Brown & Riding Insurance Service article takes into consideration defense obligations; settlement/payment obligations; situations where there are multiple insurers and continuous losses (i.e. allocation). Another, issue that must be considered is the impact of “other insurance” clauses contained in various policies.

- *Defense Obligations.* When dealing with a deductible situation, the insurer controls the defense and is governed by general coverage principles that the duty to defend is greater than the duty to indemnify. The insurer is responsible for defense costs and counsel fees, unless there is a barring limits provision in the policy which “eats” into the indemnification limits. In contrast, under a situation where self insured retention is involved, the insured is obligated to defend its own interests and administer the claim until the retention limit is exhausted. It is generally recognized that the insurer can monitor the insured’s claims handling, which must be done in good faith. When an insurer is concerned that there may be collusive activity between the insured and an implied third party, the insurer should closely monitor the insured’s activities and retain its own counsel in the appropriate case. Defense costs are the responsibility of the insured until the retention is exhausted.⁸³
- *Settlement.* When considering the rights and obligations of the insured and insurer concerning the settlement of the claim, the focus is on whose consent is required. In a deductible situation, the insurer can settle the case without the insured’s consent, can pay the settlement amount and then collect its deductible from the

⁸² For an excellent discussion of the relationship of these two concepts see the article published by Brown & Riding Insurance Services, Inc. (“Brown & Riding”) entitled Self Insured Retentions (SIR) <http://www.browndanriding.com/casualty1ihtm> (last visited 4/9/01).

⁸³ *Id.*

insured. There does not appear to be any case law on point, however, it is generally understood that an insured can settle within its retention without consulting the insurer. The reverse proposition, the insurer settling within the retention without the insured's consent, is not allowed. When, however, the loss has a value in excess of the self-retained limit, an insurer should be able to settle the case provided its actions are in good faith and the settlement is reasonable.⁸⁴ The insolvency of the insured can also have a significant impact on payment obligations. When the policy has a deductible, the insolvency of the insured does not limit the obligation of the insurer to pay the loss; whereas, in a self-insured retention situation, the insurer is not obligated to drop down and cover the insured's retention obligation.⁸⁵

- *Allocation/Continuous Loss.* A complete analysis of the allocation issue is not within the scope of this article.⁸⁶ Any analysis of the issues involved in a continuous loss where there may be multiple claims arising out of the same "occurrence" generally turns on how the policy defines "occurrence." A policy can be drafted to provide a deductible per claim and in such cases several deductibles can be triggered for the same claim.⁸⁷ If the insurance arrangement contains a self-insured retention, the insured in a situation where there are multiple primary policies can "target" one insurer and allow that insurer to obtain contribution from other insurers. Also, in the appropriate situation the issue of whether stacking of the self-retained limits is allowed must be considered. The issues have best been described as follows:

For policies that have deductibles or SIRs, how are they to be applied? Insurers argue that they should be applied 100% to each triggered policy; however, policyholders contend that only the portion of the deductible equal to the percentage of the entire loss attributable to that policy year should be applied. If deductibles or SIRs are applied at full value and there is horizontal stacking, the policyholder may have to pay significant sums before it accesses any insurance.⁸⁸

As with any type of analysis of this nature, the wording of the policy must be clear and unambiguous.

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ For an excellent discussion of allocation issues, see Nicholas J. Zoogman, *Resolving Allocation Problems*, presented at the Complex Insurance Claims Seminar conducted by the American Conference Institute, New York, N.Y., May 3 & 4, 2001.

⁸⁷ Brown & Riding, *supra* note 82.

⁸⁸ *Id.*

C. *Other Insurance Issues*⁸⁹

The concept of “other insurance” comes into play when two or more companies insure the same interest and the same entity during the same policy period. Concurrent policies are involved, as opposed to consecutive policies. The typical concurrent insurance situation exists when the driver of a non-owned automobile is a named insured under his own policy and is covered under the omnibus clause contained in the insurance policy of the owner. In such situations, the insured should tender the claim to call concurrent insurers and the loss is allocated between the insurers. There are traditionally four types of “other insurance” clauses.

- *Pro Rata Clause*. Such a clause provides that if other insurance exists, the insurer will pay its pro rata share in relation to the insurers’ respective liability limits. In other words, this would be the proportion one insurer’s policy limits bears to the aggregate limit of all other valid and collectible insurance.⁹⁰
- *Excess Clause*. The insurer’s expense is limited to the amount of the loss that exceeds all other valid and collectible insurance and its total exposure is limited by the limits of the policy containing the excess clause.⁹¹
- *Escape Clauses*. Simply stated this type of clause generally provides that the insurer is relieved from any obligation to the insured if other coverage is available.⁹²
- *Tailor-Made Clauses*. It is extremely difficult to characterize these types of clauses because they are specifically drafted to cover specific types of risks and are meant to address specific requirements of an insured. Generally, this type of clause is a combination of the other three.⁹³

How does the other insurance clause of one policy effect a policy that contains a self-insured retention? As noted above, “other insurance” refers to the existence of another insurer that insures the same risk for the benefit of the same entity during the same policy period.⁹⁴ The question initially stated is whether the self-insurance retention constitutes other valid and collectible insurance for the purpose of the other insurance clause.

⁸⁹ See generally, Richmond, *supra* note 81, at 1376-77; Goode, *supra* note 76, at 1258-59.

⁹⁰ OSTRAGER & NEWMAN, *supra* note 7, at 11.02[a], Richmond, *supra* note 81, at 1382-82.

⁹¹ *Id.* at 11.02[b].

⁹² *Id.* at 11.02[c].

⁹³ Richmond, *supra* note 81, at 1387-88. For a comparison of policies that contain various clauses, see *id.* at 1388-89.

⁹⁴ Goode, *supra* note 76, at 1260-61.

The majority rule has been stated by the Minnesota Court of Appeals in the case of *Minnesota Mining & Manufacturing Co. v. H&W Motor Express Co.*⁹⁵ There the court held that the retained limit is not coverage. A significant number of other jurisdictions follow the view that self-insurance constitutes insurance within the meaning of an automobile liability policy.⁹⁶ Courts have looked at various factors in choosing whether to follow the majority or minority rule. It has been noted that since insurance is a mechanism for the transfer of risk from one person or organization to another different entity, the minority rule is not “analytically sound.” Such issues as to whether the relationship resembles insurance; what is a lay person’s understanding; what do the statutory rules provide; legislative history and public policy considerations come into play.⁹⁷ Consequently, it is extremely difficult to predict how a jurisdiction that has not decided the issue might rule.

IV. ADDITIONAL INSURED STATUS

As discussed above, most parties intending to protect themselves from liability on a construction project will not only require that the subordinate party indemnify and hold them harmless, but also that they be made an additional insured under the indemnitor’s CGL policy.

Additional insured status is meant to help more clearly define the parties’ obligations and responsibilities. For the company seeking protection, additional insured status is supposed to be the next best thing to buying insurance, and in some ways it is better. For example, the additional insured, theoretically, has direct access to the named insured’s insurance company. As a result, the additional insured may not need to go through the named insured in order to obtain the benefits of insurance. Additionally, as a result of going through another party’s policy, it may enjoy a better loss experience on its own policy which translates to lower insurance costs for the additional insured. Of course, the indemnitee feels more comfortable with an indemnitor’s obligation to indemnify if the indemnitor can back up his obligation with insurance.

Other advantages for the additional insured include preventing subrogation, avoiding some exclusions in the additional insured’s own policy, and obtaining personal injury coverage that may be unavailable under first party contractual liability coverage. On the other hand, those positives for the additional insured can result in substantial negatives for the named insured. An additional insured will certainly increase the named insured’s exposure

⁹⁵ 507 N.W.2d 622, 625 (Minn. Ct. App. 1993); For an analysis of the majority rule, see Goode, *supra* note 76, at 1260.

⁹⁶ *Hillegass v. Landwehr*, 499 N.W.2d 652 (Wis. 1993); see Goode, *supra* note 76, at 1262.

⁹⁷ OSTRAGER & NEWMAN, *supra* note 7, at 13.13[b].

to risk. Additionally, an insurer's money spent on indemnifying and defending other parties can erode policy limits.

Courts will afford an insurance policy's provisions and terms their plain and ordinary meaning to the extent they are unambiguous, and will generally not extend or alter coverage beyond its terms. As a result, the interpretation of an additional insured's rights and obligations under the policy is determined by the policy's phraseology, and the initial focus should be on those terms. Including an additional insured on an already existing policy could have a significant effect on the type, scope, and limit of coverage provided by the policy. Additional insureds are faced with questions regarding policy limits, exclusions that may avoid coverage, the possibility that their own policies may be triggered to act as co-primary or even primary, and the additional insured's general lack of control over the other party's insurance program. Both additional and named insureds must be aware of when aggregate limits under the policy must be shared by all insured parties.

A. *Direct v. Vicarious Liability*

Insurers often take a position that the additional insured has no right to expect coverage for its own negligence, especially if the accident arose out of activities unrelated to the named insured's performance. Not surprisingly, courts attempt to enforce the parties' intentions, but such intentions are not always clear. The best way to avoid this problem is to be certain, from the inception, that there is a clear written understanding among the contracting parties, as well as the carrier, as to what liabilities are intended to be covered under the additional insured language.

Many courts will look to the language of the underlying contract when determining the extent of coverage. As a result, the court is more likely to find coverage for the additional insured's own direct negligence if the underlying agreement to procure includes insurance to protect against exactly that. If, for example, the policy simply names a party as an additional insured, without more, that party is more likely to be covered for its own direct negligence.

Courts considering public policy may draw a distinction between agreements to obtain insurance and agreements to indemnify. While agreements to indemnify for one's own liability may be contrary to public policy and thus precluded by statute, insurance that covers the direct liability of an additional insured is less likely to be found unenforceable. An April 1995 article reviewed two oft-cited decisions of a Federal Court in Pennsylvania that resulted in opposite conclusions regarding coverage for additional insureds.⁹⁸ As the authors of that article noted, the two cases highlight the importance of the policy language itself on the determination as to whether the additional insured is covered for its own direct

⁹⁸ Harry Sigmier & John J. Reilly, *Coverage for Independent Negligence of Additional Insureds*, FOR THE DEFENSE, April, 1995, at 16.

liability. In *Harbor Insurance Co. v. Lewis*,⁹⁹ a train operated by the Reading Railroad ran over a young boy in an area near a fence that the City of Philadelphia was found to have negligently maintained. The jury found both defendants jointly and severally liable. The city then sought a declaration that it was covered for the amount of the verdict under the additional insured provision of the railroad's policy. The endorsement provided that the city was an additional insured ". . . but only to the extent of liability resulting from occurrences arising out of negligence of [the named insured]."¹⁰⁰

While the city argued that the accident arose out of the negligence of the railroad, the carrier argued that the endorsement provided coverage only for the city's vicarious liability and not for liability resulting from its own negligence. The court agreed with the carrier and ruled that the city was not covered, because the additional insured endorsement provided coverage only for vicarious liability. Important to the court's conclusion was the fact that the endorsement was issued without the payment of an additional premium.

In the other case, *Philadelphia Electric Co. v. Nationwide Mutual Insurance Co.*,¹⁰¹ the court reached the opposite conclusion. In that case, PECO contracted with a tree company to provide PECO tree trimming services. The contract required the tree company to obtain a certificate of insurance naming PECO as an additional insured on the tree company's general liability policy. The agreement also contained a provision requiring the tree company to indemnify PECO for liability arising out of the tree company's acts or omissions, except to the extent PECO was solely negligent. An employee of the tree company was injured and sued PECO, who brought a declaratory judgment action against both the tree company and the tree company's carrier, Nationwide. The additional insured language in that policy provided that PECO and its employees were "added as Additional Insureds for any work performed by The Davey Tree Expert Company on their behalf."¹⁰²

Nationwide relied on the *Lewis* decision in arguing that PECO was only insured for vicarious liability. The court distinguished the *Lewis* case, however, holding that the policy in that case specifically limited coverage to liability arising out of the negligence of the named insured. It found that the policy naming PECO as an additional insured was broader, and should be read to include coverage for all liability arising in connection with the tree company's work, including PECO's own negligence. As indicated by the authors of that article, these decisions from the same court signify not only the diversity of opinion in this issue, but also the importance of the policy language used.

B. Policy Language Controls

A complex analysis of each jurisdiction's treatment of the issue is beyond the scope of this article. Nevertheless, a few representative cases indicate that the precise language of

⁹⁹ 562 F. Supp. 800 (E.D. Pa. 1983).

¹⁰⁰ *Id.* at 802.

¹⁰¹ 721 F. Supp. 740 (E.D. Pa. 1989).

¹⁰² *Id.* at 742.

the “additional insured” endorsement can make a difference with respect to whether a court ultimately finds that the policy covers the additional insured for its own direct conduct.

Many courts find that the “additional insured” language in a given policy is ambiguous. Some courts look to extrinsic evidence to determine the intention of the parties to the contract, for example, Maryland and Nevada. However, other courts generally will simply construe an ambiguity strictly against the insurer and find in favor of the coverage which the additional insured sought, for example New York. As a result, it is very important to clearly provide in plain and ordinary terms the precise parameters for coverage to the “additional insured.”

1. Coverage for Additional Insured’s Direct Liability

a. “*Arising out of*”

Many courts find that the phrase “arising out of” clearly relates to causation, but that its terms are “both broad and vague.”¹⁰³ As a result, to the extent the additional insured provision speaks to liability or damages “arising out of” the named insured’s conduct, it is a good bet that the court will find coverage for the additional insured’s direct liability. For example:

- The phrase “arising out of . . . operations performed for the additional insured . . . by the named insured” covers additional insured for its own negligence.¹⁰⁴
- The policy provided that additional insured would be covered “only with respect to liability arising out of operations performed for [additional insured] by or on behalf of named insured.” The court found that coverage to the additional insured was not limited to additional insured’s vicarious liability for named insured’s negligence. The court found the policy ambiguous, and further held that liability that is not clearly excluded from coverage is presumed to have been included.¹⁰⁵

C. *Other Phraseology*

Examples of other types of language found to reflect an intention to cover additional insured for its own negligence are:

- The policy included “as an additional insured, any person or organization when required to be so named but only as respects operations of the named insured.”¹⁰⁶ The court found that additional insured is covered for its own direct liability

¹⁰³ Cas. Ins. Co. v. Northbrook Property & Cas. Ins. Co., 501 N.E.2d 812, 814 (Ill. App. Ct. 1986).

¹⁰⁴ Dayton Beach Park No. I Corp. v. Nat’l Union Fire Ins. Co., 573 N.Y.S.2d 700, 702 (App. Div. 1991).

¹⁰⁵ McIntosh v. Scottsdale Ins. Co., 992 F.2d 251 (10th Cir. 1993).

¹⁰⁶ Clark v. B&D Inspection Service, 896 F.2d 105, 106 (5th Cir. 1990).

resulting from the project, finding that “the policy language addresses the factual context in which the liability of the named insured arises, not the legal theory on which it is based.”¹⁰⁷

- A “‘Persons Insured’ provision is amended to include any person, organization, trustee or estate for whom the named insured has contracted in writing to procure liability insurance, provided: (a) The coverage afforded to such person or organization shall apply to only the extent required by the agreement, but in no event for broader coverage than afforded by this policy . . .”¹⁰⁸ Again, the court found that the intention was to insure the additional insured for all liability resulting from the contract entered into with the named insured, and not simply its vicarious liability for the named insured’s conduct.
- The policy named additional insured “only as respects their interest as they may appear and work being performed for them by [the named insured].” The court found it unreasonable to assume that the subcontractor would agree to procure liability insurance for all of the general contractor’s operations. However, the court found it reasonable to conclude that the general intention was to free the general contractor from any liability or increased risk resulting from the subcontractor’s presence on the premises. An employee of the subcontractor was injured by the general contractor’s direct negligence. The court found that the general contractor had coverage under the subcontractor’s policy.¹⁰⁹

D. *No Coverage for Direct Negligence of Additional Insured*

On the other hand, the following cases are representative of those in which the courts found that the policy adequately limited coverage for the insured to vicarious liability for the conduct of the named insured:

- Additional insured named “but only with respect to acts or omissions of the named insured in connection with the named insured’s operations.”¹¹⁰ Named insured’s employee was injured and alleged that additional insured was solely negligent. The court found that the additional insured was not covered under the named insured’s policy, finding that the most appropriate construction of the policy was that the additional insured was covered under the policy only when the negligent acts of the named insured caused the loss. The court found that to interpret the endorsement in a way which found coverage for the additional

¹⁰⁷ *Id.*

¹⁰⁸ *Woods v. Dravo Basic Materials Co.*, 887 F.2d 618, 620 (5th Cir. 1989).

¹⁰⁹ *Valentine v. Aetna Ins. Co.*, 564 F.2d 292, 294 (9th Cir. 1977).

¹¹⁰ *Consolidation Coal Co. v. Liberty Mut. Ins. Co.*, 406 F. Supp. 1292, 1294 (W.D. Pa. 1976).

insured's direct liability would transform the "but only" language into "arising out of."

- The policy provided that "additional insureds are covered under this policy as required by written contract, but only with respect to operations performed by or for" named insured. The court found that the policy does not cover *all* of the additional insured's liability no matter how incurred, but does cover its direct liability resulting from the project.¹¹¹
- The policy insures the additional insured "but only with respect to liability arising out of (1) operations performed for the additional insured by the named insured at the location designated above or (2) acts or omissions of the additional insured in connection with his general supervision of such operations." The policy also contains an exclusion for "bodily injury or property damage arising out of any act or omission of the additional insured or any of his employees, other than general supervision of work performed for the additional insured by the named insured." A jury in the underlying action found that the additional insured was solely negligent in that its liability did not result from a failure to supervise the named insured/contractor. In a declaratory judgment action the court held that there was no coverage for the additional insured under the policy.¹¹²
- Additional insured clause provides coverage "with respect to operations performed by or on behalf of the Named Insured," but coverage "shall not apply to damages arising out of the negligence of the Additional Insured."¹¹³ The court found that the policy clearly intended to apply only to the vicarious liability of the additional insured.

E. *Other Issues Involving Coverage for Additional Insureds*

1. The Employee Exclusion

Additional insured status may also exclude coverage for certain liability. The so-called employee exclusion precludes a policy holder from recovering for injury to its own employees. Assume again that a subcontractor's employee is injured on a construction project as a result of the general contractor's negligence, and the general is an additional insured on the subcontractor's liability policy. If the subcontractor's employee sues the general and the general tenders the defense to the subcontractor's carrier, does the employee exclusion preclude coverage?

¹¹¹ *Saavedra v. Murphy Oil USA Inc.*, 930 F.2d 1104, 1110 (5th Cir. 1991).

¹¹² *First Ins. Co. v. State*, 665 P.2d 648, 653 (Haw. 1983).

¹¹³ *Nat'l Union Fire Ins. Co. v. Glenview Park Dist.*, 594 N.E.2d 1300, 1302 (Ill. App. Ct. 1992), *aff'd in part and rev'd in part*, 632 N.E.2d 1039 (Ill. 1994).

The courts have generally disagreed about whether a policy prevents any employer from recovery for injuries to its own employee. Likewise there is disagreement as to whether every insured is precluded from receiving coverage for liability resulting from injury to the employee of any insured, or whether the exclusion applies to any insured, but only for liability arising out of injury to the employee of a named insured. Ultimately, a close inspection of the policy language will generally determine a carrier's obligations. Does the exclusion speak to the "named insured's employees," or to the "insured's employees"? Does it make a distinction?

2. The Effect of "Other Insurance."

Both the carrier and the additional insured must also consider the "other insurance" issue. A prudent party will require that the indemnitor's carrier endorse its policy so that it is primary and any other policies, including the indemnitee's/additional insured's policy, shall be excess only.

The added coverage that the party contemplates as an additional insured may not exist if the additional insured has another policy covering the same liabilities. That is because an insurer will often claim that its coverage for the additional insured is only "in excess of" the coverage provided by the additional insured's own policy. If the parties and their carriers do not make clear the manner in which they intend to prioritize coverages, a battle of "other insurance" clauses can, and generally does, ensue. It is because each policy's "other insurance" clause generally attempts to shift the loss to other insurers. The California form indemnity agreement cited at the beginning of this article specifically requires that the indemnitor's policy concede primary coverage.

3. Certificates of Insurance

Parties to a construction relationship routinely require certificates of insurance as proof that appropriate coverages have been put in place. Of course, certificates of insurance, when issued by the insurance company, are useful because they can state the limits of the policy and offer some security for the certificate holder.

However, if the certificate is not issued directly by the insurer, it cannot guarantee that the information essential to an additional insured — that the named insured has met all the conditions to insure the additional insured is covered, and that the represented coverages actually exist. Additionally, it is important to note that the certificate is not the policy. It can be a representation, but also a misrepresentation, of insurance coverage. To the extent the certificate is not issued by or on behalf of the carrier, it generally will not bind the carrier to the coverages the certificate represents as having been secured.

4. Joint vs. Separate Representation

For the carrier, joint representation of, for example, a named insured/subcontractor and additional insured/general contractor may be attractive. This is particularly so if the subcontractor is obligated to indemnify the general contractor for any liability which results. In many respects their interests will be aligned and counsel can represent both. That leads to

advantages for all parties. The insurer, which does not have to assign two sets of counsel, can save on the defense costs it incurs on behalf of its insureds. Also, each of the insureds has the benefit of the strategy afforded to the other, as well as the benefit of forming a united front. This makes the underlying plaintiff's job all the more difficult.

However, due to the complex facts and issues which often surround the construction, supervision, inspection and management among the parties to a construction project, there are potential conflicts of interest between the parties. Because counsel's role is to zealously represent the interest of the client, counsel cannot represent multiple insureds if there are any potential conflicts of interest. And, as a general rule, any time two insureds are parties of the same litigation and there is any potential conflict of interest whatsoever, each is entitled to independent counsel.

5. Anti-subrogation

Subrogation is an equitable doctrine that entitles an insurer to stand in the shoes of its insured to seek indemnification from third parties whose wrongdoing causes a loss that the insurer is bound to reimburse. However, as a general rule an insurer has no right of subrogation against its own insured for a claim arising from the very risk for which the insured was covered. Public policy requires this exception to the general rule both to prevent the insurer from passing an incidence of loss to its own insured and to guard against the potential for conflict of interest that may affect the insurer's incentive to provide a vigorous defense for its insured.

As a result, the insurer that issues a single insurance policy providing for an additional insured may not bring an action against that additional insured to recover monies that the insurer paid on behalf of its vicariously liable named insured. Nor may the insurer bring an action against its named insured for monies paid on behalf of a vicariously liable additional insured, because, in essence, it is the very risk for which the parties are covered.¹¹⁴

Consider the original hypothetical. The injured employee sues the general contractor that is named as an additional insured on the subcontractor/employer's liability policy. The general commences a third-party action against the sub for contribution or indemnification. The sub then moves to dismiss the third-party claim based upon the anti-subrogation doctrine. What effect? If the result would be that the subcontractor's policy affords coverage for the loss to the general contractor as an additional insured, the third-party claim will likely be barred because the same insurer, under the same policy, intended to cover that very risk.

There do appear to be exceptions to the anti-subrogation rule. One exception occurs when the policy contains exclusions that render it inapplicable to the loss as it pertains to one insured or the other.¹¹⁵ For example, under most general liability policies, the "bodily

¹¹⁴ See, e.g., Pa. Gen. Ins. Co. v. Austin Powder Co., 502 N.E.2d 982 (N.Y. 1986).

¹¹⁵ North Star Reinsurance Co. v. Continental Ins. Co., 624 N.E.2d 647 (N.Y. 1993).

injury to an employee” exclusion will preclude coverage to the subcontractor/employer, but perhaps not to the general contractor. However, the subcontractor’s employer’s liability carrier will afford coverage to the subcontractor for such liability. In that case, the anti-subrogation rule probably will not apply.¹¹⁶

V. CONCLUSION

A clear understanding of the interrelationship of the foregoing principles will enable the claims professionals and counsel to assess the appropriate mechanisms needed to shift liability. While the plaintiff will merely focus on collecting damages from the primary defendant and its insurer, the defendant and its insurer will attempt to shift liability on to any excess insurer, reinsurer or the third-party defendant and its insurer. Out of necessity the third-party defendant and its insurer will seek any options to shift their exposure. When faced with significant exposures, each of the parties in this chain will be required to follow various procedural and legal requirements to achieve the desired result. Unfortunately, the failure to strictly comply with these requirements can result in the failure to shift liability, which will result in the over payment of claims or the forfeiture of insurance coverage. Many of the traditional principles take on a new life when insurers and insureds are faced with catastrophic damages. Absent an overall comprehension of what is necessary to protect and perfect one’s rights can result in receivership or insolvency – a serious consequence for one misstep.

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¹¹⁶ *Id.*

Liability and Other Issues Arising Out of the World Trade Center Tragedy[†]

Milton Thurm

I.

INTRODUCTION

The World Trade Center tragedy of September 11, 2001 has already spawned a number of lawsuits between the owners and operators of the World Trade Center and their various insurers. In the main, this litigation deals with insurance coverage issues; the most prominent among them is the number of occurrences involved in the incident. Other issues pending in related litigation concern arbitration clauses that exist in various policies, the extent of property damage coverage on the mall within the World Trade Center, and a host of business interruption issues. While this litigation is mammoth in proportion and involves hundreds of millions of dollars, it is probably just the tip of the proverbial iceberg in the continuum of insurance-related claims that the industry will face down the road. What has yet to surface are the thousands of claims for bodily injury brought by those who survived the horror of that day and the claims for conscious pain and suffering and wrongful death brought by the immediate kin of those who did not. This article seeks to examine some of these potential claims, thereby alerting the industry to what lies ahead. In this regard, federal legislation and prior litigation surrounding other terrorist attacks or disasters may provide the best outcome indicators.

II.

FEDERAL STATUTES ENACTED IN THE WAKE OF SEPTEMBER 11

Immediately following the attacks on the World Trade Center, the federal government enacted the Airline Transportation Safety and System Stabilization Act (“ATSSA”) on September 22, 2001.¹ The ATSSA provides \$15 billion in subsidies to ensure the solvency of

[†] Submitted by the author on behalf of the FDCC Excess & Surplus Lines Section. Mr. Thurm acknowledges the invaluable assistance of Frank Santoro, Esq., in the preparation of this article.

¹ P.L. 107-42 (2001) (full text of the statute available on the FDCC website *at* www.thefederation.org/index.html).



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with allocation of loss; late notice of claim and suit; and the assault and battery exclusion. He has defended dozens of municipal entities in all types of civil rights cases including land use, excessive force and employment discrimination. He has been a member of the Federation of Defense & Corporate Counsel since 1984 and is the immediate past Chair of its Excess and Surplus Line Section. He is an associate member of the Excess and Surplus Line Claims Association and NAPSLO. He also holds membership in the Defense Research Institute, the New York State Bar Association, the American Bar Association and the International Association of Chiefs of Police (Legal Offices Section). He is a frequent speaker and contributor of articles on insurance-related matters.

the airlines. It has been described by one scholar as “one of the largest tort reforms ever imposed by the federal government.”²

The legislation affects litigation emanating from the terrorist attacks on the World Trade Center in two ways. First, it limits the total liability of air carriers (the airlines) for claims arising out of the September 11 airline crashes and fixes the jurisdiction and applicable substantive law for litigation arising out of these attacks.³ Second, it establishes a victims’ compensation fund which provides an alternative process by which any injured individual or the survivors of a deceased victim can seek compensation. The most important feature of

² Anthony Sebok, *Assessing the New Airline Law*, Findlaw.com Commentary, at http://www.writ.news.findlaw.com/scripts/prINTER_friendly.pl?page+sebok/20010924.html (last visited 1/15/02).

³ “The term ‘air carrier’ means a citizen of the United States undertaking by any means, directly or indirectly, to provide air transportation and includes employees and agents of such citizen.” P.L. 107-42 § 402(1).

the legislation is that it offers the victims of September 11 a choice: victims who opt to make claim against the victims' compensation fund waive their right to "file a civil action (or to be a party to an action), in any Federal or State court for damages sustained as a result of the terrorist-related aircraft crashes of September 11, 2001."⁴

In the event victims choose to seek compensation in the courts, the ATSSA's liability-limiting provisions are straightforward: "liability for all claims, whether for compensatory or punitive damages, arising from the terrorist related aircraft crashes of September 11, 2001, against any air carrier shall not be in an amount greater than the limits of liability coverage maintained by the air carrier."⁵ Additionally, the ATSSA provides that "the United States District Court for the Southern District of New York shall have original and exclusive jurisdiction over all actions brought for any claim (including any claim for loss of property, personal injury, or death) resulting from or relating to the terrorist-related aircraft crashes of September 11, 2001." The ATSSA also provides that the applicable substantive law in the litigation "shall be derived from the law, including choice of law principles, of the State in which the crash occurred unless such law is inconsistent with or preempted by Federal law." Finally, the ATSSA expressly precludes the waiver and liability-limiting provisions from compromising suits against "any person who is a knowing participant in any conspiracy to hijack any aircraft or commit any terrorist act."⁶ To date, there are at least three such lawsuits pending. One of them is a class action suit where victims have opted to sue the individuals and organizations, as well as their state supporters, who are widely acknowledged as responsible for the attack.

The Aviation and Transportation Security Act ("ATSA") was later enacted in November, 2001, amending the ATSSA.⁷ The ATSA extended the tort reform provisions of the ATSSA, limiting liability resulting from the attacks for airplane manufacturers, airports, and anyone with a property interest in the World Trade Center. The ATSA also limited New York City's liability to the greater of the city's insurance coverage or \$350 million.⁸ However, the new Act specifically states that its provisions will not extend to the private security agencies which checked bags and screened passengers on September 11, 2001.

Immediately after the enactment of the ATSSA, however, one commentator noted that it is extremely vague regarding how victims will be compensated.⁹ The details governing distribution of the victims' compensation fund rest solely on the judgment of the special master, providing the special master with authority to design a system that allows victims to

⁴ P.L. 107-42 §405 (c)(3)(B)(i) (2001).

⁵ *Id.* § 408 (a) (2001).

⁶ *Id.* § 408 (c) (2001) (summary of the statute is available on the FDCC website).

⁷ P.L. 107-71 § 201 (2001).

⁸ *Id.* § 201 (a)(3).

⁹ Sebok, *supra* note 2.

submit claims. In mid-November, Attorney General John Ashcroft appointed Kenneth R. Feinberg as special master for the victims' compensation fund. Mr. Feinberg is perhaps best known for his role as special master in the Agent Orange cases. He brings a wealth of experience in mass tort resolution, including work on the asbestos litigation, a class action involving the Shoreham nuclear power plant in Suffolk County, New York, and breast implant litigation. Most recently, he filled the high profile role of arbitrating negotiations that led to the settlement of claims by victims of the German Holocaust.¹⁰ On December 20, 2001, the United States Department of Justice released Mr. Feinberg's Interim Final Regulations for the distribution of the victims' compensation fund.¹¹ Following extensive public comment and meetings with victims, victims' families and other groups, the Department of Justice then released the Final Regulations on March 13, 2002.¹²

A list of claimants is accessible on the United State Department of Justice Victims' Compensation Fund website and indicates that close to one thousand victims have filed claims under the federal victims' compensation fund, waiving their right to bring suit in federal court.¹³ While claims on the fund offer the advantage of monetary awards to the victims within months, public comments following release of the Interim Final Rules indicated widespread dissatisfaction with the special master's compensation plan.¹⁴ The most contentious and controversial aspects of the Interim Final Rules involved provisions dealing with the reduction of awards based on collateral sources. Among the critical voices was Elliot Spitzer, Attorney General of the State of New York, who issued a press release on

¹⁰ Tamara Loomis, *Ashcroft Names Special Master for Sept. 11 Compensation Fund*, N.Y. L. J., Nov. 27, 2001, at 1.

¹¹ 28 CFR § 104, available at <http://www.usdoj.gov/victimcompensation/viccompfedreg.htm> (last visited January 29, 2002).

¹² *Id.*

¹³ <http://www.usdoj.gov/victimcompensation/victimrepresentatives.pdf> (last visited April 8, 2002).

¹⁴ Robert F. Worth, *Ground Zero: Compensation; Families of Victims Rally for Higher Federal Awards*, N.Y. TIMES, Jan. 18, 2002, at B4.

December 20, 2001 calling the regulations “flawed.”¹⁵ When likewise asked about the regulations, John Lynch, spokesman for the “9-11 Widows and Victims’ Families Association,” a group that represents families of civilians and rescue workers killed in the attacks, was quoted in the *National Law Journal* as saying, “I think it is a disgrace.”¹⁶ Similarly reacting to the bitter sentiment of the victims, Senators Jon C. Corzine and Robert G. Torricelli

¹⁵ Attorney General Spitzer’s objections to the regulations are *available at* <http://www.oag.state.ny.us/press/2002/dec/dec20c01.htm>. He identified what he considered “numerous fundamental flaws in the DOJ regulations” contained in the Interim Final Rules. Several of his criticisms were addressed by the Final Rule.

1. Attorney General Spitzer was concerned that in order to be eligible for compensation, the Interim Final Rule required contemporaneous records demonstrating medical treatment within 24 hours after the attack, even though:

- (a) there are no records for the hundreds of injured victims treated at emergency triage locations on September 11th; and
- (b) many other victims first sought to reunite with their families and did not seek medical treatment for their injuries until September 12th.

The Final Rule addressed this concern by expanding the time limits to 72 hours for victims and a time limit within the discretion of the Special Master for rescue workers.

2. Attorney General Spitzer was also dissatisfied that the Interim Final Rule effectively precluded recovery by unmarried life partners.

The Final Rule was not altered to include recovery by unmarried life partners. The Final Rule relies on state law to determine who is a personal representative entitled to recover from the fund. This reliance is purportedly mandated for consistency, in order to avoid a situation where a representative as defined in the regulation recovers under the fund, and a representative under state law is still free to commence a lawsuit. The Preamble to the Final Rule suggests that criticism of state law concerning the determination of a personal representative is best directed to respective state legislatures.

3. Attorney General Spitzer also felt that the Interim Rule ignored the statutory mandate that victims be able to present evidence of their losses. Instead it determined that all individuals killed in the attacks were presumed to have suffered exactly \$250,000 in “non-economic” losses, regardless of individual circumstances, and permitted increases only upon a showing of “extraordinary circumstances.”

The Final Rule remains the same. The Special Master recognized the problems inherent in placing a value on non-economic losses, but opted for consistency and fairness in order to avoid “playing Solomon” on a case-by-case basis.

4. Attorney General Spitzer also was concerned that under the Interim Rule, awards were reduced by the amount of collateral compensation that the claimant received, even if the collateral compensation was unrelated to the damages for which recovery was sought. The Interim Rule states that charitable donations will not be counted as “collateral source” payments resulting in reduced awards, but at the same time authorizes the Special Master to determine that charitable payments are collateral sources, which will deter charities from providing immediate payment to the victims. As to the how the Final Rule addresses these concerns, *see text*.

¹⁶ Bob Van Voris, *Compensation Plan May Shut Out Sept. 11 Rescuers*, NAT’L L. J., Jan. 7, 2002, at A1.

introduced a bill to repeal the provisions of the ATSSA that allow for reduced compensation based on collateral source.¹⁷

Despite criticism regarding the collateral source compensation rules, the Final Rule incorporated no drastic changes to the Interim Rule. Summarizing the Final Rule, Special Master Feinberg reiterated that he held no power to disregard the Congressional mandate factoring collateral sources into distribution of the fund. Moreover, the Final Rule specifically notes that collateral source compensation can include life insurance, pension funds, death benefits programs, and payments by federal, state, or local governments. However, several changes were made to the collateral source provisions of the rules demonstrating that discretion was available to the Special Master when distributing the fund. The Final Rule, for example, clarifies the definition of collateral source compensation, expressly noting that certain benefits, including tax relief, contingent Social Security benefits, and contingent workers' compensation benefits are not to be treated as collateral source compensation. The Final Rule also clarifies the provision that excludes charitable donations from the definition of collateral source compensation. In most instances, money received from privately funded charitable entities will not constitute collateral source compensation. Lastly, the Final Rule affords significant discretion to the Special Master when valuing collateral sources. While the Special Master has indicated that "it will be very rare that a claimant will receive less than \$250,000.00," there is a possibility, expressly acknowledged in the summary to the Final Rule, that a victim or a victim's family would not recover any money from the victims' compensation fund based on the collateral source rules. In light of this possibility, some victims or victims' families with significant collateral sources may take their claims to court. In fact, it was reported recently that a suit was commenced against American Airlines on behalf of Ms. Bonnie Shihadeh Smithwick, a highly-paid portfolio manager who was killed when the first World Trade Center Tower collapsed. Apparently, Ms. Smithwick's family would receive no compensation under the victims' compensation fund because she held a large life insurance policy for her family.¹⁸

The other predominant factor in determining whether victims will commence civil suits is their ability to prevail in such actions. Whether the plaintiffs can recover involves several questions, including:

- Who are the possible defendants?
- What are the causes of action?
- Where do the burdens fall in proving these causes of action?
- How have plaintiffs fared in past litigation arising out of terrorist attacks and disasters?

¹⁷ Senator Jon C. Corzine, *Fix the Victims' Fund*, Letter to the Editor, N.Y. TIMES, Jan. 28, 2002, at A14.

¹⁸ Robert F. Worth, *Airline Sued in Tower Death*, N.Y. TIMES, Apr. 9, 2002, at A16.

Finally, it is worth mentioning here the latest proposed federal legislation — a bill to amend the Terrorism Risk Protection Act to ensure the continued financial capacity of the insurers in order to provide coverage risks for terrorism. The bill proposes that the federal government will cover up to 90% of claims exceeding \$25 billion in the event of an “act of terrorism.” It also proposes to further amend the ATSSA to cover any tort claim arising out of or relating to an act of terrorism. The bill would bar recovery for punitive damages, eliminate joint and several liability for non-economic damages, require that all damages be off-set by collateral sources such as insurance or gifts, and limit lawyers’ fees to 20% of any award.¹⁹

III.

SUITS ARISING OUT OF THE WORLD TRADE CENTER TRAGEDY

A. Possible Defendants

There are numerous possible defendants for suits arising out of the September 11 terrorist attacks. As discussed above, the airline companies, the aircraft manufacturers, airport owners and operators, New York City²⁰ and anyone else with a property interest in the World Trade Center are protected by federal legislation, limiting their liability to the terms of their insurance coverage. However, as the victims grow less and less enamored with the special master’s plan under the federal victims’ compensation fund, even with its liability limitations, a lawsuit against those parties may become more attractive, especially since those parties generally are sufficiently insured to cover the kinds of injuries and loss of life that occurred on September 11th. For instance, the airlines have an estimated \$1.5 billion worth of coverage for each airplane.²¹ With \$3 billion in coverage for the airplanes that were flown into the World Trade Center Towers, the airlines might prove an attractive target for victims.

As noted earlier, federal legislation does not protect airline security firms or the actual individuals and parties who perpetrated the terrorist attacks. The Foreign Sovereign Immunities Act, which was amended in 1996, allows American citizens to sue specified nations for death or injuries arising out of terrorism.²² Several nations currently are identified by statute as subject to suit. These include Iran, Iraq, Libya, Cuba, North Korea, and Sudan.²³ The 1996 amendment was intended to permit suits on behalf of those killed in the bombing of Pan Am Flight 103 over Lockerbie, Scotland, against the government of Libya, the al-

¹⁹ H.R. 3210, 107th Cong. (2001).

²⁰ Under the ATSA, the liability of New York City for suits arising out of the World Trade Center attacks is limited to the greater of its insurance coverage or \$350 million. P.L. 107-71 § 201(a)(3).

²¹ Milo Geylin, *Lawyers Wonder, Who is Liable for Sept. 11*, WALL ST. J., Oct. 18, 2001, at B1.

²² 28 U.S.C. § 1330 (2002).

²³ The United States does not recognize the Taliban, and thus Afghanistan is not included on the list.

leged perpetrator.²⁴ This statute may be invoked to sue other nations if proof can be amassed that the terrorist attack was aided by that nation.

There are currently at least two civil suits by victims of the September 11 attacks already pending against Osama Bin Laden, Al Qaeda, and the Islamic Emirate of Afghanistan. *Doe v. Islamic Emirate of Afghanistan*,²⁵ was commenced against Osama Bin Laden, Al Qaeda, the Islamic Emirate of Afghanistan and several members of the Taliban leadership. The plaintiff, "Jane Doe," seeks recovery for the loss of her husband, who was killed while working at his job in the financial industry at One World Trade Center when Flight 11 struck the building. *Smith v. Islamic Emirate of Afghanistan*,²⁶ also filed in the Southern District of New York, is a suit brought against Osama Bin Laden, Al Qaeda, the Islamic Emirate of Afghanistan and several members of the Taliban leadership by Raymond Smith, the brother of George E. Smith, who was killed when U.S. Airways Flight 175 struck the South Tower of the World Trade Center.²⁷ Both complaints allege state causes of action for wrongful death, survival, assault, battery, false imprisonment and civil RICO claims. The *Doe* suit also includes claims for negligence and intentional infliction of emotional distress. Additionally, on February 20, a class action suit was filed by a mother and six widows of other victims, seeking billions of dollars.²⁸

Among other possible defendants mentioned in the media since the attacks are the architects who designed the World Trade Center, as well as asbestos manufacturers, companies involved in constructing the World Trade Center, elevator maintenance companies, the Florida flight schools that trained the terrorists, jet fuel producers, the City of Portland (ME), and manufacturers of the structural steel used in the World Trade Center.²⁹ There are at least two civil suits brought by passengers in the hijacked jets against the airlines. These include *Mariani v. United Airlines*, filed in the Southern District of New York on December 20, 2001, which names United Airlines as the defendant and alleges wrongful death, and a survival action against the same defendant based on the breach of duty of care for safety and security of its passengers. As discussed above, because of the collateral source compensation reductions in the victims' compensation fund, more suits will follow. As noted further, the suit brought on behalf of Ms. Bonnie Shihadeh Smithwick was only

²⁴ Jerry Adler, *Suing Bin Laden*, THE AMERICAN LAWYER, Nov. 2001, at 32.

²⁵ 01 CIV 9074 (S.D.N.Y. filed Oct. 11, 2001).

²⁶ 01 CIV 1013 (S.D.N.Y. filed Nov. 14, 2001).

²⁷ Adler, *supra* note 24.

²⁸ Neely Tucker, *Bin Laden, Other Terrorists Sued*, WASH. POST, Feb. 20, 2002, at A10.

²⁹ See, e.g., Gregory Keisch, 'Little Old Lady' Denies Terrorizing Man, PORTLAND PRESS HERALD, Dec. 5, 2001, at 1B (reporting notice of claim filed with the City of Portland by a victim of the attack on the World Trade Center. Two of the hijackers boarded flights in Portland and the city retains some control over airport security); Seth Stern, *Justice is Blind After All*, CHRISTIAN SCIENCE MONITOR, Sept. 27, 2001, at 19 (mentioning Florida flight schools and architects of World Trade Center as defendants).

initiated after issuance of the Final Rule. The fact that her family would not have received compensation under the victims' compensation fund surely prompted the litigation.³⁰

Prior suits commenced in the wake of disasters demonstrate that a number of other unanticipated entities might be subject to suit. For instance, suits brought by the victims of the 1980 MGM Grand Hotel fire in Las Vegas, Nevada, included products liability claims against such defendants as B.F. Goodrich, Conoco, and Patsaote, Inc.³¹ The claims against these parties alleged that the gases produced by the combustion of PVC vinyl-coated materials were toxic and unreasonably dangerous. Similar claims surfaced in suits from the 1986 Du Pont Plaza Hotel fire in San Juan, Puerto Rico, that killed 97 people,³² and from the 1990 arson fire of the Happy Land Social Club in the Bronx, New York that killed 87 people.³³

B. Possible Plaintiffs

While the response to an inquiry about possible plaintiffs in personal injury actions occasioned by the September 11 attacks may seem fairly straightforward, recent developments are cause for alarm among insurers and New York City. Possible claims for toxic tort injuries have been noted recently in the media and among legal professionals.³⁴ In that regard, there is great uncertainty about possible adverse health effects from toxic agents released into the air following collapse of the buildings. The victims' compensation fund does not entertain the possibility that large numbers of rescue workers, clean-up crews, construction workers and New York City residents may have been exposed to toxic chemicals that would increase their chances of contracting diseases such as cancer or suffering long term neurological defects. Researchers have identified asbestos, lead, fiberglass, PCBs, mercury and other potentially harmful substances in the air and dust that surround the disaster site. Thus, the list of potential defendants may grow commensurately with the list of harmful substances. The *St. Louis Post-Dispatch* reported that one study found dust in the neighborhood as caustic as drain cleaner.³⁵ However, reports about the extent of contamination vary drastically. The Environmental Protection Agency has been monitoring the downtown area for asbestos, particulates and other contaminants typically found in large building fire and collapse situations since September 11. It has detected no pollutants from

³⁰ Worth, *supra* note 18.

³¹ See *In re MGM Grand Hotel Fire Litig.*, 660 F. Supp. 522 (D. Nev. 1987).

³² See *In re San Juan Dupont Plaza Hotel Fire Litig.*, 768 F. Supp. 912 (D. P.R. 1991).

³³ See *Clarendon Place Corp. v. Landmark Ins. Co.*, 587 N.Y.S.2d 311 (App. Div. 1992).

³⁴ See Bob Van Voris, *Are Toxic Lawsuits in the Air after Sept 11?*, NAT'L L. J., Feb. 18, 2002, at A1; Associated Press, *NYC Faces Trade Center Lawsuits*, available at <http://www.cbsnews.com/stories/2002/02/08/national/printable328742.shtml>.

³⁵ Van Voris, *supra* note 34.

the fire and building collapses that are cause for concern to the general public. Within one block of the World Trade Center, the EPA is finding low levels of asbestos in the dust from the building collapse.³⁶

There have been approximately 1,300 notices of claim served on New York City by firefighters and other rescue workers who claim that breathing the air at the disaster site has made them sick.³⁷ With the high concentration of persons living and working in the downtown New York City area, the potential for toxic tort claimants could be staggering. There has been insufficient research to determine whether or to what extent people were exposed to toxic chemicals in the hours, days and months following the attack. Further scientific research should provide a clearer picture of potential toxic tort claims.

IV.

THEORIES OF RECOVERY AND APPLICABLE LEGAL STANDARDS

Pursuant to the ATSSA, the law to be applied in suits arising from September 11th events will derive from state law (including choice of law principles), where the crash occurred. Thus, suits arising out of the World Trade Center attack will be governed by New York law.

Negligence will likely predominate theories of action for civil suits brought against the above-mentioned parties. To sustain an action for negligence, the plaintiff must demonstrate: (1) a duty owed by the defendant to the plaintiff; (2) a breach of that duty; (3) that the breach of duty proximately caused the plaintiff's injuries, and (4) damages. The most critical elements applicable to any suit emanating from the September 11th attacks are duty and proximate causation. Generally, the law of negligence in New York is similar to the law of other jurisdictions. Thus, to the extent that the law of other states, such as Pennsylvania, is applied in lawsuits arising from the September 11th attacks, the foregoing legal principles will be generally applied.

A. *Duty*

Negligence is not actionable unless it involves the invasion of a legally protected interest, i.e., the violation of a right.³⁸ The issue whether the defendant owes the plaintiff a duty is purely a legal question for the courts. The New York Court of Appeals has addressed the element of duty in a case alleging negligence and noted that: "[t]he existence and scope of an alleged tortfeasor's duty, at the threshold, is a legal, policy-laden determination depen-

³⁶ See http://www.epa.gov/epahome/wtc/headline_092101.htm (last visited, April 5, 2002).

³⁷ Van Voris, *supra* note 34.

³⁸ 532 Madison Avenue Gourmet Foods, Inc. v. Finlandia Center, Inc., 750 N.E.2d 1097 (N.Y. 2001).

dent on consideration of different forces, including logic, science, competing socio-economic policies, and contractual assumptions of responsibility.”³⁹ Thus, whether the victims can sustain causes of action in negligence against the potential defendants noted above will depend largely on a legal determination — a policy-driven line of demarcation drawn around the concept of duty. In determining whether a duty exists and in determining its scope, New York courts have been influenced by public policy concerns such as avoiding limitless liability, mass litigation, and fraudulent claims. The court of appeals has even held that it is “bound to consider the larger social consequences of decisions” affecting duties in negligence under the law.⁴⁰

A duty may arise from a special relationship that requires the defendant to protect against the risk of harm to the plaintiff. For example, landowners have a duty to protect tenants, patrons and invitees from foreseeable harm caused by the criminal conduct of others while they are on the premises; their special relationship puts them in the best position to protect against that risk.⁴¹ The duty to protect against foreseeable criminal activity, however, does not extend to members of the general public.⁴²

Furthermore, while the foreseeability of harm may affect a determination of causation, the foreseeability of harm does not define duty. Absent a duty running directly to the injured person, there can be no liability in damages, however careless the conduct or foreseeable the harm. For instance, in *Strauss v. Belle Realty Co.*,⁴³ the court of appeals considered whether a utility owed a duty to a plaintiff injured in a fall on a darkened staircase during a citywide blackout. While the injuries were logically foreseeable, there was no contractual relationship between the plaintiff and the utility to provide lighting for the common areas in the building. The court restricted liability for damages in negligence to direct customers of the utility in order to avoid a crushing exposure to suit by millions of electricity consumers in New York City and Westchester.

B. *Proximate Causation*

Beyond the existence of a duty, it is essential that the breach of a duty be the “proximate cause” of the injury suffered in order to sustain a cause of action for negligence. Generally, an act or omission is the proximate cause of an injury if it was a substantial factor in bringing about the injury.⁴⁴ Stated another way, an act or omission is the proximate cause of an injury if it had such an effect in producing the injury that reasonable people

³⁹ *Milken & Co. v. Consolidated Edison Co.*, 644 N.E.2d 268, 271 (N.Y. 1994).

⁴⁰ *Waters v. New York City Hous. Auth.*, 505 N.E.2d 522 (N.Y. 1987).

⁴¹ *Nallan v Helmsley-Spear, Inc.*, 407 N.E.2d 451 (N.Y. 1980).

⁴² *Waters*, 505 N.E.2d 522.

⁴³ 482 N.E.2d 34 (N.Y. 1985).

⁴⁴ *Alexander v. Eldred*, 72 N.E.2d 996 (N.Y. 1984).

would regard it as the cause of the injury.⁴⁵ A proximate cause must be one which, in view of all surrounding circumstances, might readily have been foreseen by an ordinary and prudent person as likely to result in injury.

While there can be more than one proximate cause of an injury, an intervening act will constitute a superseding cause of the injury and will sever liability when the act is extraordinary in nature.⁴⁶ Stated conversely, the causative link between the defendant's act or omission and the plaintiff's injury is not broken by the negligent or deliberate conduct of a third person when such conduct is normal or foreseeable under the circumstances.⁴⁷ The crucial aspect of this inquiry is a determination of how far the first wrongdoer should be charged with forecasting the future results of his or her conduct.

V.

PRIOR LITIGATION ARISING OUT OF DISASTERS OR INJURIES CAUSED BY TERRORISTS

A. *Oklahoma City Bombing*

In *Gaines-Tabb v. ICE Explosives, USA, Inc.*,⁴⁸ victims of the terrorist bombing brought a class action against the manufacturer of ammonium nitrate that was sold as fertilizer and allegedly used to construct the bomb that destroyed the Alfred P. Murrah Federal Building in Oklahoma City. The plaintiffs' principal causes of action were negligence and products liability.

As their negligence claim, plaintiffs alleged that the manufacturer of ammonium nitrate was negligent in making explosive grade ammonium nitrate available to the perpetrators of the terrorist act. Without reaching the issue of whether the manufacturer owed a duty to the victims, the court held that the plaintiffs could not prevail on their claim for negligence because they could not show, as a matter of law, that the defendants' conduct was the proximate cause of their injuries. The court held that "the conduct of the bomber or bombers was unforeseeable, independent of the acts of the defendants, and adequate by itself to bring about plaintiffs' injuries[;] the criminal activities of the bombers acted as the supervening cause of the plaintiffs' injuries."⁴⁹ In rendering its decision, the court noted that ammonium nitrate bombs were used for illegal acts on only two occasions in the last twenty years, and that it was extremely difficult to properly manufacture ammonium nitrate bombs; only a small percentage of the population would possess the knowledge to do so.

⁴⁵ *Ferrer v. Harris*, 434 N.E.2d 1342 (N.Y. 1982).

⁴⁶ *Huber v. Malone*, 645 N.Y.S.2d 526 (App. Div. 1996).

⁴⁷ *Mull v. Ford Motor Co.*, 368 F.2d 713, 717 (2d Cir. 1966) (applying New York law).

⁴⁸ 160 F.3d 613 (10th Cir. 1998).

⁴⁹ *Id.* at 621.

B. *Hijacking*

In the case of *Stanford v. Kuwait Airways Corp.*,⁵⁰ the plaintiffs were three American diplomats who were also passengers aboard Kuwait Airways Flight KU221 when the airplane was hijacked by four terrorists. Plaintiffs were tortured over six days, and one of the plaintiffs was murdered before Iranian commandos thwarted the hijacking. Plaintiffs commenced a negligence action against Middle East Airlines Airliban, S.A. (MEA), alleging that MEA had a duty to use due care to avoid the risk of hijacking.

The facts are convoluted, but are worthy of brief mention considering the likelihood of claims against airline security firms arising out of the September 11th attacks. On December 2, 1984, four hijackers purchased “interline” tickets from MEA for travel from Beirut to Bangkok, Thailand, via the cities of Dubai and Karachi. At Dubai, the flight connected with another airline. The court was careful to note that the hijackers “had a stench about them.”⁵¹ Their one-way tickets were purchased with cash on very short notice and the itinerary they chose was strange. There were regularly scheduled direct flights from Beirut to Bangkok. If the hijackers had taken the next flight from Beirut they could have avoided a 24-hour layover in Karachi and arrived in Bangkok at the same time. Perhaps the most suspicious aspect of the hijackers’ conduct was their failure to check baggage for the long-distance flight. On the first stopover in Dubai, the hijackers boarded the MEA flight, armed with pistols, explosives and other weapons. The hijackers and other passengers were held on the tarmac, which was poorly lit and largely unguarded, during the stopover. The hijacking occurred after the flight departed Dubai.

Addressing the plaintiffs’ negligence claims, the court first ascertained whether a duty existed on the part of MEA as owed to the victims. The court reiterated the broad legal principles discussed above, and held that MEA had a duty to protect the plaintiffs from the unreasonable risk of foreseeable harm. The court specifically held that MEA, as a first leg interline carrier, had a duty to protect passengers on other connecting interline flights from unreasonable risk or harm through the use of reasonable precautions in the face of reasonably foreseeable risks. The court also rejected MEA’s claim that, as a matter of law, the criminal acts of the hijackers and/or the negligence of the other interline carrier were intervening superceding causes of the plaintiffs’ injuries, leaving the issue to the jury for determination.

⁵⁰ 89 F.3d 117 (2d Cir. 1996).

⁵¹ *Id.* at 120-22.

VI. CONCLUSION

The September 11th attacks were unprecedented in all respects. From a legal standpoint, the issue of compensating victims of the attack is fraught with uncertainty. The immediate issues concern whether victims will elect to participate in the victims' compensation fund or take their chances pursuing compensation under tort law in civil litigation. As stated, the possibility of large scale litigation by the September 11 victims depends largely on the success of the victims' compensation program. In the event the victims elect to litigate their claims, judicial application of such concepts as "duty," "foreseeability" and "proximate causation" to the extraordinary factual circumstances of September 11 will take center stage. As set forth above, these decisions not only will have immediate financial consequences, they will also have larger social consequences for reasons articulated by the New York Court of Appeals. Because of the extraordinary nature of the September 11th attacks, prior litigation and cases such as the Oklahoma City bombing offer only limited precedent as models by which to predict success or failure in the courts. Under any circumstances, the insurance industry must be prepared to engage a host of claims from many different insureds on a panoply of legal theories.

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IMPLICATIONS OF OFFICER AND DIRECTOR MALFEASANCE

The names Enron, Global Crossing, Arthur Anderson and others once called to mind wealthy, powerful corporate establishments. Of late that perception has been marred by charges against officers and directors of the same corporate entities. Combined with other factors, these charges have caused serious instability to the entities named and, indeed to the entire corporate world.

In this issue we bring together the work of several authors who explore myriad liability and insurance issues emanating from situations involving corporate mismanagement. We hope they provide guidance to readers and professionals addressing similar issues.

Ed.

Enron and the D&O Aftermath: Tips and Traps for the Unwary[†]

Lori E. Iwan
Charles M. Watts, Jr.

Those who cannot remember the past are condemned to repeat it.
—George Santayana

I.

INTRODUCTION

With the same reckless abandon used by the average investor who throws money into the stock market, insurance companies wrote D&O policies for public companies throughout the 1990's without regard to when the bubble might burst. As a result, the insurance industry must now pay the price for risks taken in a softer market, just as it did in the aftermath of the 1929 Crash and following Black Monday in 1987.

In fact, Enron repeats the '87 crash with a new name. Like the iceberg that doomed the Titanic, what lies beneath Enron poses a real and present danger to the D&O market. Enron's failure merely illuminated the problem; it didn't create the problem. Moreover, the widespread impact of the Enron ripple effect threatens to tumble the entire D&O market along with Enron. This article, therefore, enables both underwriters and claims personnel to examine directors and officers coverage with a fresh perspective.

II.

THE BASICS

"D&O insurance is, by nature, based on a more open-ended contract. D&O coverage typically protects against a catchall collection of 'wrongful acts'.¹ "The first D&O policies were written by Lloyd's in response to the wave of lawsuits that deluged directors of public companies after the 1929 Wall Street crash."² The typical policy in recent times consists of two insuring agreements:

[†] Submitted by the author on behalf of the FDCC Business Law Section.

¹ Judith A. Blades, *The Need for D&O Coverage*, BEST'S REV., July 1, 2001, available at 2001 WL 12285550.

² *Wall Street Losses Hit Lloyd's*, THE INS. INSIDER, Sept. 2001.



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electrical control equipment, and industrial equipment in cases involving catastrophic injury, fire loss and business interruption claims. She is a frequent lecturer for the Chicago Bar Association, the National Practice Institute, the Defense Research Institute, the Federation of Defense & Corporate Counsel, Mealey's, private industry and insurers. She is the author of numerous articles on trial tactics, law office economics, products liability, healthcare, preventive law and technology issues. She authors "Lori's Links," a monthly Internet column regarding legal research sites on the World Wide Web at www.thefederation.org. Ms. Iwan is a member of the American Bar Association (Litigation and Corporate Counsel Sections), the Illinois State Bar Association (Tort Law Section), the Defense Research Institute (former Law Institute member, as well as Technology, Products Liability, and Trial Tactics Sections), the Illinois Association of Defense Trial Counsel, The Lawyers Club of Chicago, and the Federation of Defense & Corporate Counsel (Board of Directors, Litigation Management College Dean, Product Liability Past Section Chair, and Technology Section Vice-Chair).

- Direct coverage for directors and officers of the company when an entity does not or cannot indemnify them.
- Reimbursement coverage to a company for indemnifying its D&Os for wrongful acts (the Insuring Agreement C-Entity clause).



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“The top three D&O insurers based on premium — American International Group Inc., Chubb and Lloyd’s — write about 65% of the primary business.”³ Thus, “D&O is a niche market, accounting for \$3.5 billion to \$6 billion in annual gross premium written.”⁴

Typical D&O claims arise when the board of directors and/or officers of the corporation violate their duties. The duties of the board of directors are typically broader, however, than those of the officers. Non-delegable duties of the Board generally encompass overall management and instruction. Specifically, they include organizing the corporation, establishing and overseeing the accounting structure, selecting and supervising management, preparing the annual report, conducting shareholder meetings and implementing resolutions. Directors and officers must act within their authority with the requisite knowledge and ability, obtain expert advice, and act with a duty of loyalty. Liability can arise from a violation of company standards, prospectus misrepresentations, statutory violations, or criminal or tortious acts. In addition, potential claimants can comprise a number of groups: the company itself, liquidators, shareholders, creditors, third parties and government authorities.

³ Lynna Goch, *Cover Charge*, BEST’S REV., May 1, 2002, available at 2002 WL 10441437.

⁴ *Id.*

Directors owe a fiduciary duty to both the corporation and its shareholders. The fiduciary duty is generally categorized as a duty of loyalty and a duty of due care. Under the duty of loyalty, a director owes an undivided, unselfish loyalty to the corporation.⁵ The duty of loyalty can be breached in a number of respects: competing with the corporation, appropriating a corporate opportunity, using insider information, disclosing trade secrets, appropriating customers or spending corporate money for personal gain.

The duty of care requires that in managing the corporation, a director use that amount of care exercised by an ordinarily careful and prudent person in similar circumstances. The duty includes using “reasonable diligence” in gathering and considering material information. “Directors may not shut their eyes to corporate misconduct and then claim that because they did not see the misconduct, they did not have a duty to look. The sentinel asleep at his post contributes nothing to the enterprise he is charged to protect.”⁶ Notwithstanding this caution, courts have developed a corresponding “business judgment rule” to protect directors. This rule codifies a presumption that the directors acted on an informed basis, in good faith and in honest belief that the action was taken in the best interest of the corporation.⁷

Enron’s problems and the ensuing litigation serve to highlight the obligations owed by directors and officers under the securities laws. The Securities Act of 1933 and the Securities Exchange Act of 1934 have been interpreted to permit claims by shareholders in initial public offering,⁸ secondary market transactions,⁹ proxy solicitation,¹⁰ and tender offers.¹¹

Private securities litigation alleging fraud generally is brought against corporations and their directors and officers under the Securities Exchange Act of 1934. Typically, Section 10(b) prohibits misrepresentation or fraud in connection with the buying and selling of securities, and Rule 10b-5 sanctions the use of deceptive and manipulative devices to facilitate fraud. To properly allege a Section 10(b) claim, a plaintiff must demonstrate that misrepresentation of material facts by persons acting with scienter caused them injury. The plaintiff must prove that the defendant acted with scienter by a preponderance of the evidence. The Supreme Court has defined scienter as “a mental state embracing intent to deceive, manipulate, or defraud.”¹²

The standard for finding director liability is stringent. “[O]nly a sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists – will establish the lack of good faith

⁵ Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

⁶ Francis v. United Jersey Bank, 432 A.2d 814, 822 (N.J. 1981).

⁷ Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

⁸ Securities Act of 1933 §§ 11, 12(2).

⁹ Securities Exchange Act of 1934 § 10 (b).

¹⁰ *Id.* at § 14(a).

¹¹ *Id.* at § 14(e).

¹² Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

that is a necessary condition to liability.”¹³ Furthermore, only a systematic or sustained failure of the board to exercise oversight, such as the board’s utter inability to assure a reasonable system for reporting information, will precipitate a bad faith finding so as to support liability for individual directors. Mere negligence, and most likely gross negligence, will not support director liability.¹⁴ The standard necessary to precipitate individual director liability is one that approaches bad faith.¹⁵

Responding to the rise in abusive and meritless securities fraud lawsuits, Congress passed the Private Securities Litigation Reform Act (PSLRA) in 1995, making it increasingly difficult for private plaintiffs to file frivolous or unsubstantiated securities fraud claims. Congress intended that the PSLRA would apply a more stringent uniform pleading standard intended to reduce the number of private securities cases brought against corporations and/or their directors and officers. Plaintiffs must now “specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.”¹⁶ To sufficiently plead scienter under the PSLRA, the complaint must “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”¹⁷

The PSLRA, however, has fallen short of its intended effect. Class action securities cases have risen to an all-time high. Also, the federal appellate courts have interpreted the PSLRA standard, which was intended to provide uniformity, in significantly different ways. In point of fact, three standards have emerged. The Second and Third Circuit Courts of Appeal allow plaintiffs to adequately plead scienter by alleging facts supporting an inference that defendants had a “motive and opportunity” to commit fraud, or facts providing circumstantial evidence of recklessness or knowing misbehavior.¹⁸ The First, Sixth, and Eleventh Circuits, on the other hand, have adopted a tougher standard. Scienter in those circuits is adequately pleaded by “alleging facts giving rise to a strong inference of recklessness, but not by alleging facts merely establishing that a defendant had the motive and opportunity to commit securities fraud.”¹⁹ The Ninth Circuit has adopted the toughest stan-

¹³ *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch. 1996).

¹⁴ Jonathan L. Freedman & Bart R. Schwartz, *Audit Committees of the Boards of Directors: How Much Responsibility Do They Have? How Much Responsibility Should They Have?* ACCA Docket 20, no. 5 (2002): 4863.

¹⁵ *Id.*

¹⁶ 15 U.S.C. § 78u-4(b)(1) (1997).

¹⁷ *Id.* at § 78u-4(b)(2).

¹⁸ *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999).

dard of all, requiring plaintiffs to “plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct.”²⁰ Under this standard, recklessness is defined as “a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.”²¹ To properly allege a “strong inference of deliberate recklessness,” a plaintiff must state facts that come closer to demonstrating intent, as opposed to mere motive and opportunity.

III. THE STATE OF THE D&O MARKET

“The D&O business is very concentrated—85% [of the primary business is written] by the top 10 companies.”²² Even before Enron failed, the market for D&O insurance was “‘a complete mess,’ pummeled by the dot-com implosion, hundreds of securities class actions, a faltering economy and years of soaring loss ratios.”²³ Although claim awards were rising, 1999 prices for D&O coverage declined for the fourth consecutive year, according to the “1999 Directors and Officers Liability Survey,”²⁴ offering little regard for the future. More than \$100 million in losses have occurred in the D&O area over the past eighteen months alone.

Although the events of September 11 did not add to the D&O claims, “those events have adversely affected the availability, price and terms of D&O coverage,” since insurers have redirected their reserves to address the financial impact of September 11 in other unrelated lines of insurance.²⁵ In short, the reserve cushion that allowed insurers to offer favorable D&O coverage terms, unaffected by the loss ratios of the D&O book of business, is gone.

All in all, the pricing and availability of D&O coverage at all levels has been affected by the following events:²⁶

(1) Increase in frequency of claims. The number of suits jumped dramatically from

¹⁹ *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 549 (6th Cir. 1999).

²⁰ *Silicon Graphics*, 183 F.3d at 974.

²¹ *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 389 (9th Cir. 2002).

²² Lynna Goch, *Falling Markets, Rising Risks*, BEST’S REV., May 2001, available at 2001 WL 12285366.

²³ Barbara Bowers, *Risk Takes Center Stage: Enron Hurts Already-Faltering D&O Market*, BEST’S REV., June 2002 (quoting Donald J. Bailey, managing director of risk services for Aon Financial Services Group), available at 2002 WL 10441319.

²⁴ *1999 Directors and Officers Liability Survey*, published by Tillinghast-Towers Perrin, a management and human resources consulting firm in Chicago.

²⁵ *Willis Study Finds D&O Market in Disarray*, INS. J., March 14, 2002, available at <http://insurancejournal.com/html/ijweb/breakingnews/international/in0302/in0314022.htm>.

293 in 2000 to 511 in 2001. More than 300 of those suits were related to the underwriting practice of offering shares in initial public offerings in exchange for kickbacks and other side deals (so called “share laddering”). In fact, over 1,000 share laddering cases were filed, although these have since been consolidated to 320 involving the same number of issues and against nearly 50 financial underwriters. Other typical claims involve bankruptcy and accounting restatement or irregularities.²⁷ The most common accounting violation identifies improper revenue recognition, alleged in 66% of the accounting cases. The second most common violation is overstatement of assets (29% of the cases). High tech continues to be the most prominent target (38% of the cases), followed by telecommunications (11%), health care providers (8%), banking and brokerage firms (6%) and pharmaceuticals (4%).²⁸ Potential shareholder class actions thought to be pending include claims against the directors of technology companies Lucent, Cisco Systems and Nortel, and against the dot-coms identified as Excite, Priceline.com, iVillage or Drugstore.com.²⁹ The recent rise in shareholder class actions has been attributed to the proliferation of private individuals who held shares in the 1990’s, the dot-com technology boom and the Internet itself. The World Wide Web allows aggrieved investors and disgruntled employees access to chat rooms where they commiserate and disseminate unfavorable (or insider) information. Class action web sites that list current and proposed class actions or solicit new cases make it easy for the unhappy customer to join these efforts.

(2) Increase in severity of claims. The largest payouts in history were paid or proposed within the past two years: Cendant’s payout totaled \$3.2 billion, Bank of America has proposed \$490 million, and two Waste Management cases have approximated \$677 million. When accounting violations are alleged, the settlement values are higher; in 2000, the average accounting violation case settled for nearly \$21 million. *The Insider* estimates that Chubb’s D&O book is running at a loss ratio approaching 170%, while some believe the Executive Risk book to be double that figure.³⁰ The current estimate for Lloyd’s exposure on the 1998-2000 underwriting years is approximately £250mn, though senior underwriting sources predict that the rising trend in class action suits against institutions which advised in IPO’s, mergers and acquisitions could quadruple that number. The wider London company market exposure to D&O claims is thought to be even higher.³¹

(3) Increasing regulatory scrutiny. In fiscal year 2001, the United States Securities and Exchange Commission (“SEC”) brought 484 cases. Of that number, financial fraud cases represented 23%; offering cases involved 20%; broker-dealer cases consumed 13%;

²⁶ *See id.*

²⁷ The term “irregularities,” when used in the accounting context, means fraud or egregious error.

²⁸ Tower C. Snow, D&O Symposium, *The Evolving World of Securities Litigation*, Professional Liability Underwriting Society, Feb. 6, 2002.

²⁹ *Wall Street Losses Hit Lloyd’s*, *supra* note 2.

³⁰ *Id.*

³¹ *Id.*

and insider trading cases were 12% of the total. These numbers represent an increase in financial fraud and issuer reporting cases over the prior year and an upward trend in filings.³² As of February 2002, the SEC has gathered 250 financial fraud cases in its inventory, with cases arriving at nearly one per day. The Waste Management case was the first fraud injunction case commenced against a Big Five accounting firm in 20 years. The auditor climate clearly has changed, resulting in auditors who blow the whistle on clients more frequently than a year earlier.

(4) Little benefit to insurers for claims that could be settled, but for refusal of the insureds.

(5) Little or no insured participation in claims payments due to low retentions and broad grants of coverage.

(6) Insufficient premium to pay for losses.

(7) Bankruptcy of D&O insurers. Reliance Group Holdings was the sixth largest writer of D&O insurance in 1999. Late in 2000, that insurer's operation was liquidated, leaving large gaps in coverage.

(8) Departure of reinsurance support. "The smaller D&O markets and MGA's that relied on the availability of facultative reinsurance are reporting that those reinsurance markets have pulled virtually all of their facultative capacity, resulting in either larger exposed nets or reduced limits of liability for business written by those direct writers of D&O business. D&O treaty capacity also seems to be in question."³³ Reinsurers' "historical willingness to roll multi-year reinsurance treaties has diminished, leaving direct D&O writers to negotiate for substantially higher reinsurance premiums or modified treaty structures, including excess-of-loss treaties with substantial nets retained by the direct writers."³⁴

In the current market, healthy companies with favorable claims experience can expect to pay nearly 35% more in premiums, but companies with greater risk exposures based on size and industry type are facing increases of 50% or more. As recently as June 2002, the *Wall Street Journal* reported rates increases of 300 to 400%.³⁵ Thus, the hardening market is forcing insureds to accept higher rates, less coverage and larger retentions.

The D&O crisis is not limited to the United States market, however. Just as the number of securities class action lawsuits filed in the United States has risen, so has the exposure to companies based elsewhere. "[S]ome underwriters had assumed that non-US companies were better protected from such actions, but they now recognize that a company listed on any US stock exchange, regardless of where the company is based, 'has a very severe exposure to class action claims.'"³⁶ Not surprising to anyone familiar with the American propensity for litigation, numerous European companies have found their directors and

³² Thomas C. Newkirk, US SEC, D&O Symposium, *The Evolving World of Securities Litigation*, Professional Liability Underwriting Society, Feb. 6, 2002.

³³ *D&O Market Trends*, DUANE MORRIS FINANCIAL PRODUCTS INSIGHTS (Winter 2001), available at <http://www.duanemorris.com/publications/finprod.pdf>.

³⁴ *Id.*

³⁵ WALL ST. J., June 7, 2002, at C20.

officers subject to litigation in United States courts.³⁷ More significant, however, is the number of claims filed in European courts. Europe has witnessed claims by liquidators,³⁸ claims by shareholders,³⁹ claims based on prospectus liability,⁴⁰ and claims based on corporate governance issues.⁴¹

IV. LESSONS FROM ENRON

“Enron was a massively complex business. From all accounts, there were few people who understood just exactly what Enron was doing. Through the use of derivatives, Enron evolved from an energy trading business to a company that boasted it could create markets in anything. To do this, Enron created complex partnerships, used intricate financing vehicles, and relied heavily on shifting risks from one entity to another.”⁴²

A sampling of press releases by insurers covering the impact of Enron’s bankruptcy highlights the poor performance of the D&O line of insurance in 2000 and 2001. Various sources place Enron’s D&O coverage at \$350 million. According to The St. Paul Compa-

³⁶ Carolyn Aldred, *Non-US Companies Facing Steep Hikes on D&O Policies Covering US Exposures*, BUS. INS., Feb. 11, 2002, available at 2002 WL 9517115.

³⁷ Phillips; Alcatel; Baan Company; Deutsche Bank; DaimlerChrysler; Intershop; Deutsche Telekom, to name a few.

³⁸ ARAG (German supervisory board obligated to pursue chief executive who failed to halt illegal activity resulting in DM 80 million losses); Nasa Electronique (D&Os of failed French Company held joint and severally liable for FF400 million shortfall due to mismanagement based on violations of bankruptcy, account and company standards); Banque Pallas Stern (FF9 billion bank failure, largest ever in France); Spar-und Leihkasse Thun (liquidator sued board, management and auditors for CHG 50 million based on alleged mismanagement); Omni Holding (former board members paid CHF 5 million to settle liquidator’s claim of liability in connection with CHF 1 billion failure of the holding company).

³⁹ Union Bank of Switzerland (BK Vision v. Senn) (CHF 240 million lawsuit against the entire board for failing to intervene in bank share transactions that allegedly manipulated the outcome of a shareholder’s vote); SairGroup (Board resigns and special auditor appointed after CHF 2.9 billion in losses in 2000); World Online (Dutch shareholder association sued the company and its bankers on behalf of 10,000 small investors after collapse of this Internet provider; investors lost EUR 1.6 billion within two weeks prior to IPO when it was learned that CEO had sold her shares for a fraction of the offering price); Biber Holding (Swiss shareholder action group sued former Chairman of bankrupt paper company for mismanagement and misinformation).

⁴⁰ Phillips (in wake of ADR stock drop suit in the U.S., a Dutch shareholder association’s suit against the company — but not the D&O’s — was filed in the Netherlands and reportedly settled for Euro 4.5 million); Holzmann (major Dutch shareholder suing the company and its bankers for DM 400 million arising out of substantial investment in this German company that had to be rescued by the German government).

⁴¹ Cadbury (UK); Vienot (France); Dragghi (Italy); Olivencia (Spain); KonTraG (Germany).

⁴² Editor, *Enron’s Impact on the Insurance Industry* (May 23, 2002), available at <http://www.riskindustry.com>.

nies, its principal net exposures, after tax, following the Enron bankruptcy, are \$64 million in face value from surety bonds and \$19 million in treaty reinsurance and D&O liability insurance.⁴³ PartnerRe estimates net loss exposure to Enron at \$34 million, but it was not well situated to accurately estimate the actual losses, if any, under the various reinsurance contracts since Enron hopes to reorganize. In that event, many liabilities may be partially or even entirely paid, and many of the primary insureds will mitigate the amount of their actual losses.⁴⁴

Enron proved that many insurers were not tracking their exposure. The years 1997-98 have been compared to the “perfect storm;” a cascade of events had to merge precisely, creating the “storm of the century.” In the case of D&O coverage, the market, insurance and reinsurance all contributed to the downfall.⁴⁵ As such, the Enron debacle affected specific coverage lines: D&O, surety coverages, accountants’ liability and fiduciary liability. It also brought into question the status of independent auditors and the possible conflicts that might exist between independent auditing and consulting services. The Enron situation also raises questions about the extent to which board members are obligated to unearth possible fraud among a company’s senior employees.

Clearly, Enron’s situation will test a variety of D&O policy exclusions and defenses. The bankruptcy has already spawned at least two separate actions in which insurers seek to void D&O coverage, having relied on information that contained “material misrepresentations” when the policies issued to Enron. If they succeed, nine other insurers are expected to follow suit, potentially voiding the \$350 million of coverage Enron thought it had reserved for its directors and officers.

Equally significant, Enron’s impact extends well beyond its own insurers. In *Newby v. Enron Corp.*, the class action lawsuit filed by the infamous Bill Lerach, two new developments may cause additional concern for the insurance industry. Not only has the list of defendants been expanded to include those who did work for Enron, but the lead plaintiffs in the lawsuit are the Regents of the University of California, an entity marked by a veneer of respectability. In addition, the April 8, 2002 amended complaint adds over three dozen defendants that include many Wall Street principals, additional partners and offices of Arthur Andersen, and two law firms. The named banks and securities firms include Merrill Lynch, Credit Suisse First Boston, Citigroup, Deutsche Bank, J.P. Morgan Chase, and Bank of America. According to the 502-page complaint, these additional defendants were named because “[t]his fraudulent scheme could not have been and was not perpetrated only by Enron and its insiders. . . . It was designed and/or perpetrated only via the active and know-

⁴³ *The St. Paul Reports Aggregate Limits Exposed to Enron Bankruptcy at Less than \$85 million After-tax, Net of Reinsurance*, ST. PAUL RE, December 4, 2001, available at <http://www.stpaulre.com/home.nsf/vContentW/E8E85EC8670A2F3E85256B5D00767715!OpenDocument&Highlight=0,december,4,2001>.

⁴⁴ *PartnerRe Estimates Net Loss Exposure to Enron at \$34 Million*, INS. J., December 14, 2001, available at <http://insurancejournal.com/html/ijweb/breakingnews/international/in1201/in1214012.htm>.

⁴⁵ Ralph Jones, President and CEO, Chubb & Son, D&O Symposium, Professional Liability Underwriting Society, Feb. 6, 2002.

ing involvement of” the various law firms, banks, and the accounting firm hired by Enron. The D&O excess carriers for these other institutions are expected to heed these proceedings as well, given the potential that losses will breach the upper layers of coverage.

V. WHAT’S AN INSURER TO DO?

The question of what an insurer should do in the face of potentially overwhelming D&O exposure can be answered succinctly. Insurers should read the fine print on the policy and the information furnished in application and renewal forms; they should examine carefully the allegations of the case presented, and they must thoroughly review the law of the jurisdiction where any coverage action might be filed. An Enron-like claim seems to raise all the issues most actively litigated in the D&O coverage arena: (1) rescission based on a material misrepresentation or omission in the policy application or renewal; (2) application of standard exclusions; (3) allocation of indemnity and defense costs between insured directors and officers and uninsured persons, and between covered and non-covered claims; and (4) bankruptcy court authority over D&O policies and proceeds payable to the directors and officers of a debtor corporation.⁴⁶ **Early involvement in the evaluation, preservation, and assertion of coverage issues is essential to minimizing exposure at the excess and surplus level.** These issues are discussed more fully below.

A. *Rescission Based on Misrepresentation*

Several federal district courts, applying state law, have permitted rescission of D&O policies based on material misrepresentations in the policy application. This defense extends to misrepresentations and inaccuracies contained in financial statements whose submission was required by the policy application or renewal forms.⁴⁷ Misrepresentation in a policy application or renewal bars recovery when the misrepresentation is material to the risk assumed by the insurer, or when the insurer would not have offered the same terms had it known the truth. Courts have restricted the right to rescind a policy only to those situations where the information was specifically required by the insurer in the application process.⁴⁸ If the insurer did not request the specific information from the insured before issuing the policy or renewal, the courts assume the information was immaterial to underwriting the risk.⁴⁹

Misrepresentations can emanate from a number of sources:

- Direct response to a question in the policy or renewal application.

⁴⁶ BARRY OSTRAGER & THOMAS NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 20.01, at 1067 (11th ed. 1999).

⁴⁷ Nat’l Union Fire Ins. Co. v. Sahlen, 999 F.2d 1532, 1536 (11th Cir. 1993) (applying Florida law). Similar rules have been applied in Louisiana, Washington and California.

⁴⁸ Home Ins. Co. v. Spectrum Info. Tech., Inc., 930 F. Supp. 825 (E.D.N.Y. 1996).

- A false statement in the “cognizance representation” (the insured’s statement that he or she is unaware of any fact or circumstance that might precipitate a claim).⁵⁰
- Materials that the insurer is required to attach to the application (e.g., Annual Reports, SEC filings, financial statements, etc.).
- Statements between the insurer and the insured made in conference calls or meetings (provided the insurer has carefully documented that the specific information was requested by the underwriter during these calls/meetings).

Severability clauses have crept into D&O policies in recent years during the soft market. The severability clause seeks to afford coverage to “innocent” directors and officers who did not sign the policy application and did not know of the misrepresentation. Given the scope of non-delegable duties of a board of directors, it is difficult in an accounting case to imagine that the board had no knowledge of the error, irregularity or restatement of income such that the board could credibly claim innocence. Hence, the insurer should not act too quickly when affording coverage to those directors and officers who did not sign the policy.

For example, in the Enron situation, a memorandum was circulated by an accounting employee to CEO Kenneth Lay, with copies to senior management. A sampling of those concerns raised in the memo highlights the extent to which it was widely known within Enron itself that overly aggressive accounting was being used for certain significant deals:

- “Enron has been very aggressive in its accounting - most notably the Raptor transactions and the Condor vehicle.”
- “To the layman on the street it will look like we recognized funds flow of \$800 mm from merchant asset sales in 1999 by selling to a vehicle (Condor) that we capitalized with a promise of Enron stock in later years. Is that really funds flow or is it cash from equity issuance?”
- “To avoid such write-down or reserve in Q1 2001, we ‘enhanced’ the capital structure of the Raptor vehicles, committing more ENE shares.”
- “I am incredibly nervous that we will implode in a wave of accounting scan-

⁴⁹ See *Collins v. Pioneer Title Ins. Co.*, 629 F.2d 429, 433 (6th Cir. 1980).

⁵⁰ In order to assert a false cognizance representation, a renewal or continuity of coverage must be submitted; the insurer must ask for a new statement prior to issuing the renewed or continuous coverage. A policy that relies on the original statement, or incorporates it by reference, or merely indicates the renewal is a supplementation of the original application to which the cognizance representation was attached, is not sufficient to rescind coverage. *Nation Union Fire Ins. Co. v. Cont’l Cas. Corp.*, 643 F. Supp. 1434 (N.D. Ill. 1986).

dals.”

B. Exclusions

1. Regulatory Exclusion

Regulatory exclusion commonly excludes coverage for proceedings brought by regulatory agencies. Although a few courts have held that, when applied to actions brought by the banking regulatory agencies FDIC and FSLIC, the exclusion is void as against public policy,⁵¹ the vast majority of courts have upheld the exclusion.⁵²

2. Security Law Violation Exclusion

D&O policies may exclude coverage for losses arising out of the violation of security laws. Such an exclusion was the subject of litigation in *Bendis v. Federal Insurance Co.*, which barred coverage for a claim:

... where all or part of such claim is, directly or indirectly, based on, attributable to, arising out of, resulting from, or in any manner related to any actual or alleged violation of the Securities Act of 1933, Securities Exchange Act of 1934, the Investment Company Act of 1940, the Public Utility Holding Act of 1935, any state Blue Sky or securities law, all as they may be amended, or any law relating to securities transactions, or any of their amendments.⁵³

In *Bendis*, nine counts of the complaint alleged securities law violations. The remaining two counts alleged fraud and negligent misrepresentation, though these were based on the same factual allegations that framed the securities law violations. The Tenth Circuit Court of Appeals affirmed the district court finding that the policy exclusion barred coverage for all eleven counts because the tort claims were so related to the alleged securities violations as to put them “squarely within the express terms of the policy exclusion.”⁵⁴

3. Dishonesty and Criminal Acts Exclusion

The “Dishonesty Exclusion” in a typical D&O policy provides that the company shall not be liable to make any payment for loss in connection with any claims made against any of the insured persons brought about or contributed to by the dishonesty of such insured person if a judgment or other final adjudication adverse to such insured person establishes that acts of active and deliberate dishonesty were committed or attempted by such insured person with actual dishonest purpose and intent, and were material to the cause of action so

⁵¹ Fed. Sav. & Loan Ins. Corp. v. Oldenburg, 671 F. Supp. 720, 723-24 (Utah 1987).

⁵² See cases cited in OSTRAGER & NEWMAN, *supra* note 46, § 20.02[d], at 1081.

⁵³ Bendis v. Fed. Ins. Co., 958 F.2d 960, 961 (10th Cir. 1991).

⁵⁴ *Id.* at 963.

adjudicated.⁵⁵

One of the leading cases involving application of the dishonesty exclusion established the “final adjudication” standard, by which the court held that the exclusion for dishonesty attaches only after a final judgment or other final adjudication (e.g., a plea of “guilty” in a criminal case alleging fraud or dishonesty) that implicates the directors.⁵⁶ Other courts adopted a similar view, which essentially gutted the exclusion.

A second test also has been applied by some courts. The “dishonest in fact” test is more flexible than the dishonesty exclusion, since it allows insurers to litigate application of the exclusion in a coverage action.⁵⁷ This view makes perfect sense when one considers the pleading standard required in a securities action pursuant to the PSLRA of 1995. The PSLRA sought to eliminate the frivolous shareholder lawsuit by requiring that plaintiffs allege fraud or other intentional wrongdoing in order for a securities case to survive the pleading stage. Given this pleading requirement, it only makes sense to expedite a decision regarding the coverage exclusion for fraud early in the litigation, rather than waiting for a final adjudication on the merits.

4. Personal Profit Exclusion

The personal profit exclusion is largely self-explanatory. If the directors or officers reaped large personal gain from the alleged malfeasance, this exclusion should offer the insurer respite from the storm. As with the dishonesty exclusion, however, this exclusion is subject to the “adjudication” requirement or the “in fact” test.

5. ERISA and Plan Management Exclusion

It is fairly common for D&O policies to contain exclusions for claims arising out of the insured’s role as an ERISA trustee or similar plan manager. These exposures are covered, if at all, by fiduciary liability coverage.

6. Insured v. Insured Exclusion

The insured v. insured exclusion typically excludes coverage when the entity seeks damages from the directors or officers, or when directors and officers seek to recover from each other. The typical exclusion states:

It is understood and agreed that the insurer shall not be liable to make any payment for loss . . . which is based upon or attributable to any claim made against any director or officer by any other director or officer or by the institution . . . except for a shareholder derivative action brought by a shareholder of the institution other than an insured.⁵⁸

⁵⁵ *PepsiCo, Inc. v. Cont’l Cas. Co.*, 640 F. Supp. 656, 660 (S.D.N.Y. 1986).

⁵⁶ *Id.*

⁵⁷ *See Nat’l Union Fire Ins. Co. v. Cont’l Ill. Corp.*, 666 F. Supp. 1180 (N.D. Ill. 1987).

The courts have determined that this exclusion unambiguously precludes coverage for claims by the insured corporation against former executives and claims between covered executives. The exclusion is sometimes difficult to apply because of ambiguity surrounding identification of the “entity.” The potential “entities” could include the bankruptcy trustee, an entity acting on behalf of the corporation, a liquidator, creditors, and assignees. Case law on this issue is inconsistent, in part because of varying policy language.⁵⁹

Typically, many courts have declined to apply the exclusion when a bank regulator steps into a bank. The courts also have carved out shareholder derivative actions and declined to apply the exclusion when a shareholder action has been instituted, even though the particular directors or officers may hold shares in the corporation. In bankruptcy proceedings, the courts have reached differing outcomes depending on whether the company was in complete liquidation (exclusion applied)⁶⁰ or whether a business entity was formed by the creditors under a plan of reorganization to pursue the claims of the individual creditors (exclusion not applied).⁶¹

C. Other Coverage Issues

1. Notice

Excess policies, like primary policies, contain notice requirements. However, whether the insured and/or the primary insurer have the responsibility to notify the excess insurer of a potential loss is unsettled and varies by jurisdiction. The duty of the primary insurer to notify the excess insurer arises out of industry custom and common law; it is not a contact duty as is the case for an insured. Thus, although the primary should notify the excess carrier, it is important that an excess insurer insist that its insured provide notice of any securities litigation claim because the chance of such a claim reaching excess coverage is high. Thus, the excess policy notice provisions should require prompt notice of a claim, and the excess insurer should explain its desire for notice to its insured.

An excess insurer should also observe the conduct of the insured’s defense, where possible, and become directly involved where exposure is high. Timely notice permits an excess insurer to protect its interests during settlement negotiations where it may carry considerably more risk than the primary insurer. Except for the fact that coverage under an excess policy is not triggered until the primary or underlying insurance is exhausted, an excess insurer has the same rights to investigate claims, involve itself in settlement talks,

⁵⁸ Fed. Deposit Ins. Corp. v. Zaborac, 773 F. Supp. 137, 142 (C.D. Ill. 1991), *aff’d sub nom.* Fed. Deposit Ins. Corp. v. Am. Cas. Co., 998 F.2d 404 (7th Cir. 1993).

⁵⁹ Level 3 Communications, Inc. v. Fed. Ins. Co., 168 F.3d 956, 958 (7th Cir. 1999).

⁶⁰ Reliance Ins. Co. v. Weis, 148 B.R. 575 (E.D. Mo. 1992), *aff’d in part*, 5 F.3d 532 (8th Cir. 1993) (since there is no difference between the debtor and the bankruptcy estate, the exclusion applies).

⁶¹ Nat’l Union Fire Ins. Co. v. Jewel Recovery LP (In re Zale), No. 392-3001-SAF-11, Adversary Proceeding No. 393-3309 (Bankr. N.D. Tex. Apr. 11, 1995).

and make independent settlement decisions. As New York's highest court put it, "all of the salient factors point to the conclusion that excess carriers have the same vital interest in prompt notice as do primary insurers."⁶²

2. Cooperation

A common cooperation clause provides: "The Insureds shall, as a condition precedent to exercising their rights under this coverage section, give to the Company such information and cooperation as it may reasonably require. . . ." Recent case law has upheld a D&O carrier's denial of coverage when the insured refused to submit to an interview by the insurer in order to determine if misrepresentations were made in the policy applications.⁶³ Thus, an insured's failure to cooperate or failure to testify regarding knowledge available when policy application was made may form a basis for denying coverage under the policy.

3. Identifying the Insured

Policy questions may arise about who is insured once the legal relationships among corporate entities are examined in the light of day. For example, in the Enron controversy, does D&O coverage extend to the directors and officers of Condor and Raptor, the two partnerships involved in the off-balance-sheet accounting?

The structure of any deal must be carefully examined to determine if coverage extends beyond the obvious board members of the parent company. For example, where a corporation forms a joint venture with another and owns 50% or less of the venture, there is no duty to report the debts of the venture on the corporate books. To illustrate, suppose Company A and Company B both realize that it would advance their interests to construct a power plant to provide electricity to meet growing demand. However, both A and B are highly leveraged and do not wish to add debt to their respective balance sheets. A and B thus form a joint venture and contribute \$50 million each. Joint Venture goes to Bank, which is impressed by the credit status of A and B, and procures a loan of \$500 million. Joint Venture pays \$50 million back to both A and B, using the remainder to construct the power plant. Under applicable accounting standards, neither A nor B is required to report \$200 million in debt on its books. Under the circumstances, are the directors or officers of the joint venture covered by the D&O policies of A or B? To the extent the directors and officers in the joint venture are identical to those in the parent companies, an insurer may be able to restrict coverage, claiming that the individuals were acting outside of their capacity as directors or officers for the parent company.

4. Allocation of Loss and Defense Costs

"Many believe the single-most important judicial decision affecting D&O insurance

⁶² *Am. Home Assur. Co. v. Int'l Ins. Co.*, 684 N.E.2d 14, 18 (N.Y. 1997).

⁶³ *Bogatin v. Fed. Ins. Co.*, No. 99-4441, 2000 WL 804433 (E.D. Pa. June 21, 2000).

since *Smith v. Van Gorkon* in Delaware in 1985 was the *Nordstrom v. Chubb* decision by the 9th Circuit Court in 1995.”⁶⁴ The dilemma in D&O settlements was always identified as the allocation of liability among the defendants, particularly in securities claims. Shortly after the *Nordstrom* decision, however, Chubb, AIG and many other insurers introduced “allocation endorsements.” These endorsements specified an allocation and then offered an additional or discount premium, depending on the allocation percentage. The endorsements almost immediately resulted in a 50 to 60% loss cost but, due to market conditions, did not result in commensurate premium increases. The endorsement effectively clarified allocation issues, thereby improving the working relationship during the claims-settlement process, but actual paid claims have increased substantially.

The courts have articulated two rules to determine how defense and indemnity costs should be allocated between insured directors and the corporation or other uninsured persons. The two rules are known as the “larger settlement” rule and the “relative exposure” rule. Pursuant to the “larger settlement” rule, allocation is permitted to the extent that any settlement was enlarged by the wrongful actions of uninsured persons. Where the corporation’s liability is determined to be vicarious of the actions of insured directors and officers, the entire settlement has been allocated to the directors and officers. The “relative exposure” rule, on the other hand, provides that the amount in issue is allocated according to the degree to which the parties contributed to the injuries in the underlying litigation.

Similarly, an insurer may allocate defense costs between covered and non-covered claims asserted against an insured in the litigation. Courts are divided, however, about whether the insurer has a duty to advance defense costs to directors and officers. The popular press reports that the court denied requests from Enron’s lawyers to have insurers cover the legal costs of representing Enron and its executives in hearings before Congress and in other judicial proceedings pursuant to the terms of a fiduciary liability policy.⁶⁵ Other media reports contain potentially inconsistent accounts, suggesting that a federal judge has allowed executives and directors to tap insurance policies in order to cover legal fees arising from the company’s failure.⁶⁶

In determining whether defense costs should be allocated among covered and non-covered claims, most courts have adopted the “reasonably related” test. If the cost is reasonably related to the defense of a covered claim, it may be apportioned wholly to the covered claim. Although courts are divided on the burden of proof that attends the allocation issues, a majority of courts place the burden on the insured.

VI. TIPS FOR THE FUTURE

⁶⁴ Peter R. Taffae, *Navigating Rough Seas*, BEST’S REV., Jan. 1, 2002, available at 2002 WL 10441037.

⁶⁵ Christopher Oster, *Questioning the Books: Judge Says That Insurers Should Decide if Enron Lawyers Get Insurance Money*, WALL ST. J., Feb. 28, 2002, at A4.

1. Do not underestimate the potential exposure to directors and officers. Lately, people have been inundated with news of financial scandal. The Enron/Andersen debacle provides fodder for politicians who seek to curry favor with their constituents. Each new scandal is front page news. Many people are upset that their portfolios and retirement accounts have fallen dramatically over the past two years. The substantial patience of the investing public is increasingly tested by the mounting reports of conflicts of interest and accounting manipulations by corporate officers and directors. Each week a new villain seems to emerge in the form of a person to whom one can assign responsibility for the declining value of these retirement accounts. Disappointment with investments is palpably giving way to anger, and anger feeds a call to action. Many in the public believe that some entity should compensate them for the loss of paper wealth. This sentiment will fuel more litigation. Likewise, the SEC's new fury will generate the liability findings necessary to prove these cases with greater ease. Accompanied by closer scrutiny and the potential for new regulation of accountants, public disclosure of questionable practices will likely increase in the immediate future.

2. Monitor insureds in high-risk industries and the web sites tracking their financial success or failure, as well as the sites that identify potential class actions; keep an early alert for any potential loss.

3. Enhance the underwriting process to ensure that the following factors are being critically analyzed:

- Executive employment contracts that provide incentives to executives for good performance, or that protect or pay substantial income if the executive is terminated (these contracts may cloud the executive's business ethics).
- Notice of any SEC or IRS investigation or inquiry, or the issuance of any earnings restatement, irregularity or error, including specific notice whenever the company's earnings fail to meet published targets.
- The background and expertise of the audit committee: whether it is a financially astute, proactive body, or a perfunctory gathering of members lacking financial training and credentials.
- Whether comprehensive requests for information are part of the application and renewal process.
- Whether cognizance representations are required to be signed by all directors and officers, or at least those holding executive incentive contracts, and whether

⁶⁶ Barbara Bowers, *Risk Takes Center Stage: Enron Hurts Already-Faltering D&O Market*, BEST'S REV., June 1, 2002, available at 2002 WL 10441319.

the renewal process requires the submission of new signed statements. (It should).

- The relationship between the auditor and the company. The amount of fees paid, other projects undertaken by the auditor, the internal accounting functions performed by the auditing company and the length of the relationship are relevant factors to consider when determining whether the auditor has maintained its objectivity relative to the corporation's books and records.

4. Critically examine any claim for the application of exclusions, allocation of costs and indemnity issues, and compliance with policy terms.

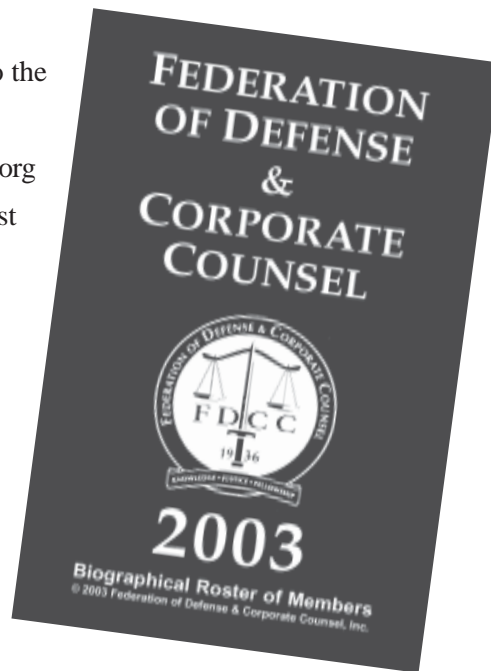
VII.

CONCLUSION

In the hardened insurance market, there is increasing opportunity to bring D&O premiums in greater alignment with potential risks. The one certainty following the Enron failure is that no one can or will do as good a job of protecting the interests of the insurer as the insurer itself. Thus, heightened vigilance is required of insureds in an effort to identify and respond to the early warning signs of financial trouble.

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Accountants' Liability after Enron[†]

James W. Semple

I.

INTRODUCTION

Accountants are professional individuals and organizations that perform financial and consulting services, including the preparation and auditing of financial reports. Accountants are either certified (Certified Public Accountants or CPAs) or non-certified. Their specific duties embrace diverse financial services that include completion and review of financial statements, tax advice, return preparation, and preparation of other financial reports. Consulting services are a significant and growing practice area for accountants. These vary considerably, and often provide counsel to management on accounting aspects of their business or the design of accounting and financial reporting systems.

The vulnerable plight of the public auditor is cogently described by the court in *Bily v. Arthur Young*:¹

Investment and credit decisions are by their nature complex and multifaceted. Although an audit report might play a role in such decisions, reasonable and prudent investors and lenders will dig far deeper in their "due diligence" investigations than the surface level of an auditor's opinion. And, particularly in financially large transactions, the ultimate decision to lend or invest is often based on numerous business factors that have little to do with the audit report. The auditing CPA has no expertise in or control over the products or services of its clients or their markets; it does not choose the client's executives or make its business decisions; yet, when clients fail financially, the CPA auditor is a prime target in litigation claiming investor and creditor economic losses because it is the only available (and solvent) entity that had any direct contact with the client's business affairs.²

[†] An earlier version of this article was published in the Summer 2002 issue of DECLARATIONS, the publication of the Excess/Surplus Lines Claims Ass'n, and is adapted with its permission. It is submitted by the author on behalf of the FDCC Professional Liability Section.

¹ 834 P.2d 745 (Cal. 1992).

² *Id.* at 763.



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and Insurance Section. An active member of the Federation of Defense and Corporate Counsel, Mr. Semple currently serves as Vice Chair of its Professional Liability Section. Furthermore, he is ABA trained as a mediator for the Delaware Superior Court and has mediated, arbitrated and advocated in hundreds of alternative dispute resolution proceedings. A charter member of the Delaware chapter of The American Board of Trial Advocates, he frequently speaks and writes, locally, nationally, and internationally, on business litigation, trial and dispute resolution issues.

When Enron collapsed into the largest bankruptcy in United States history, its employees lost their savings held in Internal Revenue Service Section 401(k) plans. These were connected to the energy company's stock. The reputation of Arthur Andersen, Enron's auditing firm, was irreparably damaged after company officials admitted that thousands of Enron documents were destroyed. Those events led to a flurry of probes, including a criminal indictment of Andersen by the United States Department of Justice. The SEC and the Labor Department — as well as six congressional committees — are also investigating Enron's collapse. At the heart of Enron's troubles are its "off the books" accounting measures. In order to keep debt off its books, Enron established many outside partnerships that were reviewed by Andersen. A major issue elicited by the scandal was Andersen's dual role as Enron's auditor and consultant, which critics identify as a serious conflict of interest. Andersen has been accused of overlooking the huge sums of money kept off Enron's books

because Enron represented potentially \$100 million per year in fees to the auditor. Enron fired Andersen when they both came under fire for their roles in the collapse of the world's largest energy trading company.

On June 15, 2002, a jury in the United States Court for the Southern District of Texas convicted Andersen of criminally obstructing justice. Within ten days of that conviction, Anderson was alleged to be the accountant behind the WorldCom collapse, a financial and ethical scandal that promises even to eclipse Enron. On October 11, 2002, Andersen was sentenced to five years probation, and fined \$500,000. Of course, by then the firm had lost its most lucrative clients and essentially imploded.

In addition to criminal conviction in Enron, Andersen faces civil actions filed by former Enron shareholders and employees, who allege that Andersen improperly certified Enron's financial statements. Prior to the Enron matter, Andersen had agreed to huge settlements in the Waste Management and Sunbeam cases and, while the Enron debacle unfolded, Andersen recently agreed to pay \$217 million to settle a separate civil suit involving Arizona Baptist Foundation, an allegedly fraudulent charity. Altogether, the civil suits leave Andersen exposed to billions of dollars in possible fines and other court-ordered payments. Some have estimated that Andersen's total exposure to liability from Enron is \$10 billion to \$20 billion.³ It may yet file a bankruptcy petition.

Other recent accounting scandals have also occupied headlines. For instance, Ernst & Young reportedly paid \$335 million to settle the *Cendant* audit case,⁴ and \$185 million in the Merry-Go-Round Enterprises consulting case.⁵

³ "Targeting Arthur Andersen," THE DAILY DEAL, reprinted in *Law.com*, <http://www.law.com> (2002-02-18).

⁴ See Shannon P. Duffy, *Ernst & Young Reaches \$335 Mil. Settlement in Cendant Corp. Case*, LEGAL INTELLIGENCER, Dec. 20, 1999, at A1. On December 17, 1999, Ernst & Young agreed to pay \$335 million to Cendant Corporation shareholders to settle a lawsuit that accused the New York accounting firm of negligence.

⁵ See Matt Fleischer & Karen Donovan, *Merry-Go-Round, Indeed*, NAT'L L. J., Mar. 27, 2000, at A6 (noting settlement). Ernst & Young was sued by the bankruptcy trustee for Merry-Go-Round Enterprises Inc., alleging failure to design any workable turnaround strategy and failing to provide basic turnaround services, all of which caused Merry-Go-Round to succumb. The trustee initially was asking \$3 billion in punitive damages and \$800 in compensatory damages.

II. BASES FOR LIABILITY

A. *State Law*

Accountants face common law liability for defamation,⁶ fraud,⁷ breach of fiduciary duty,⁸ breach of contract,⁹ and negligence,¹⁰ often bolstered by allegations recounting violations of the Accounting Institute of Certified Public Accountant (“AICPA”) Code of Professional Conduct. In addition, causes of action based upon statute,¹¹ such as the deceptive trade practice statutes, are often alleged. Recovery, or its potential, depends in large part on the circumstances of a particular case, as well as the accountant’s precipitating behavior.

1. Defamation

In a defamation suit, a plaintiff must prove the following elements: (1) a false and defamatory statement concerning another; (2) an unprivileged publication to a third party; (3) fault amounting at least to negligence on the part of the publisher, and (4) existence of special harm caused by the publication. Defamation lawsuits against accountants are rare. Usually they are filed by dismissed or fired employees of the audited company, and often they are unsuccessful because it is difficult to establish the requisite elements. By way of particular

⁶ See, e.g., *Abella v. Barringer Res., Inc.*, 615 A.2d 288 (N.J. Super. Ct. Ch. Div. 1992) (independent auditor sued for defamation over information contained in the footnote of a corporation’s financial report); *Burke v. Deiner*, 463 A.2d 963 (N.J. Super. Ct. App. Div. 1983) (accountant held potentially liable for allegedly defamatory statements contained in audit report); *Williams v. Hobbs*, 131 N.W.2d 85 (S.D. 1964) (accountant sued for statements in audit report); *Bailey v. Rogers*, 631 S.W.2d 784 (Tex. Ct. App. 1982) (accountant sued for defamation over statement made in a special report of partnership accounts).

⁷ See, e.g., *Reisman v. KPMG Peat Marwick LLP*, 965 F. Supp. 165 (D. Mass. 1997) (auditors held potentially liable for fraud to investors in two corporations involved in stock swap); *Joel v. Weber*, 569 N.Y.S.2d 955, 959-61 (App. Div. 1991) (accountant potentially liable to singer Billy Joel on fraud claim).

⁸ See, e.g., *Baldwin v. Kulch Assocs., Inc.*, 39 F. Supp. 2d 111, 119-20 (D.N.H. 1998) (accountant sued for breach of fiduciary duty); *Elm City Cheese Co. v. Federico*, 752 A.2d 1037, 1052 (Conn. 1999) (accountant liable for breach of fiduciary duty to former client).

⁹ See, e.g., *Jewish Hosp. v. Boatmen’s Nat’l Bank*, 633 N.E.2d 1267, 1279 (Ill. App. Ct. 1994) (accountant held potentially liable to intended beneficiaries of trust when bad advice reduced their inheritance); *CAE Indus. Ltd. v. KPMG Peat Marwick*, 597 N.Y.S.2d 402, 403 (App. Div. 1993) (accountant held potentially liable for failing to complete an audit by the appointed time).

¹⁰ See, e.g., *Ultramares Corp. v. Touch, Niven & Co.*, 174 N.E. 441 (N.Y. 1931) (privity is necessary for recovery under the theory of negligence).

¹¹ See, e.g., *Arthur Andersen & Co. v. Perry Equip. Corp.*, 945 S.W.2d 812, 815 (Tex. 1997) (user of an audit report was a “consumer” with standing to sue accounting firm under state deceptive trade practices statute); *In re Prof. Fin. Mgmt. Ltd.*, 703 F. Supp. 1388, 1397-98 (D.Minn. 1989) (accountants are covered by the Minnesota consumer fraud statute).

example, the element of publication to a third party often fails. When an accountant makes a report to the SEC on Form 10-K, the form specifically indicates to all readers that its preparation is the responsibility of the registrant (the company), and not the accountant.¹²

2. Fraud

To establish a claim of fraud, plaintiff must prove by clear and convincing evidence that the accountant: (1) falsely represented or deliberately did not disclose when it had duty to disclose; (2) a material fact; (3) intentionally and knowingly; (4) with intent to mislead; (5) on which misrepresentation plaintiff reasonably relied, and (6) which caused damage to the party so misled. The damages are often measured by the plaintiff's expected profits emanating from the transaction, although punitive damages may be available in particular circumstances upon a showing that the defendant acted with malice. The courts have defined malice as ill will, malevolence, grudge, spite, wicked intention, or conscious disregard for the rights of another.¹³

3. Breach of Fiduciary Duty

Courts have been reluctant to recognize a fiduciary duty between accountants and their clients, and extremely hesitant or cautious about extending such duty to third parties. There appears to be consensus among the courts that an accountant will only be considered a fiduciary when there is a close relationship between the plaintiff and the accountant. This involves something more than a mere business relationship, often described as a relationship that developed over the years, growing into a position of trust and confidence or certain reliance and influence.¹⁴ This prototype presents an even greater problem for third parties because the courts have consistently held that, without showing a close relationship, no fiduciary duty can exist.¹⁵

¹² *Abella v. Barringer Res., Inc.*, 615 A.2d 288, 290 (N.J. Super. Ct. Ch. Div. 1992) (defamation claim dismissed for lack of requisite publication since accountant merely reported the information provided to it by the company).

¹³ *Arnlund v. Deloitte & Touche LLP*, 199 F. Supp. 2d 461, 486 (E.D. Va. 2002).

¹⁴ *See, e.g., Fleet Nat'l Bank v. H&D Entertainment, Inc.*, 926 F. Supp. 226, 242 (D.Mass. 1996) (accountant-client relationship usually does not involve fiduciary duties), *aff'd*, 96 F.3d 532, 540 (1st Cir. 1996) (noting that if the accountant had been engaged as the receiver's financial advisor on the sale, the view might have been different); *Burdett v. Miller*, 957 F.2d 1375, 1381-82 (7th Cir. 1992) (fiduciary duty arose as business relationship shaded into social friendship while accountant provided investment advice which cultivated relation of trust and confidence over a period of years).

¹⁵ *See, e.g., Gutfreund v. Christoph*, 658 F. Supp. 1378, 1395 (N.D.Ill. 1987); *Venturtech II v. Deloitte Haskins & Sells*, 790 F. Supp. 576, 588 (E.D.N.C. 1992) (there can be no fiduciary duty from accountant to third party investors because, although element of trust or confidence is present, no element of superiority or influence was demonstrated), *aff'd*, 993 F.2d 228 (4th Cir. 1993).

4. Breach of Contract

In breach of contract actions, including those for breach of the implied covenant of good faith and fair dealing, the plaintiff must prove three essential elements: (1) the existence of a valid contract, (2) the breach of a material term of the contract, and (3) resulting damages. These claims often arise in willful breaches of contract. For instance, wrongful withdrawal from engagement resulting in a substantial loss to the client was considered a breach of contract and a breach of the implied covenant of good faith.¹⁶ A fundamental tenet of contract law limits recovery to those damages that arise naturally from the breach or were reasonably foreseeable at the time the contract was entered.¹⁷ A plaintiff's damages are generally measured by what is necessary to put the plaintiff in as good a position as it would have occupied had there been full performance.¹⁸ Historically, damages for breach of contract have been limited to the non-breaching party's expectation interest. The traditional goal of contract remedies has not been the compulsion to perform but compensating the promisee for loss resulting from the breach.¹⁹ The Uniform Commercial Code also adheres to the traditional view that expectation damages are the standard remedy for breach of contract.²⁰ As the Delaware court noted in *E.I. DuPont de Nemours & Co. v. Pressman*:

Traditional contract doctrine is also supported by the more recent theory of efficient breach. The theory holds that properly calculated expectation damages increase economic efficiency by giving "the other party an incentive to break the contract if, but only if, he gains enough from the breach that he can compensate the injured party for his losses and still retain some of the benefits from the breach."²¹

5. Negligence

A negligence cause of action is preferred to one sounding in contract because of the recoverable damages. The Restatement provides: (1) the damages recoverable for a negligent misrepresentation are those necessary to compensate the plaintiff for the pecuniary loss to him or her, of which the misrepresentation is a legal cause, including (a) the difference between the value of what the plaintiff has received in the transaction and its purchase price or other value given for it; and (b) pecuniary loss suffered otherwise as a consequence of the plaintiff's reliance upon the misrepresentation.²² In subsection (a), the Restatement provides an out-of-pocket measure for general damages; in subsection (b), it provides for such additional consequential or special damages as the plaintiff may prove.

¹⁶ *Id.*

¹⁷ *Hadley v. Baxendale*, 156 Eng.Rep. 145 (1854).

¹⁸ *Am. Gen. Corp. v. Continental Airlines Corp.*, 622 A.2d 1, 18 (Del. Ch. 1992).

¹⁹ *E.I. DuPont de Nemours & Co. v. Pressman*, 679 A.2d 436, 445 (Del. 1996); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 347 (1979).

²⁰ 6 DEL. C. § 1-106 (2001).

²¹ *Pressman*, 679 A.2d at 445.

The seminal issue in a negligence case is whether and to what extent an accountant's duty of care in preparing an independent audit of a client's financial statements extends to persons other than the client. Once the duty is established, the plaintiff then must demonstrate that the defendant breached this duty and proximately caused an injury. Whether a duty exists is a legal issue decided by the court. Because the broader tort measure of damages greatly increases the exposure of a named accountant, it is critical to identify the circumstances that prompt a duty.

Justice Kennard in *Bily v. Arthur Young & Co.* cogently summarized the divergent law on this issue:

A substantial number of jurisdictions follow the lead of Chief Judge Cardozo's 1931 opinion for the New York Court of Appeals in *Ultramares, supra*, 174 N.E. 441, by denying recovery to third parties for auditor negligence in the absence of a third party relationship to the auditor that is "akin to privity." . . . In contrast, a handful of jurisdictions, spurred by law review commentary, have recently allowed recovery based on auditor negligence to third parties whose reliance on the audit report was "foreseeable."

. . . .

Most jurisdictions, supported by the weight of commentary and the modern English common law decisions cited by the parties, have steered a middle course based in varying degrees on *Restatement Second of Torts section 552*, which generally imposes liability on suppliers of commercial information to third persons who are intended beneficiaries of the information. . . . Finally, the federal securities laws have also dealt with the problem by imposing auditor liability for negligence-related conduct only in connection with misstatements in publicly filed and distributed offering documents.²³

Measuring damages in negligent misrepresentation claims is the subject of recent controversy. Ordinarily, the damages are measured by a plaintiff's out-of-pocket losses. However, some argue that negligent misrepresentation cases should be viewed as fraud cases that calculate damages in terms of the plaintiff's expectations. Currently, the Georgia Supreme Court is facing this issue.²⁴

²² RESTATEMENT (SECOND) OF TORTS § 552B (1977).

²³ *Bily v. Arthur Young & Co.*, 834 P.2d 745, 752 (Cal. 1992).

²⁴ *BDO Seidman v. Mindis Acquisition*, 559 S.E.2d 111 (Ga. Ct. App. 2002), *cert. granted*, 2002 Ga. LEXIS 416 (Ga. May 13, 2002) (No. S02C0788). Briefing on the issue of damages centers on whether the standard for accountants' liability for negligent misrepresentation is the same as the standard of knowing and intentional fraudulent behavior. In the lower court, defendants did not challenge the jury instruction, which provided for the "benefit of the bargain" measure of damages.

6. Statutory

Most state statutes do not provide a private right of action for violating statutory schemes that regulate the conduct and licensing of public accountants. Thus, unless a plaintiff can demonstrate that: (1) he or she belongs to the class protected by the statute; (2) the injury is of the type intended to be protected by the statute, and (3) the legislature has either expressly or impliedly created a private right of action, no individual may bring suit for such a violation. Unlike the licensing and the regulatory statutes, however, most deceptive trade practices statutes and consumer fraud protection statutes permit private causes of action to enable victims of the deceptive trade practices to obtain recourse.

Many states have adopted statutes modeled after Section 10(b) of the Securities and Exchange Act of 1934, regulating fraudulent securities practices and accounting practices involved in the sale of securities. In that regard, the language of Section 7303 of the Delaware Securities Act is virtually identical to Securities and Exchange Commission Rule 10b-5, promulgated by the SEC pursuant to Section 10(b) of the Securities Exchange Act of 1934.²⁵ The purpose of this Delaware Securities Act is “to prevent the public from being victimized by unscrupulous or overreaching broker-dealers, investment advisors or agents in the context of selling securities or giving investment advice.”²⁶

Another source of evidence for accountant liability is the AICPA Code of Professional Conduct. Among other things, the Code requires a member to be honest and candid within the constraints of client confidentiality. The Code mandates that “service and the public trust should not be subordinated to personal gain and advantage. Integrity can accommodate the inadvertent error and the honest difference of opinion; it cannot accommodate deceit or subordination of principle.” Code Rule 203 mandates that accountants must comply with the generally acceptable accounting practices (“GAAP”) and generally acceptable accounting standards (“GAAS”) when preparing financial statements. Although violation of the AICPA Code of Professional Conduct does not create an independent civil cause of action, alleged violations are often used to demonstrate breach of the duty of care or non-compliance with GAAP and GAAS regulations. Representations regarding GAAP conformity, included in a letter or other communication from a client to its auditor or others related to that entity’s financial statements, are subject to Rule 203. Within the meaning of that rule, it may be considered an affirmative statement with respect to members who signed the letter or other communication. It is important to note that while other legislative regulations attempt to shield the accounting profession from liability rooted in negligence, the

²⁵ See *Singer v. Magnavox Co.*, 367 A.2d 1349, 1360 (Del. Ch. 1976), *aff’d in part and rev’d in part*, 380 A.2d 969 (Del. 1977) (observing that “6 Del.C. § 7303 is almost identical to, and in fact is identical in the wording of its three subdivisions to, Securities And Exchange Commission Rule 10b-5”), *overruled on other grounds*, *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

²⁶ 6 DEL.C. § 7301(b) (2001).

Code expressly mandates that negligence in preparing financial statements or records may subject an accountant to violation of the Professional Code of Conduct.²⁷

B. *Selected Federal Law*

On the federal level, accountants are exposed to civil liability for violations of the Securities Act of 1933 (the "Act of 1933") and the Securities Exchange Commission Act of 1934 (the "Act of 1934"). Under the Act of 1933, potential exposure to liability emanates from a concern that because investors rely on various security-related disclosures and statements, such disclosures have been prepared with integrity and accuracy. For example, accountants are civilly liable to a third party who acquires a security on account of false registration statements made in connection with such security.²⁸ Actual reliance is necessary for Section 11(a)(4), and liability is conditioned on proof that the plaintiff who acquired the security actually relied on the untrue statement. The measure of damages can be calculated by the difference in the price of the security acquired and the value of stock at the time of the purchase.

Similarly, an accountant may be civilly liable for including an untrue statement or omitting a material fact in a prospectus or other communication.²⁹ Section 17 of the Act of 1933 includes a comprehensive anti-fraud regulation which mandates that it is unlawful for any person to engage in any transaction, practice, or course of business which operates as a fraud or deceit on the purchasers of securities. On the same note, Section 14(e) of the Act of 1934 mandates that it is unlawful for any person to make untrue statements of material fact or to omit material information in connection with any tender offer or request or invitation for tenders. Similarly, SEC Rule 14a-9 provides that it is unlawful to make a false or misleading statement of material fact in a proxy statement, or to omit stating a material fact that is necessary to prevent any statement in the proxy statement from being false or misleading.

Another widely used cause of action arises from Rule 10(b) of the SEC Rules. Five elements are necessary to state a claim under section 10(b) of the Securities Act of 1934 and SEC Rule 10(b)-5. Accordingly, evidence must support: (1) a defendant's misstatement or omission of a material fact, (2) in connection with the purchase or sale of securities, (3) involving scienter on the part of the defendant, (4) a justifiable reliance on the

²⁷ Under the Code, "a member shall be considered to have committed an act discreditable to the profession in violation of Rule 501 when, by virtue of his or her negligence, such member:

(a) Makes, or permits or directs another to make, materially false and misleading entries in the financial statements or records of an entity; or (b) Fails to correct an entity's financial statements that are materially false and misleading when the member has the authority to record an entry; or (c) Signs, or permits or directs another to sign, a document containing materially false and misleading information."

²⁸ Section 11 of the Securities Act of 1933 (15 U.S.C.A. § 77k) imposes liability for negligent misstatements in registration statements.

²⁹ Section 12(2) of the Securities Act of 1933 (15 U.S.C.A. § 771(2)) imposes liability for negligent misrepresentation in a prospectus.

misstatement or omission by the plaintiff, and (5) proximately caused damages.³⁰ The United States Supreme Court defined “scienter” as a “mental state embracing intent to deceive, manipulate or defraud.”³¹ In *In Re MicroStrategy*, the court likewise identified four factors that support a strong inference of scienter on the part of independent accountants: (1) the magnitude of GAAP and GAAS violations and subsequent restatement of financial records; (2) the auditor’s access to the defendant corporation’s resources and knowledge of its operations and business arrangements; (3) the auditor’s disregard of red flags signaling improper revenue recognition; and (4) the auditor’s violation of its obligation to remain independent and its motivation to maintain the client’s appearance of profitability.³²

The Private Securities Litigation Reform Act (the “PSLRA”), however, poses a significant procedural obstacle to commencing action against an accountant. This legislation requires plaintiffs to satisfy a heightened standard for establishing scienter, and to “state with particularity facts giving rise to a strong inference” that the defendant acted with scienter.³³ The courts thus require a plaintiff to “plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct.”³⁴ In *In re Health Management Securities Litigation*, for example, the court found that plaintiff investors satisfied the heightened standard for establishing scienter by alleging that auditors acted recklessly in certifying corporate financial statements. Specifically, the auditors failed to follow generally accepted accounting standards or their own procedures when they used the “Gross Profit Method” to determine the accuracy of the corporation’s inventory. They also ignored certain “red flags,” including “in-transit” inventory valued at 50% of inventory at the end of the previous fiscal year.³⁵

III. IMPLICATIONS

A. *Expanded Exposure*

The old adage that “bad facts make bad law” will find new life in the post-Enron legal world. Because of the scope of the Enron debacle and, particularly, the involvement of Andersen in the “independent” audit of the energy giant, the courts may be more inclined to abolish or relax the privity requirement, replacing it with the foreseeability rule or the

³⁰ *In re SCB Computer Technology, Inc.*, Securities Litigation, 149 F. Supp. 2d 334, 343 (W.D. Tenn. 2001).

³¹ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

³² *In Re MicroStrategy*, 115 F. Supp.2d 620, 651 (E.D.Va. 2000).

³³ 15 U.S.C. § 78u-4(b)(2) (2002).

³⁴ *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999).

³⁵ *In re Health Mgmt. Inc. Sec. Litig.*, 970 F. Supp. 192, 203 (E.D.N.Y. 1997).

Restatement standard when faced with compelling facts and innocent plaintiffs. To perform this substitution effectively replaces the conservative contract measure of damages with the more expansive tort measure.

B. *Legislative Action*

The Sarbanes-Oxley Act of 2002 (the "Act") was passed by Congress and signed into law by President Bush at the end of July, 2002.³⁶ The Act establishes a framework for widespread regulation of corporate governance and relevant accounting practices. It also attempts to heighten the standards of conduct for corporate executives, and it establishes a new regulatory system for the audit profession. Finally, it requires auditor independence.

Among the most controversial and pressing of its regulations, the Act prescribes that the CFO and CEO must certify corporate financial reports. Specifically, the Act requires that each quarterly or annually submitted report must be signed by the principal executive officer and the principal financial officer certifying that: (1) such officers reviewed the report; (2) the report contains no untrue statements, does not omit a material fact, and is not misleading; (3) financial data included in the report is fairly represented as of the date and for the period covered by the report; (4) signing officers are responsible for establishing and maintaining internal controls and can certify their effectiveness; and (5) the signing officers have disclosed to the auditor and the auditing committee of the board of directors any deficiency in the design or operation of internal controls.³⁷ These certification rules took effect thirty days after the enactment date of the Act.

Other key regulations include the prohibition of loans to directors and officers³⁸ (which is going to create complications for financial institutions trading securities under the SEC), protection to the whistleblower,³⁹ forfeiture of bonuses and share trading profits upon a finding of material non-compliance with the Act,⁴⁰ and creation of the Public Company Accounting Oversight Board (the "Board").⁴¹ In addition, the Act requires that corporations adopt a code of ethics for senior financial officers,⁴² and it requires the amendment of federal bankruptcy laws to reflect the new non-dischargeability of incurred debts resulting from securities fraud or common law fraud, deceit or manipulation.⁴³

³⁶ H.R. 3673 107th Cong., 116 Stat. 745 (2002).

³⁷ 15 U.S.C. § 7241 (2002).

³⁸ 15 U.S.C. § 78m (2002).

³⁹ 18 U.S.C. § 1514A (2002).

⁴⁰ 15 U.S.C. § 7243 (2002).

⁴¹ 15 U.S.C. § 7211 (2002).

⁴² 15 U.S.C. § 7264 (2002).

⁴³ 11 U.S.C. § 523 (2002).

Attempting further to ensure auditor independence, the Act provides a laundry list of prohibited activities for a registered public accounting firm that performs auditing services. Among the proscribed activities are any non-auditing services, such as bookkeeping, financial information systems design and implementation, appraisal or valuation services, actuarial services, investment advisor or investment banking services, and any other services provided contemporaneously with the audit that are determined later to be impermissible by the Accounting Oversight Board.⁴⁴

It is yet unclear who will enforce these regulatory schemes. Absent funding for strong enforcement,⁴⁵ the Act offers little more than political theater. Its true impact on accountants' liability law is uncertain because it will not apply to most accountants who do not service publicly registered and traded companies.

C. "Ripple" Litigation

Suits by employees against corporations, officers, directors and accountants for failure to inform regarding an employer's failing financial position are already occurring under the fiduciary duties of the Employee Retirement Income Security Act (ERISA). In one action arising from the Enron scandal, filed on behalf of Enron employees and participants in its 401(k) plan, the complaint details how Andersen falsely represented that Enron's financial statements conformed to generally accepted accounting practices. In addition, Andersen is alleged to have falsely represented that its audits of Enron's financial statements were performed in accord with generally accepted auditing standards, and knowingly issued or consented to the issuance of numerous false financial reports, all of which were essential to Enron's scheme of presenting itself in a false light to investors and employees. United States Law Week has reported that: "In the wake of the collapse of Enron Corp., employees at a number of major corporations are bringing class actions accusing their employers of violating their fiduciary duties in managing Internal Revenue Code § 401(k). In most cases, the plans were set to encourage investment in company stock, and employees are asserting under the Employee Retirement Income Security Act (ERISA), [that] firms had a duty to provide them with detailed financial information."⁴⁶ Among the companies being sued are Global Crossing, Lucent Technologies, Nortel Networks, Providian Financial Corp., Quest Communications, Tyco and Williams Companies.

⁴⁴ 15 U.S.C. § 78j-1 (2002).

⁴⁵ See 18 U.S.C. § 1349 (2002) (attempts and conspiracy to commit criminal fraud offenses); 18 U.S.C. § 1341 (2002) (criminal penalties for mail and wire fraud); 29 U.S.C. § 1131 (2002) (criminal penalties for violations of ERISA); 28 U.S.C. § 994 (2002) (amendment to sentencing guidelines relating to certain white-collar offenses), and 18 U.S.C. § 1350 (2002) (corporate responsibility for financial records).

⁴⁶ 70 U.S.L.W. 2723-26.

D. *Effects on Insurance*

Anecdotal reports recount that premiums have increased from 15% to 50% over 2001. Some insurers are reviving co-pays, with provisions ranging from 10% to 20%. Corporate behavior will be subject to greater scrutiny. The relationships between an accounting firm and its clients are a focus. If a firm does both audit and consulting work, it faces greater difficulty obtaining coverage, as do financially strapped companies. Applications for new and renewal coverage will likely be revised to inquire about potential conflicts in performing consulting and audit functions for the same company or family of companies; about employing or providing advice for "off the books" accounting techniques; about notice procedures to third parties (potential plaintiffs), and to request certification or verification that the applicant is complying with AICPA standards in all matters.

There is little case law covering material misrepresentation in the accountant liability underwriting process. Insurance policies traditionally have been considered contracts requiring the utmost good faith.⁴⁷ In *Rust v. Metropolitan Life Insurance Co.*,⁴⁸ the United States Supreme Court held: ". . . [a] failure by the insured to disclose conditions affecting the risk, of which he is aware, makes the contract voidable at the insurer's option."⁴⁹ A fraud defense, however, may be diminished by economic factors in the historically unpredictable insurance market. Traditionally, flush economic times create a difficult market for selling insurance. In their quest to write new business, insurers sometimes do not examine new applications with the same scrutiny that generally prevails. To succeed in a fraud defense, insurers must show that (1) the insured supplied false or incomplete information on its application; (2) the misrepresentation was material, and (3) the insurers actually relied on the misrepresentation to their detriment.⁵⁰ In their avidity to sell, if the insurers provided express delivery from the selling agent's brief case to a file drawer, they will fail in their proof of actual reliance on any misrepresentations.

Defenses based upon exclusions for dishonesty or intentional acts should see action as well. Generally, it is the unintentional but foreseeable scope of the intentional act that controls.⁵¹ When the act that causes the injury is intentional, the specific issue facing the court is how to determine whether the resulting injury is reasonably foreseeable.⁵²

⁴⁷ *Rust v. Metropolitan Life Ins. Co.*, 175 A. 198 (Del. Super. Ct. 1934); *New Castle County v. Hartford Accid. & Indem. Co.*, 685 F. Supp. 1321, 1327 (D. Del. 1988); 12A APPLEMAN ON INSURANCE LAW AND PRACTICE § 7271 (1981).

⁴⁸ *Id.*

⁴⁹ *Stipchich v. Metropolitan Life Ins. Co.*, 277 U.S. 311, 316 (1928); *see also Rust*, 175 A. at 198-99.

⁵⁰ ROBERT E. KEETON & ALAN I. WIDDIS, *INSURANCE LAW* § 5.7 at 570 (Student ed. 1988).

⁵¹ *Farmer in the Dell Enterprises v. Farmer's Mut. Ins. Co.*, 514 A.2d 1097, 1100 (Del. 1986).

⁵² *E.I. duPont de Nemours & Co v. Admiral Ins. Co.*, Del. Super., C.A. No. 89C-AU-99, Steele, V.C. (February 22, 1996) (Memorandum) at 9-10. *See also Battisti v. Continental Cas. Co.*, 406 F.2d 1318 (5th Cir. 1969) (lawyer conduct falls within dishonesty and fraud exclusion of professional liability insurance contract); *Stargatt v. Avenell*, 434 F. Supp. 234, 241 (D.Del. 1977) (dishonesty exclusion applied).

Under these circumstances, other issues may surface with renewed vigor. Because the accounting misconduct alleged in an Enron-type suit occurs over several calendar years and can affect several fiscal years (which may or may not involve the same calendar years), the trigger and allocation wars of the late Twentieth Century will likely be renewed as well.

IV. CONCLUSION

The Enron case has morphed into the Enron syndrome as other huge corporations discover or disclose their own audit failures and restate their earnings or losses. The stock market remains in ICU. The most serious consequence is the investing public's lagging confidence in financial statements and institutions. This crisis in public confidence threatens the recovery of financial markets essential to America's prosperity.

Public outrage at Enron's effect on its employees and investors, and the sense of inequity in the fallout of those effects upon the "haves" and the "have nots" may well provide the impetus to forego the admonition that "an auditor is a watchdog, not a bloodhound."⁵³ If forgotten, the liberal foreseeability rule or the Restatement standard may replace the profession-friendly privity rule, in which case accountants' liability may never be the same again.

⁵³ *In re Kingston Cotton Mill Co.*, 2 Ch. 279, 288 (1896).

The Reinsurance Implications of the Enron Collapse[†]

Colin V. Croly

I.

INTRODUCTION

The past twelve months have been turbulent ones for the world's reinsurers. The collapse of Enron followed only three months after the tragic events of September 11, and only weeks after the Toulouse disaster. Lori Iwan and Charles Watts have reviewed the circumstances that led to and surrounded Enron's demise in their article.¹

In large part, those circumstances were unique to Enron. It is clear, nevertheless, that at least in relation to the highly "aggressive" nature of its accounting practices, Enron was not alone, as subsequent developments at Xerox and WorldCom have shown. Consequently, the relevance of many of the issues that are discussed herein is unlikely to be limited to Enron.

Investigations into Enron's business and dealings are ongoing. Given this and the enormous complexity of the factual matrix, the full range and extent of the potential exposures for direct insurers remains unclear and will remain so for some time.

Equally, as other authors have discussed, it is already certain that the targets for Enron-related claims will include the company's directors and officers, Arthur Andersen, Enron's lawyers as well as diverse investment banks involved in the structuring and financing of various special purpose entities ("SPEs") and in marketing and dealing in Enron securities.²

Accordingly, while a detailed evaluation of the potential exposures (and of the potential issues) arising at direct level is outside the scope of this paper, it is clear that the sources of such potential exposure are likely to include:

[†] Submitted by the author on behalf of the FDCC Reinsurance Section.

¹ Lori E. Iwan & Charles M. Watts, Jr., *Enron and the D&O Aftermath: Tips and Traps for the Unwary*, 53 FED'N DEF. & CORP. COUNS. Q. 65 (Fall 2002); see also the Report of the Special Investigative Committee of the Board of Enron, February 1, 2002.

² The defendants to the Milberg Weiss class action which focuses on alleged violations of securities laws include the Directors of Enron, Andersen, individual Andersen Partners, Vinson & Elkins, Kirkland & Ellis, JP Morgan Chase, Citigroup, Credit Suisse First Boston, Lehman Brothers and others.



Colin Croly is the head of Barlow Lyde & Gilbert's Reinsurance & International Risk team. He acts for many of the leading specialist reinsurance companies, Lloyds Syndicates, direct insurers and others involved in reinsurance and international risk. His representation includes litigation in the Commercial Court in London, arbitrations and other forms of dispute resolution both in London and, acting in conjunction with a network of overseas correspondent lawyers and expert market representatives, elsewhere in the world, particularly in the USA. Colin is a prolific writer of reinsurance articles and is joint editor of REINSURANCE PRACTICE & THE LAW, an acclaimed looseleaf textbook on Reinsurance Law,

authored by the Reinsurance & International Risk team at Barlow Lyde & Gilbert, published by LLP. He speaks regularly at conferences throughout the world on reinsurance issues. Colin is Secretary General of AIDA (Association Internationale de Droits des Assurances), founding Chairman of the AIDA Reinsurance Working Party, and a Board Member of the FDCC. As such, he also chairs the Reinsurance Section and co-chairs the International Activities Committee. He is also an active member of the British Insurance Law Association (BILA) and the Defense Research Institute. Colin read Economics and Law at Cape Town University, followed by a Masters Degree in International Law at London University. He qualified as an attorney in South Africa in 1971, joining Barlow Lyde & Gilbert in London in 1976. He has been a partner since 1980 and has headed the Reinsurance & International Risk team since its inception. With more than forty-seven legal staff, it is the largest dedicated team of Reinsurance Lawyers in Europe.

1. D&O cover relating to the Directors and Officers of Enron;
2. E&O cover relating to Andersen; and
3. E&O cover relating to Enron's legal and financial advisors.

In addition, significant claims have arisen under surety bonds issued by or in connection with transactions entered into by Enron (*Enron Surety Bonds*).

Undoubtedly, complex coverage and other issues have already arisen and will arise at direct level.³ These issues are likely to include whether proper disclosure was made to insurers on placement of the relevant policies and, hence, whether insurers are entitled to avoid certain covers. As and when these issues are resolved, insurers will, in turn, seek payment from their reinsurers. At that point a number of key reinsurance issues are likely to be brought into focus, including:

1. the extent to which, if at all, insurers/reinsureds can bind their reinsurers to follow⁴ any settlements or compromises concluded with insureds/claimants (*Follow the Settlements Issues* or, as they might be more commonly referred to in the United States, “Follow the Fortunes” issues);
2. linked to 1., the extent to which any failure on the part of insurers/reinsureds to involve their reinsurers in the settlement of underlying claims might affect their rights of recovery (*Claims Co-operation Issues*); and
3. the extent to which, if at all, insurers/reinsureds can aggregate claims relating to, or arising out of, the collapse of Enron for the purposes of presentation to reinsurers (*Aggregation Issues*).

In addition, in relation to certain of the surety bonds issued by Enron, including perhaps, the *Mahonia Bonds* that are currently the subject of proceedings in New York, specific issues may arise concerning the true nature/classification of those bonds. For example, whether properly analyzed they amount to financial guarantees⁵ and, hence, whether they fall within the scope of or might otherwise be excluded from the sureties’ reinsurance protections (*Surety Bond Issues*).⁶

³ In this regard, it is understood that a number of Enron’s D&O carriers have filed suit alleging fraud on the part of Enron. See INS. DAY, Apr. 17, 2002.

⁴ In other words, “indemnify them in respect of.”

⁵ Or “financial guarantee insurance” within the meaning of relevant provisions of New York’s Insurance Law.

⁶ Since the surety bond issues are likely to be discrete and since the issues would seem to be, principally, ones for determination by reference to the laws of the various States of the United States, they are not addressed in more detail in this article.

It is impossible, at present, to say how these various issues might be resolved. In this article, however, I hope to provide an idea of some of the general principles that might be relevant to their resolution.

I should emphasize that my comments are made from an English law perspective. No doubt, many of the issues will also be considered under the laws of a particular States in the United States, and hence, by reference to different principles.⁷

II. FOLLOW THE SETTLEMENTS ISSUES

As noted earlier, it is inevitable that coverage and other issues will arise at the direct insurance level. Bearing in mind the complexity of the factual context in which they will fall to be resolved, the resolution is unlikely to be straightforward although, in the ordinary way, many of those issues may ultimately be compromised or settled before they come before the courts or other tribunals.

Insurers entering into settlements or compromises will in turn look to their reinsurers to respond. Whether reinsurers will be bound to do so will of course depend on the specific circumstances, including the terms of the reinsurance and the facts of the settlement or compromise. However, certain general principles by which such issues will be considered can be identified.

A. *The General Nature of Reinsurance*

1. The Principle of Indemnity

While there is scope for debate as to the precise nature of reinsurance or more accurately, particular contracts of reinsurance⁸ that debate is in most cases arid, since irrespective of the precise nature of a given contract, it is generally accepted as a matter of English law that:

A policy of reinsurance is an agreement by way of complete or partial indemnity of the insurer. That has long been settled *Like every contract of indemnity, it can only operate if the liability of the debtor, the insurer, is established, and it is necessarily contingent on that liability being established.* It follows that the insurer has no cause of action against the reinsurer until the loss for which the former is liable (if any) has been ascertained.⁹

⁷ References, if any, to the position under laws other than the laws of England and Wales should not be viewed as in any way definitive.

⁸ See, e.g., *Toomey v. Eagle Star Ins. Co.* [1994] 1 Lloyd's Rep. 516.

⁹ *Daugava v. Henderson* [1934] 49 Lloyd's Rep. 252, 254 (emphasis added).

In consequence and in the absence of any provision to the contrary, “the reassured, in order to recover from their underwriters, must prove the loss in the same manner as the original assured must have proved it against them, and the reinsurers can raise all defences which were open to the reassured against the original assured.”¹⁰

B. *Contracts Not Containing “Follow the Settlements” or Similar Provisions*

1. *Obligation to Prove Liability*

It follows that in order to recover from its reinsurer in respect of any given claim, a reinsured under a contract that does not contain a “follow the settlements” or similar provision must establish both:

- (a) that it was liable in law to its cedent/insured in respect of the relevant underlying loss/claim; and
- (b) the amount of the loss for which it was so liable.

2. *Proving Liability*

Generally, to prove liability, a reinsured must establish either that:

- (a) its liability had been determined by a judgment or award given by a court or tribunal where:
 - (i) the court or tribunal was of competent jurisdiction;
 - (ii) the judgment was not in breach of an exclusive jurisdiction clause or other clause by which the original insured was contractually excluded from proceedings in that court;
 - (iii) the reinsured took all proper defenses; and
 - (iv) the judgment was not manifestly perverse, or
- (b) that, on the balance of probabilities, it was liable under the terms of the relevant underlying contract for an amount not less than the amount of the settlement.¹¹

¹⁰ See London County Commercial Reinsurance Office, Ltd. [1922] 10 Lloyd’s Rep. 370, 371.

¹¹ See Commercial Union Assurance Co. v. NRG Victory Reinsurance, Ltd. [1998] 2 Lloyd’s Rep. 600.

As *Commercial Union*¹² demonstrates, the burden that the reinsured must discharge to satisfy these requirements is, potentially, an onerous one. A dispute arose between Commercial Union, as reinsured, and NRG Victory relating to the recoverability of claims associated with the loss of the *Exxon Valdez*. It was common ground in those proceedings that, in the absence of a “follow the settlements” or similar provision, NRG Victory could be bound only in respect of “settlements” that Commercial Union was liable to make under the relevant underlying contracts. NRG Victory argued, further, that Commercial Union could not so prove its liability, notwithstanding that it had settled proceedings brought by its insured in Texas on the basis of advice from counsel that the insured would have succeeded at trial. That argument was upheld.

The Court of Appeal made clear that: “[Commercial Union] were required to demonstrate liability to Exxon, and could only be entitled to recover on some wider basis if they could show some kind of ‘follow settlements’ clause binding the reinsurers to the plaintiffs’ settlement.”¹³

Since there was no such clause¹⁴ and since the advice to settle was ultimately based, not on an assessment of the legal merits of Commercial Union’s case but on the view that the jury was likely to find against reinsurers in any event, the Court of Appeal held that Commercial Union had not discharged its obligation of proving that, on the balance of probabilities, it had a liability *in law under the terms and conditions of the underlying risk*.

C. *Effect of “Follow the Settlements” or Similar Provisions*

It is of course open to the parties to agree to alter the general position, and hence to relieve the reinsured to a greater or lesser degree from its obligation to establish an actual liability in law, and hence to reprove the original claim.

As Lord Mustill commented in *Hill v. Mercantile & General Reinsurance Co.*¹⁵:

There are only two rules, both obvious. First, that the reinsurer cannot be held liable unless the loss falls within the cover of the policy reinsured and within the cover created by the reinsurance. Second that the parties are free to agree on ways of proving whether these requirements are satisfied.¹⁶

¹² See *id.*

¹³ *Id.* at 612.

¹⁴ As a matter of English law, no such term is likely to be implied.

¹⁵ [1996] L.R.L.R. 341.

¹⁶ *Id.* at 350.

1. Types of provision

The precise wording of such provisions varies considerably, often depending on the nature of the reinsurance in question. Facultative reinsurances written in the London Market often contain, or incorporate provisions along the lines of the following: “[b]eing a reinsurance of and warranted same gross rate and conditions as and to follow the settlements of the [reinsured].” This is, perhaps, the classic formulation of a “follow the settlements” provision.

The wording to be found in a London Market non-proportional treaty might be somewhat different, although its effect may be broadly similar. A typical example might read: “[a]ll loss settlements by the reinsured shall be binding upon reinsurers provided that such settlements are within the terms and conditions of the original policies and within the terms and conditions of this policy.”¹⁷

Finally, a proportional treaty, such as a quota share, may contain a more general formulation that may require the reinsured to “follow the fortunes of the reinsured in all respects.” While there has been no decided case on the meaning of “follow the fortunes” wording under English law, other formulations have been considered in some detail by the English courts. These will be discussed subsequently. It is likely that “follow the fortunes” provisions would be construed in broadly the same way.

2. “Follow the settlements”

The leading English authority on follow the settlements clauses is the Court of Appeal’s decision in *Insurance Co. of Africa v. Scor (UK) Reinsurance Co.*¹⁸ The case concerned a direct policy insuring the old customs building in Monrovia, which had been leased by the insured, ATC, from the Liberian Government. Insurance Company of Africa (ICA), a local company, reinsured to the extent of 98.6% in London, with Scor being the lead reinsurer. The reinsurance slip contained a “follow the settlements” clause and also a claim control clause. A fire destroyed the building in February 1982. ICA accepted liability following reports by two loss adjusters. Scor then received anonymous letters to the effect the fire had been fraudulently arranged by the controller of ATC and that one of the loss adjusters had been party to the fraud. Scor refused to follow ICA and to pay the claim and confirmed this view following its own investigations.

¹⁷ While the first part of the clause (“all loss settlements by the reinsured shall be binding upon reinsurers”) is likely to have similar effect to the “follow the settlements” wording considered in *Ins. Co. of Africa v. Scor (U.K.) Reinsurance Co.*, [1985] 1 Lloyd’s Rep. 312, the inclusion of the “provisos” (i.e., that any settlements must, nevertheless, be within the terms and conditions of the original policies) have the potential to emasculate the clause to some extent at least. *See Hill v. Mercantile & Gen. Reinsurance Co.* [1996] 3 All E.R. 865.

¹⁸ [1985] 1 Lloyd’s Rep. 312.

In the interim, ATC had commenced proceedings in Liberia against ICA. ICA had no real defense other than their reinsurers were refusing to pay the claim. At the trial, ICA did no more than to put ATC to proof of their claim. Not surprisingly, they were adjudged liable to indemnify ATC for their loss, and had to pay \$600,000 by way of additional damages and \$58,000 by way of legal costs. ICA then commenced proceedings in the Commercial Court in London against Scor for the whole of the amount of the Liberian judgement.

Scor defended the proceedings on a number of grounds. They pleaded that the underlying claim was invalid by reason of arson and fraud. They contended further that the local loss adjuster was incompetent. Justice Leggatt, the judge at first instance, held that neither of these allegations was made out and held that Scor must follow the settlement made by ICA.

Although the case involved a judgment rather than a settlement, and on that basis the insurer had proved its loss and was able to recover from the reinsurers, the Court of Appeal, nevertheless, gave its views on the general effect of follow the settlements clauses. The judgment most often quoted is that of Lord Justice Robert Goff, who explained the principles that apply in connection with a follow the settlements clause in the following passage:

In my judgment, the effect of a clause binding reinsurers to follow settlements of the insurers, is that the reinsurers agree to indemnify insurers in the event that they settle the claim by their assured, i.e., when they dispose, or bind themselves to dispose, of a claim, whether by reason of admission or compromise, provided that the claim so recognized by them falls within the risks covered by the policy of reinsurance as a matter of law, and provided also that in settling the claim the insurers have acted honestly and have taken all proper and businesslike steps to make the settlement.¹⁹

The result, therefore, is that where a follow the settlements clause appears, the reinsured can recover from the reinsurer in respect of a settlement reached with the reinsured provided that:

- (a) the reinsured has acted in a bona fide and businesslike fashion; and
- (b) as a matter of law, the claim falls within the risks covered by the reinsurance agreement.

The significance of the foregoing principles is that once the reinsured has acted in a bona fide and businesslike fashion and has settled and paid a claim and has called upon reinsurers to provide an indemnity, the reinsurers cannot reopen the settlement. This assumes that the settlement was reached in an honest and businesslike fashion. The burden of proof in this regard will be discussed subsequently.

¹⁹ *Id.* at 330.

Rather, the key question becomes whether the loss “as a matter of law” falls within the risks covered by the reinsurance policy. This is usually a straightforward matter of the interpretation of the relevant reinsurance policy, although the position may well be more complicated, particularly at retrocessional levels, if issues of aggregation arise.²⁰

3. “Loss Settlements Binding”

“Loss settlements binding” provisions do not give rise to any fundamental differences of principle. In general, the comments of Lord Justice Goff in *SCOR* with respect to “follow the settlements” wording are equally applicable. Nevertheless, the wording of clauses may vary and each clause must, therefore, be individually construed albeit, perhaps, with those principles in mind.²¹

The form of loss settlements provision set out above²² was considered by the House of Lords in *Hill v. Mercantile & General Reinsurance Co.*²³ Lord Mustill considered that “the crucial words are ‘within the terms and conditions’ of the original policies and of the reinsurance”²⁴ which, in his view, “draw a distinction between the facts which generate claims under the two contracts and the legal extent of the respective covers.”²⁵

On that basis, when provisions of this type appear, a reinsured can certainly bind its reinsurer to its settlements of factual issues, provided it has acted in an honest and businesslike fashion. However, it will find it difficult to bind reinsurers as to its determinations of the legal implications of those facts.²⁶ The position is, nevertheless, neither clear nor

²⁰ The question of whether, for example, a second tier reinsurer can bind his retrocessionaires to follow his assessment of, for example, the number of events involved for the purposes of event-based aggregation is, in the absence of a judgment, a thorny one. See *Hill v. Mercantile & Gen. Reinsurance Co.* [1996] 3 All E.R. 865. See also *Axa Reinsurance v. Field* [1996] 2 Lloyd’s Rep. 233; *Brown v. GIO Insurance, Ltd.* [1998] Lloyd’s Rep. I.R. 201.

²¹ These tensions have revealed themselves for a century in successive reformulations of the clause. They can also be seen in the strenuous efforts of the courts to maintain some continuity of principle by applying prior decisions given on one form of clause in one state of facts to another form of clause in a different state of facts. I find this process unfruitful . . . [and] prefer to read the follow settlements clause, see what it says, and apply what it says to the special facts of the case.

Hill, [1996] L.R.L.R. 350.

²² “All loss settlements by the reinsured shall be binding upon reinsurers provided that such settlements are within the terms and conditions of the original policies and within the terms and conditions of this policy”

²³ [1996] L.R.L.R. 341.

²⁴ *Id.* at 351.

²⁵ *Id.*

²⁶ *But see* *Brown v. GIO Ins., Ltd.* [1998] Lloyd’s Rep. I.R. 201. Specific wording may entitle the reinsured to do just that.

straightforward since, fundamentally, the distinction between facts and their legal implications may be difficult if not impossible to draw. Further, it is worth emphasizing again that each clause needs to be considered individually. For example, many wordings, particularly the more recent ones, expressly provide that reinsurers are bound by the reinsured's settlements including settlements of coverage issues. Where such wording appears, the distinction between facts and their legal implications, at least in relation to the risks underlying the reinsurance in question, may be largely irrelevant.

In those circumstances the key questions, again, relate to the manner in which and basis upon which the reinsured reached the underlying settlement. This assumes that no claims co-operation or control clause appears that might affect matters. This will be discussed subsequently.

4. Burden of Proof

In this regard, the sole requirement is for the reinsured to have acted in a bona fide and businesslike fashion. It was held in *Charman v. Guardian Royal Exchange Assurance Plc*²⁷ that the burden of proof is borne by the reinsurer to demonstrate that the reinsured has not acted in a bona fide and businesslike fashion. The reinsurer is entitled, however, to receive information from the reinsured as to how the settlement was reached and, if appropriate, may use that information to argue that a settlement was not concluded in a bona fide and businesslike manner.

Justice Webster, in *Charman*, set out some useful guidelines regarding the requirements of bona fide and businesslike behavior. In this case Lloyd's underwriters, as reinsureds, appointed a loss adjuster to investigate the insured's loss and then settled the loss for the sum recommended in the adjuster's report. Justice Webster determined that in order to satisfy the *Scor* test, underwriters were obliged, as was the case on the facts before him:

1. when appointing a loss adjuster to act in a businesslike fashion in making the appointment, making sure that the adjuster is regarded as reasonably competent; and
2. before accepting the adjusters report, to ensure that it has been made in a businesslike fashion; and
3. having received the report, to negotiate with the insured in a businesslike fashion in the light of the report.

Once the factual basis of the reinsured's liability has been ascertained, it remains to consider whether the reinsured had any defense to the insured's claim. If the reinsured had

²⁷ [1992] 2 Lloyd's Rep. 607.

an arguable defense that has not been taken, it is possible that the reinsured cannot be said to have acted in a bona fide and businesslike fashion vis-à-vis the reinsurer in settling the claim.

Each case needs to be examined in the light of its specific facts and legal considerations, for it may be that the defense is weak or that the factual basis for it cannot be made out. Provided that the reinsured has considered the prospects of success of the defense, it is likely to be difficult for the reinsurer to prove that the reinsured's conduct is not bona fide and businesslike. However, it should be emphasized that the phrase "bona fide and businesslike" does not refer to the reinsured's general commercial interests, which may indicate a need to settle in disregard of any possible defenses.

III. CLAIMS CO-OPERATION ISSUES

A. *Significance of Claims Co-operation Issues*

My earlier caveat regarding the presence of claims co-operation/control clauses is an important one. As the Court of Appeal's recent decision in *Gan Insurance Co. v. Tai Ping Insurance Co.*,²⁸ has emphasized, the question of whether a reinsured can bind its reinsurer to follow its settlements can be fundamentally affected by the presence of provisions that require the reinsured to involve the reinsurer in the claims settlement process.

Again, the implications of a given clause will depend upon its specific wording. However, the effect of such provisions, or rather of a failure to comply with them, can be dramatic. That is because they can have the effect of either emasculating any "follow the settlements" provision²⁹ or, worse, as in *Gan*, precluding the reinsured from effecting any recovery at all when, properly construed, compliance with the relevant requirements is a condition precedent to the reinsured's right of recovery.³⁰

B. *Gan v. Tai Ping*

The insurer, Tai Ping placed a facultative slip policy with Gan as one of its reinsurers in respect of its participation in an Erection All Risks insurance policy relating to the production and installation of machinery at a Taiwanese factory. Following a fire at the factory, Tai Ping settled its share of liability under the original policy. Gan resisted Tai Ping's claim for

²⁸ [2001] Lloyd's Rep. I.R. 667

²⁹ See Scor [1985] 1 Lloyd's Rep. 312.

³⁰ Such provisions are unlikely to appear in treaty reinsurances, but are more common in facultative risks.

payment under the reinsurance, alleging that in compromising its insureds claim, Tai Ping had breached the terms of the “Scor form” of claims co-operation clause (“CCC”) contained in the reinsurance policy. This provided as follows:

Notwithstanding anything contained in the reinsurance agreement and/or policy wording to the contrary, it is a condition precedent to any liability under this policy that:

- (a) the reinsured shall, upon any knowledge of any circumstances which may give rise to a claim against them, advise the reinsurers immediately, and in any event, not later than 30 days.
- (b) The reinsured shall co-operate with the reinsurers and/or their appointed representatives subscribing to this policy in the investigation and assessment of any loss and/or circumstances giving rise to a loss.
- (c) No settlement and/or compromise shall be made and liability admitted without the prior approval of the reinsurers.³¹

The Court of Appeal affirmed the Commercial Court’s decision that compliance with the terms of the CCC was a condition precedent to Gan’s liability, as the CCC expressly stated this to be the case. The court also held that non-compliance meant the reinsured could not recover, even if it could prove that it was liable to the insured.³² This aspect of the judgment has harsh consequences for cedants in breach of their obligations under similarly worded CCCs.

The court also determined there was a breach of sub-paragraph (c) of the CCC if the reinsured either settled *or* admitted liability without the prior approval of the reinsurer. This reversed the Commercial Court’s interpretation that there must be both settlement and an admission of liability for there to be a breach of the CCC. The Court of Appeal said this interpretation was improbable and lacking in business sense.

1. The key issue - withholding approval

The issue of greatest consequence in the case was whether there were to be implied into the slip policy terms that the reinsurer could not withhold approval of a settlement unless there were reasonable grounds for withholding approval. The Commercial Court had ruled that this term should be implied into the CCC on “business efficacy” grounds.

³¹ [2001] Lloyd’s Rep. I.R. 671

³² *Scor* was distinguished in this respect.

The Court of Appeal rejected this reasoning but emphasized that the right of reinsurers to withhold approval of a settlement was not unqualified. Rather, reinsurers must act in good faith after considering the facts giving rise to the particular claim and not act “arbitrarily” or withhold their consent to a settlement for “extraneous reasons.”

2. Relevance to the Enron Situation

The relevance of this in the context of Enron will be obvious. Under contracts governed by English law, insureds/reinsureds cannot simply take account of “follow the settlements” provisions. Careful consideration of all of the provisions of any given contract is essential. When these include provisions dealing with the reporting/control of claims and settlements, insureds/reinsureds should tread with care.

IV. AGGREGATION ISSUES

If it is certain that coverage and allocation issues will arise at the direct level, it is equally certain that there will be scope for healthy debate at the reinsurance level regarding the extent to which losses relating to the collapse of Enron can be aggregated.³³

A. *Aggregation Generally*

Loosely defined, aggregation is concerned with regulating the way in which the (re)insured can treat several losses as a single claim for the purposes of its (re)insurance recoveries. Therefore, depending on the terms of the aggregation clause, a (re)insured can take a number of unrelated losses, or losses only related by an agreed connecting factor, and treat them as a single loss for the purposes of making a claim. The way in which losses can be aggregated is entirely a matter of negotiation between the parties. Consequently the starting point must always be the terms of the contract where the intentions of the parties are recorded.

B. *Forms of Wording*

While there are as many ways to aggregate claims as there are ways of drafting a contract, the London Market has tended to use similar terms in many of its wordings and certain phrases have now come up for judicial consideration on a number of occasions. Those most likely to be relevant in the context of Enron are provisions based on the notions of a potentially unifying, or aggregating:

³³ Aggregation issues are also likely to arise at direct level, for example where policies include wording limiting recoveries in respect of losses arising from a given “occurrence” or “originating cause.” *See, e.g.*, *Kuwait Airways Corp. v. Kuwait Ins. Co.* [1996] Lloyd’s Rep. 664; *Cox v. Bankside Members Agency, Ltd.* [1995] 2 Lloyd’s Rep. 437.

1. event;
2. occurrence; and
3. cause.

C. “Event” Based Wordings

In recent years, a substantial body of English case law has developed concerning the interpretation of “event” and “occurrence” based wordings. Further, many of the cases have focused on the liability sphere in which the application of the concepts of “event” and “occurrence” is less clear than it might be, for example, in the context of losses caused by natural catastrophes.

“Event” based language has historically formed the basis of aggregation clauses in the London Market Excess of Loss wordings. Here, it is common to see a clause that provides cover within limits for “each and every loss” suffered by the insured. “Each and every loss” is then typically defined as: “Each and every loss and/or occurrence and/or catastrophe and/or disaster and/or calamity and/or series of losses and/or occurrences and/or catastrophes and/or disasters and/or calamities arising out of one event.”³⁴

The first significant case on the meaning of “one event” was *Caudle v Sharp*³⁵ in which it was held by the Court of Appeal that the key phrase “arising out of one event” had three elements to it which needed to be satisfied before losses could be aggregated.

1. There needs to be a linking factor between the losses that can properly be described as an event.

In *Axa Reinsurance (UK) plc v. Field*,³⁶ the House of Lords clarified this by stating that “in ordinary speech, an event was something which happened at a particular time, at a particular place, in a particular way . . .”³⁷ In *Caudle*, it was argued that an underwriter’s “blind spot” as to the potentially disastrous nature of a certain type of risk, qualified as an event which was common to thirty-two separate contracts of that type which he negligently underwrote. However, the court held that this “blind spot” merely amounted to a state of affairs and could not qualify as an event.

³⁴ See *supra* note 31. In this particular clause, a distinction seems to be drawn between an “occurrence” and an “event,” with “event” bearing a wider meaning.

³⁵ [1995] L.R.L.R. 433 (CA).

³⁶ [1996] 2 Lloyd’s Rep. 233.

³⁷ *Id.* at 239.

More recently, in *Scott v. Copenhagen Reinsurance*,³⁸ Justice Langley, considering the extent to which certain losses arising out of the Iraqi invasion of Kuwait in August 1990 were capable of being aggregated, emphasized³⁹ that the term “event” connotes (and demands) unity of:

- (a) cause,
- (b) locality,
- (c) time; and
- (d) (where relevant) the intentions of the human agents involved.

2. The losses to be aggregated must “arise out of” the event. In other words, the event that links the various losses must cause the losses.

In *American Centennial Insurance Co. v INSCO Ltd.*,⁴⁰ fourteen directors were implicated in the collapse of a savings and loan association. The E&O insurers tried to aggregate the fourteen separate claims that they had paid on the grounds that the collapse of the association was one event. The court agreed that the collapse of the association could be an event but held that it did not cause the losses. Even if the association had not collapsed, the directors would still have been liable for negligence.

3. The losses must not be too remote from the event out of which they arise. In *Caudle v. Sharp*⁴¹ the court held that even if the underwriter’s blind spot could be counted as an event, which it could not, the reinsured’s claim to aggregate still failed as the subsequent contracts were too remote to be regarded as “arising out of” the event. There were simply too many intervening factors between having a blind spot for a certain type of risk and actually writing each contract.

D. “Occurrence” Based Wordings

Like “event,” “occurrence” is a wider basis for aggregating claims than, for example, “accident” based wordings and involves looking at matters from the perspective of the assured’s conduct or the incident in issue. The leading case here has, until recently, been the Court of Appeal decision in *Kuwait Airways Corp. v. Kuwait Insurance Co.*⁴²

³⁸ Commercial Court, July 2002 (currently unreported).

³⁹ As had Rix, J. in *Kuwait Airways Corp. v. Kuwait Ins. Co.* [1996] Lloyd’s Rep. 664, in the context of “occurrences.”

⁴⁰ [1996] L.R.L.R. 407 (QB Comm. Ct.).

⁴¹ [1995] L.R.L.R. 433 (CA).

⁴² [1996] 1 Lloyd’s Rep. 664.

This case arose out of the capture of Kuwait airport and seizure of fifteen aircraft owned by Kuwait Airways that were on the airfield following the Iraqi invasion of the country. Although Iraq was subsequently forced to withdraw from Kuwait, the aircraft had already been flown out of the country into Iraqi territory. Consequently, Kuwait Airways put in a claim for the loss of its fleet. The airline's insurance provided an aggregate limit for recovery of \$300 million for all ground losses "arising out of the same occurrence." The issue was whether the loss of each aircraft was an occurrence or whether the occurrence was earlier than that. On the facts, the court held that the occurrence was the seizure of the airport and the loss of each aircraft arose out of that.

The case law on "occurrence" was supplemented by the decision in *Mann v. Lexington Insurance Co.*⁴³ In that case, a number of shops owned by the same company were damaged in the Indonesian riots of May 1998. The shops were located over a wide area and the damage occurred over a two-day period of rioting. The relevant clause provided a limit of \$5 million "per occurrence," and retrocessionaires argued that the relevant occurrence for this purpose was the coordinated provocation and orchestration of the rioting by the Indonesian government to achieve its own purposes. On a preliminary issue, the Court of Appeal held that even if the government orchestrated the riots, and it expressly declined to decide this issue, it would still be incorrect to aggregate the losses on this basis. The court stressed that the term "occurrence" requires a unity of time and location that was not found in the Indonesian riots. The riots all took place in different places and over a two-day period. Consequently, the retrocessionaires had to treat the loss of each shop as a separate occurrence and as a separate claim.

More recently still, Justice Langley in *Scott v. Copenhagen Reinsurance*,⁴⁴ referring to *Kuwait Airways* commented that: "In [*Kuwait Airways*], Rix J addressed the effect of the provision that the ground limit of loss was (as he held) subject to the qualification 'any one occurrence'... He said that 'occurrence' and 'event' may well be synonyms. I agree and think they usually are so."

Bearing these comments in mind, and taking account of the similar views expressed in *Mann v. Lexington Insurance*, it appears now that in the absence of any indication to the contrary, the English courts will treat the concepts of "event" and "occurrence" as being identical.

E. "Cause" Based Wordings

"Cause" based aggregation is more common in United States wordings, but is found in direct insurance policies in England. This was considered by the English courts in *Cox v.*

⁴³ [2001] 1 Lloyd's Rep 1.

⁴⁴ Commercial Court, July 2002 [2002] EWHC 1348.

*Bankside Members Agency Ltd*⁴⁵ in which the relevant clause provided that the claimant could aggregate claims that arose from the same “originating cause.”

It is clear, from *Cox v. Bankside* and from the related case of *Axa v. Field*, that the term “cause” has a much wider meaning than the previous terms discussed. In particular, a cause does not require an incident that takes place in a particular location at a particular time but rather can include a continuing state of affairs or the absence of something happening.

F. *Application in the context of Enron*

There are many ways in which claims can be aggregated. The discussion above shows some of the possibilities as the English courts have considered them.

1. The Collapse of Enron as an “Event,” “Occurrence” or “Cause”

It is impossible at this stage to offer any particular views as to how particular wordings might operate in the context of the Enron claims. However, given the general requirement that the “event,” “occurrence” or “cause” be causative in some sense of the losses sought to be aggregated, it is most unlikely that as a matter of English law the collapse of Enron would be capable of forming the basis of an aggregate presentation of “liability” based losses/claims.⁴⁶ This is so under any of the wordings discussed above.⁴⁷

Without pre-empting any issues that might arise at direct level, it will usually be the case with liability claims that the collapse, whether that be of a building, a company or a S&L, will arise out of or be “caused” by the individual acts or omissions complained of. In other words, “events” of this nature are consequences rather than causes of the losses sought to be aggregated. As such, they are unlikely to be capable of amounting to “events” for reinsurance purposes under standard wordings.

2. Other possibilities

Since the collapse of Enron is unlikely to constitute a relevant “event” or “occurrence,” the questions of aggregation at the reinsurance level are likely to focus, instead, on more specific circumstances. These will pre-date the dates on which relevant causes of action accrued and which are potentially common to a more limited range of claims/losses.

It is impossible to speculate as to what these might be at present other than to say that, in this context, in addition to the question of causation, the application of the four “unities” is likely to be of particular significance. The question of “unity of intention of human

⁴⁵ [1995] 2 Lloyd’s Rep. 437.

⁴⁶ The position in relation to, for example, claims arising under credit business may be less clear cut and, again, will depend on the construction of specific policy wordings.

⁴⁷ This would be consistent with general principle and with the decision of *Am. Centennial Ins. Co. v. Inco Ltd.* [1996] L.R.L.R. 407 (Q.B. Comm. Ct.), in which an argument that the collapse of the S&L in question was an “event” for reinsurance purposes was rejected.

agents” almost certainly will give rise to real complexities given the range of individuals and organizations and, hence, the range of possible motivations/intentions potentially involved.

These general comments aside, the diversity of the claims likely to be made and of the coverages potentially exposed render any attempt to offer more specific views on questions of aggregation fruitless at this point.

V. CONCLUSION

That the Enron affair will give rise to significant issues for reinsurers across a range of markets is certain. At this early stage, it is impossible to offer even preliminary views as to the manner in which those issues, many of which are likely to be contract-specific,⁴⁸ might be resolved.

In addressing them, however, reinsurers will no doubt bear in mind that the approach adopted in relation to Enron may well have broader significance. Leaving aside the Surety Bond Issues, it may serve, or be viewed, as a precedent for the manner in which similar issues arising out of the WorldCom debacle, and quite possibly the problems at Xerox and Global Crossing, might be resolved.

⁴⁸ Concerning, for example, the application of specific provisions/exclusions contained within particular contracts.

Standard Form 1005

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Publication of Indiana & Corporate Law		1 2 3 4 5 6 7 8 9 10 11 12		November 10, 2022	
Number of Copies (Net press run)		Number of Copies (Gross press run)		Number of Copies (Net press run)	
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1. Publication Title: Publication of Indiana & Corporate Law

2. Issue Date: 1 2 3 4 5 6 7 8 9 10 11 12

3. Filing Date: November 10, 2022

4. Number of Copies (Net press run): 1000000

5. Number of Copies (Gross press run): 1000000

6. Number of Copies (Net press run): 1000000

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3. Intangible Assets	3.1. Goodwill	1,000	1,000
	3.2. Patents	0	0
	3.3. Software	0	0
	3.4. Other intangible assets	0	0
	3.5. Other intangible assets	0	0
4. Financial Assets		1,000	1,000
4.1. Financial Assets	4.1.1. Cash and cash equivalents	0	0
	4.1.2. Other financial assets	0	0
5. Financial Liabilities		0	0
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3. Do not use "and/or" in any of the responses. Use "or" if you are unsure which to choose. Do not use "or both".
4. Item 10. Complete the statement only if you are a publisher of a newspaper, magazine, journal, or other publication that is published at least once a week. Do not use "and/or" in any of the responses. Do not use "etc." unless it is necessary to indicate that there are other items that are not listed.
5. Item 11. Complete the statement only if you are a publisher of a newspaper, magazine, journal, or other publication that is published at least once a week. Do not use "and/or" in any of the responses. Do not use "etc." unless it is necessary to indicate that there are other items that are not listed.
6. Item 12. Complete the statement only if you are a publisher of a newspaper, magazine, journal, or other publication that is published at least once a week. Do not use "and/or" in any of the responses. Do not use "etc." unless it is necessary to indicate that there are other items that are not listed.
7. Item 13. Complete the statement only if you are a publisher of a newspaper, magazine, journal, or other publication that is published at least once a week. Do not use "and/or" in any of the responses. Do not use "etc." unless it is necessary to indicate that there are other items that are not listed.
8. Item 14. Complete the statement only if you are a publisher of a newspaper, magazine, journal, or other publication that is published at least once a week. Do not use "and/or" in any of the responses. Do not use "etc." unless it is necessary to indicate that there are other items that are not listed.

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The FEDERATION OF DEFENSE & CORPORATE COUNSEL QUARTERLY, published quarterly through the office of publication by the Federation of Defense & Corporate Counsel, Inc., 11812-A North 56th Street, Tampa, FL 33617.

All inquiries as to subscriptions or back issues should be addressed to the Executive Director - FDCC, 11812-A North 56th Street, Tampa, FL 33617.

Subscription Rates: Non members \$60.00 per year or \$15.00 per copy. University Law Libraries \$34.00 per year or \$8.50 per single issue.

Entered as Periodicals matter at Springfield, Illinois and additional mailing offices.

Manuscripts and correspondence relating to the submission of articles for possible publication should be sent to the Editor, Professor John J. Kircher, Marquette University Law School, 1103 West Wisconsin Avenue, P.O. Box 1881, Milwaukee, WI 53201-1881. All other correspondence should be directed to the Executive Director.

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