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PROTECTION FROM FINANCIAL MELTDOWN THROUGH EXCESS SIPC COVERAGE – REAL PROTECTION OR MARKETING GIMMICK?

By: Nicholas N. Nierengarten, Gray Plant Mooty[1]

The financial crisis of the past two years is a vivid reminder that sometimes remote but catastrophic risks can and do materialize ("Black Swan" events in the current parlance). Large, and presumably stable, financial institutions were on the brink of collapse and some did collapse. The midnight rescue of Bear Stearns, the Lehman Brothers bankruptcy, the Bernie Madoff Ponzi scheme, the near collapse of Merrill Lynch (averted through the shotgun wedding with Bank of America) and other unexpected events, have all contributed to renewed focus on risk reduction and mitigation, including risk transference through insurance.

In addition to various recently created federal programs and backstops, there are existing programs which grew out of financial crises of the past. Most of people are familiar with the Federal Deposit Insurance Corporation ("FDIC") and the protection it affords for funds held on deposit at a bank. When many broker-dealers failed in the late 1960s, the government established an investor protection program by way of the Securities Investors Protection Act ("SIPA") and the Securities Investor Protection Corporation ("SIPC").[2] Not unlike its reaction to the recent financial crisis, in enacting SIPA, Congress "sought to restore investor confidence in the securities markets and avoid a domino effect involving solvent brokers that had substantial open transactions with firms that failed."[3] The familiar SIPC logo ("Member SIPC") on

Continued on page 20

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[2] Securities Investor Protection Act of 1970, as amended, 15 U.S.C. § 78aaa-lll.

[3] *In re Adler Coleman Clearing Corp.*, 195 B.R. 266, 269 (Bankr. S.D.N.Y. 1996) (citing *SIPC v. Barbour,* 421 U.S. 412, 415, 95 S.Ct. 1733, 1736, 44 L.Ed.2d 263 (1975)).

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Continued from page 2

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MESSAGE FROM THE CHAIR

It's an exciting time for insurance coverage law, and the Insurance Coverage Litigation ("ICLC") committee is trying to match that excitement.

I've been practicing in this field for about twenty-five years, and I'm not sure that I remember a time where so many insurance-related issues were emerging at once: financial scandals, technology challenges, natural disasters, and climate change. All four issues are upon us and all involve insurance implications. Moreover, many of the issues that were supposed to have matured and passed on, continue to kick with us. When I first started practicing I was advised by a wise old partner that asbestos was "over." He was wrong. Many had predicted an end to environmental coverage litigation in the 90s. Wrong again. Insurance coverage remains one of the busiest fields in the law.

ICLC would like to be one of the busiest committees in the ABA. We're planning CLEs, newsletters, and survey contributions. We're also trying to develop new functions such as podcasts, regional meetings, a community service program, and even a golf outing. We hope to soon finish the new edition of our book on the CGL policy.

As the saying goes, all we need is you. We have opportunities for everyone: speakers, writers, meeting goers, and telecommuters. Whatever your needs and preferences, we're committed to finding a spot for you.

Feel free to contact me with your interests, suggestions, and most of all, proposed contributions. Workers are always welcomed!

I look forward to seeing you at our midwinter program in Phoenix, February 25 through 28.

Alan Rutkin

BACKSEAT DRIVERS: HOW REINSURANCE CONCERNS CAN STEER INSURER ACTIONS IN HANDLING COVERAGE CLAIMS.

By: Harold J. Moskowitz, Esq. and James T. H. Deaver, Esq.[1]

Companies have long known that not everyone who can affect the outcome of a dispute or deal is necessarily at the negotiating table. Thus, success in business can sometimes depend upon understanding not only the direct interests of those seated across the table, but upon an understanding and appealing to the interests, be they direct or indirect, of those parties who are not actually present.

This is particularly true when large corporations, with insurance programs involving multiple insurers over substantial periods of time, have reason to present very large coverage claims to their insurers. The sophisticated corporate risk manager who must shepherd such a major claim through the process until resolution knows that his audience consists of more than the insurance companies that sold him the relevant policies, it also includes all of the companies that reinsured those policies.

Just about all large corporations and their coverage counsel are aware that the insurance companies that sold them liability policies routinely buy reinsurance to limit their own risk. As one court explained,

> Under a reinsurance contract, the "reinsured" party is the original insuring entity. The reinsured transfers, or cedes, part or all of its risk under the insurance policy to another entity, the "reinsurer." When entering into a reinsurance contract, a reinsured agrees to pay a particular premium to a reinsurer in return for the reinsurer assuming the risk of a portion of the reinsured's potential financial exposure under certain direct insurance policies it has issued to its insured. This type of contract allows a reinsured to spread its risk of loss from its insurance policies among other insurers.

Suter v. General Accident Ins. Co. of America, 2004 U.S. Dist. LEXIS 29535, at *2-*3 (D.N.J. 2004)(internal citation and quotation marks omitted). Insurers who buy reinsurance are often known as "ceding companies."

Since large companies often buy individual policies with limits in the tens of millions of dollars, the original insurance companies, in turn, may end up buying reinsurance from several different reinsurers for just one policy. These reinsurers may, in turn, choose to buy some reinsurance for themselves, a practice known as "retroceding." The reinsurers of reinsurers are generally known as "retrocessionaires." As a result, the overall audience scrutinizing a risk manager's presentation of a major insurance claim can be surprisingly large and diverse when all the reinsurers and retrocessionaires are accounted for.

But what does this all mean to the original corporate insured? After all, the insured only has contractual relationships with its actual insurers. Further, one noted pair of commentators has stated that "a ceding insurer is obligated to make coverage determinations without regard to whether or not a given risk is reinsured." *Ostrager and Newman*, Handbook on Insurance Coverage Disputes, 14th Ed., §15.04 [a], citing *Mentor Ins. Co. (U.K) v. Norges Brannkasse,* 996 F.2d 506, 516-518 (2d Cir. 1993); *Brown v. United States Fidel. & Guar. Co.,* 314 F.2d 675, 678 (2d Cir. 1963). Despite these limitations, reinsurers can have substantial influence on how a major insurance claim is assessed and treated by a corporation's insurers. Thus, it behooves corporations, their risk managers, and their counsel to understand the means by which that influence is exercised.

One route for a reinsurer to be involved in a major insurance claim against a ceding company is through

Continued on page 15

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The authors wish to express their thanks to their associate, Abigail Nitka, Esq., who greatly assisted with the legal research underlying this article.

RECENT CASE LAW COMMENTS ON FACTORS FOR RESCISSION

By: Melinda B. Margolies and Thomas Lookstein[1]

While the law concerning rescission varies across the United States, a central ground for rescission is misrepresentation of material facts in the application process.[2] Two recent rulings discussed below illustrate the myriad factors courts analyze and weigh in rescission cases. In *Platte River Ins. Co. v. Baptist Health*,[3] a Directors and Officers ("D&O") policy was rescinded where the insured failed to disclose its knowledge about a potential claims increase, despite the insured's argument that the underwriter could have independently investigated the risk based on the submitted materials. In *JP Morgan Chase & Co. v. AIU Ins. Co.*,[4] the Court weighed a number of factors in finding for the insured against rescission including: (1) the insurer's acceptance of an informal set of materials in place of an application; (2) the insured's failure to warrant the accuracy of such information; (3) the limited evidence of specific reliance on public disclosures in the coverage binding determination; and (4) the timing of the rescission and retention of the policy premium as proof of waiver. *Platte River* and *J.P. Morgan Chase* are useful case studies on the type and weight of evidence scrutinized by courts in rescission actions.

Platte River Ins. Co. v. Baptist Health

Platte River illustrates a court's evaluation of an insured's failure to disclose potential claim risks. Baptist Health, a non-profit corporation operating hospitals in Arkansas, adopted an Economic Conflicts of Interest Policy in May of 2003, which provided that "no physician who directly or indirectly acquires or holds an ownership or investment interest in a competing hospital shall be eligible to apply for initial or renewed appointment of clinical privileges in the professional staff of any Baptist Health hospital" (the "ECOI Policy").[5] Baptist Health applied to Darwin Professional Underwriters ("Darwin") for D&O coverage in 2003, submitting both a D&O renewal application from its prior insurer, Executive Risk Indemnity, Inc. (the "ERII Application"), and a copy of its new ECOI Policy. On July 28, 2003, Baptist Health's CEO Russell Harrington signed the ERII Application containing the following question and answer:

> No Entity nor any individual proposed for coverage is aware of any fact, circumstance, situation, transaction, event, act, error, or omission which they knew or should reasonably have known may result in a claim that may fall within the scope of the proposed insurance, except as follows. If answer is "None," so state: None.[6]

Platte River bound coverage for Baptist Health, subject to receipt of additional documents and a completed Darwin application (the "Darwin Application"), signed by Senior V.P. Allen Smith on December 31, 2003. The Darwin Application stated:

> Does anyone for whom insurance is intended have any knowledge or information of any act, error, omission, fact or circumstance which may give rise to a Claim which may fall within the scope of the proposed insurance? Yes __ No X.

The Darwin Application further provided that all of the statements in the application, "**ARE MATERIAL TO THE ACCEPTANCE OF RISK, AND RELIED UPON BY THE UNDERWRITER.**"[8] Platte River issued Baptist Health a claims made D&O Policy for the Policy Period of December 16, 2003 through December 16, 2004, which was extended to December 16, 2005 (the "Platte River Policy").

Baptist Health applied for coverage disclosing only the existence of the new ECOI Policy and twice denying knowledge of any circumstances that might give rise to future Claims. What Baptist Health failed to disclose to Platte River were a number of incidents surrounding the adoption of the new ECOI Policy, which the Court found very significant in its rescission analysis. Prior to signing the July 2008 ERII

Continued on page 10

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[2] Barry R. Ostrager and Thomas R. Newman, *Handbook on Insurance Coverage Disputes* § 2.07 at 98 (13th Ed. 2006).

[3] No. 07-0036, 2009 WL 2015102 (E.D. Ark. April 17, 2009), *modified*, April 20, 2009.

[4] Index No. 601904/06 (Sup. Ct. N.Y. Co., dated March 3, 2009 and filed March 25, 2009).

[5] *Baptist Health*, 2009 WL at 1.

[6] *Id*. at 7.

[7] *Id*. at 8.

[8] *Id*.

THE APPLICATION OF THE POLLUTION EXCLUSION TO METHAMPHETAMINE LABS: AN UNCHARTED COURSE

By Christina L. Dixon[1]

I. Introduction

It is not rare to see or hear news about methamphetamine labs ("meth labs") discovered in unlikely places. This past winter, a story broke online about the rise of methamphetamine "cooks" secretly converting hotel and motel rooms into covert drug labs.[2] The online article described the remnants of such operations left over after checkout, stating "contaminates can lurk on countertops, carpets, bathtubs…"[3] Clearly, in the wake of such operations, the premises may need a deep cleansing, if not a complete remodeling. Hotel owners and landlords, not wanting to bear this expensive burden left by criminals, have begun to look to their insurers to foot the bill.

The portable meth lab problem not only affects first party insurance policies, as common sense would lead you to believe. Rather, the contaminants often go unnoticed by housekeeping, and the hotel room or apartment is leased to another person who then gets sick. Further, the particles and debris from the meth lab can migrate to the apartment next door, and the tenant could then sue for damage to property and loss of use of the apartment. These scenarios inexorably lead to the questions of whom, and under what authority, and under what circumstances, should pay for the damages.

There are few decisions regarding insurance coverage for claims related to meth labs and those decisions concern first-party disputes. Although helpful for a discussion regarding the potential classification of the left-overs of a meth lab as "pollutants" or "contaminants," these decisions do not translate perfectly from the first-party to the third-party context.

This article reviews current first-party case law relating to claims resulting from clandestine meth labs and examines the different applications of the CGL policy's pollution exclusion to non-traditional environmental claims to see how courts might handle a third-party claim resulting from a meth lab.

II. First-Party Insurance Decisions Concerning Meth Labs

Two reported decisions concerning insurance coverage for damages caused by methamphetamine labs demonstrate that meth lab "left-overs" can qualify as contaminants or pollutants in insurance parlance. In *Graff v. Allstate Ins. Co.*,113 Wash. App. 799, 54 P.3d 1266 (2002), the policyholder was a landlord of a residential rental property, who made a claim under his fire insurance policy after it was discovered that a tenant was operating a clandestine methamphetamine lab out of the rental property. Following the removal of the meth lab, the landlord was unable to rent out the property because it was determined unsanitary and rendered derelict by Tacoma, Washington authorities. The landlord made a claim under the policy for property damage and the insurer denied the claim.[4]

The policy, in *Graff* covered "all risks of physical loss" to the insured rental property, but contained the following exclusion:

> Wear and tear; marring; scratching; deterioration; inherent vice; latent defect; mechanical breakdown; rust; mold; wet or dry rot; *contamination,* smog; smoke from agricultural smudging or industrial operations; settling, cracking, shrinking, bulging, or expansion of pavements, patios, foundations, walls, floors, roofs, or ceilings; birds, vermin, rodents, insects or domestic animals.... (Emphasis added).

The Court implicitly concluded that the meth lab leftovers constituted contamination, triggering the exclusion.

The policy also contained a separate grant of general coverage for "vandalism and '"malicious mischief."

The Washington Court of Appeals concluded that, the tenant's operation of a clandestine meth lab fell within the meaning of the vandalism clause of the policy, triggering coverage. However, the Court, employed the efficient proximate cause doctrine and

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Special appreciation is expressed to Denver attorney Adam B. Kehrli for assistance with this article.

[2] *Meth Makers Leave Behind a Toxic Trail at Motels*, Bill Poovey (Associated Press), February 23, 2009.

[3] *Id.*

[4] *Graff v. Allstate Ins. Co.*, 113 Wash. App. 799, 54 P.3d 1266 (2002).

refused to preclude coverage under the exclusion cited above, reasoning that:

> Graff's tenant acted in conscious or intentional disregard for Graff's property rights. Further, contrary to Allstate's claim, it can be said that vandalism, a covered peril, preceded the contamination, an excluded peril. First, Graff's tenant exposed the premises to hazardous chemicals-by cooking or by mixing-and second, there was the resulting contamination.[5]

The insured, notwithstanding the finding of a contamination under the exclusion, was nevertheless entitled to coverage because of the vandalism, including the costs associated with cleaning up the rental property and attorneys fees.

In the second reported decision, *Fleming v. USAA,* 144 Or. App. 1, 925 P.2d 140 (1996), *reversed*, *Fleming v. USAA*, 329 Or. 449, 988 P.2d 378 (1999), the court initially came out the other way. The Oregon Court of Appeals upheld the insurer's application of pollution exclusion to bar coverage under the dwelling policy. The insured owned a residential rental property and the tenant's illegal meth lab resulted in lead and mercury contamination of the property.

The Oregon Court of Appeals opinion addresses the key coverage issue related to methamphetamine labs – whether there is dispersal or discharge of a contaminant or pollutant. With little analysis, the Court determined that the operation of a meth lab resulted in the discharge or dispersal of lead and mercury and applied the pollution exclusion to preclude coverage for chemical damage to the rental unit. However, without disturbing the finding of a dispersal or discharge, the Oregon Supreme Court reversed, finding that the location of the exclusion in the policy violated an Oregon statute.[6]

III. Examination of Coverage Issues in the Context of a Standard Comprehensive General Liability Policy

Whether a third-party claim for damages arising from a meth lab is covered by a CGL policy depends largely on whether (1) an "occurrence" as defined in the policy?; (2) the term pollutant is ambiguous as applied to the chemicals of a meth lab; and (3) assuming no ambiguity, whether there was a "discharge, dispersal, release or escape" of the "pollutants." And, even if the answer to all these questions are affirmative, are the reasonable expectations of the insured frustrated by the application of the pollution exclusion to non-traditional environmental claims? The search for answers should start with a review of the applicable jurisdiction's reported decisions interpreting the pollution exclusion connection with non-traditional environmental claims. As the sampling of decisions below demonstrates, courts come down on both sides of the issue and reach their conclusions in different ways.

A. Was There "Bodily Injury" or "Property Damage" Caused by an "Occurrence"?

Often courts refuse to apply pollution exclusions for injuries caused by a contaminant or irritant arising from its intended use.[7] For example, in *Calvert Ins. Co. v. S&L Realty Corp.*, the insurer denied coverage for plaintiff's claims under an absolute pollution exclusion where it's insured, a building owner, was sued for damages resulting from the plaintiff's exposure to fumes from cement used to install a floor. In that case, the work area was not properly vented during the installation, causing the plaintiff to become sick from the inhalation of fumes.[8] The court determined that the question of how the injury occurred, and whether the acts causing the injury were intentional, reckless, or negligent were relevant. The court looked to those courts interpreting the exclusion to apply only to instances of environmental pollution for support and determined that the insurer could only escape its obligation to defend if it could show no reasonable probability that the insured may be held liable for some act or omission covered by the policy.[9]

B. Is the Term Pollutant Ambiguos?

One way to argue the pollution exclusion is ambiguous as it relates to nontraditional environmental claims is to argue that the term "pollutant" is ambiguous. For instance, in *Donaldson v. Urban Land Interest, Inc.*, 564 N.W.2d 728 (Wis. 1997), the Wisconsin Supreme Court determined that the term "pollutant" was ambiguous when applied to bodily injury resulting from breathing high levels of carbon dioxide due to an inadequate air exchange ventilation system.[10] The Indiana Appeals Court followed this approach in *Freidline v. Shelby Ins. Co.*, 739 N.E.2d 178 (Ind. App. 2000) and found ambiguous a pollution

5 *Id.* at 806, 54 P.3d 1266, 1269 (2002).

6 *Fleming v. USAA*, 144 Or. App. 1, 925 P.2d 140 (1996), *reversed*, *Fleming v. USAA*, 329 Or. 449, 988 P.2d 378 (1999) (Oregon statute requires insurer to provide conspicuous explanation of policy provisions limiting or excluding coverage).

7 See, *Meridian Mut. Ins. Co. v. Kellman*, 197 F.3d 1178, 1185 (6th Cir. 1999); *Island Assocs. V. Eric Group, Inc.*, 894 F. Supp. 200 (W.D. Penn. 1995).

8 *Calvert Ins. Co. v. S&L Realty Corp.*, 926 F. Supp. 44, 45 (S.D.N.Y. 1996).

9 *Id.* at 47.

10 *Donaldson v. Urban Land Interests, Inc.*, 564 N.W.2d 728 (Wis. 1997).

exclusion in connection with injuries caused by fumes from substances used during carpet installation in office building. The court relied upon an Indiana Supreme Court decision in which an identical pollution exclusion was declared ambiguous where contamination occurred from gasoline emitted from a gas station.

In other jurisdictions, courts have determined the term "pollutant" is unambiguous and applicable beyond environmental pollution claims.[11]

For example, the court in *Park-Ohio Indus., Inc. v. Home Indem. Co.*, 975 F.2d 1215 (6th Cir. 1992),[12] found the exclusion unambiguous and precluded coverage for bodily injury damages allegedly caused by carcinogenic agents emitted by defective furnaces used in stripping rubber.

The Sixth Circuit, after a review of the policy language and case law, held that the insurer had no duty to defend under the policy based on a plain reading of the exclusion.

Additionally, courts show concern for construing the terms "irritant" and "contaminant" in isolation and typically construe these terms as substances generally recognized as polluting the environment. In fact, some courts have determined that the terms are terms of art applicable to traditional environmental pollution.[13] This is the case in *Atlantic Mut. Ins. Co. v. McFadden*, 595 N.E.2d 762 (Mass. 1992) where the court was faced with the application of a total pollution exclusion clause involving lead paint contamination in a residence. In *McFadden*, the Court examined whether a residence contaminated by lead paint fell within the pollution exclusion to preclude coverage for injuries sustained by the McFaddens. The trial court found that there is no language to suggest that lead in paint is a pollutant within the definition of that term. The appeals court agreed, noting that courts consider what an objectively reasonable insured would expect to be covered.[14] Further, the Court noted that the terms discharge, dispersal, and release are "terms of art in environmental law" that generally refer to injury caused by improper disposal or containment of hazardous waste.[15] Using this rationale, the court affirmed the grant of summary judgment to the plaintiff's and against Atlantic.

C. Was there a Discharge, Dispersal Release or Escape of a Pollutant?

Absent a showing of discharge, dispersal, seepage, migration, release or escape, some courts have found that the absolute pollution exclusion cannot apply.[16] Thus, a second way to render the pollution exclusion ambiguous in connection with nontraditional environmental claims is to argue that there was no "discharge, dispersal, release or escape" of a pollutant. For instance, in *Meridian Mut. Ins. Co. v. Kellman*, 197 F.3d 1178, 1183 (6th Cir. 1999), the policyholder was using a chemical to seal the floor on the seventh floor of a high school. During application, the sealant released noxious fumes that migrated to the plaintiff's classroom on the sixth floor due to improper ventilation. The Sixth Circuit found the absolute pollution exclusion ambiguous and determined coverage in favor of the policyholder.[17]

A second decision, *Belt Painting Corp. v. TIG Insurance Co.*, 795 N.E.2d 15 (NY 2003), further demonstrates the problem in establishing a dispersal in some industrial pollutant claims. Here, a painting contractor's fumes allegedly caused harm to an employee in the building being painted. The insurer denied coverage based on the pollution exclusion but the New York Court of Appeals disagreed, finding that the "discharge, dispersal or release" terms are ambiguous as applied to paint or solvent fumes that drifted a short distance from the area of the insured's intended use, which was within the building.

D. Are the Reasonable Expectations of the Insured Frustrated by the Application of the Pollution Exclusion to Non-Traditional Environmental Claims?

Reasonable expectations, not policy terminology, appears to drive many courts to find the ambiguity in the application of the pollution exclusion to nontraditional environmental claims, for instance, California's highest court restricted the pollution exclusion to traditional environmental claims in *MacKinnon v. Truck Ins. Exch.*, 31 Cal.4th 635, 3 Cal.Rptr.3d 228, 73 P.3d 1205 (2003), because otherwise the reasonable expectations of the insured would be frustrated. In *MacKinnon*, the

11 *Park-Ohio Industries v. Home Indemnity Co.*, 975 F.2d 1215, 1222 (6th Cir. 1992).

12 975 F.2d 1215 (6th Cir 1992).

13 See, e.g., *Atlantic Mut. Ins. Co. v. McFadden*, 595 N.E.2d 762 (Mass. 1992); *W. Alliance v. Gill*, 686 N.E.2d 997 (Mass. 1997) (holding pollution exclusion did not preclude coverage for release of carbon monoxide from restaurant oven).

14 *Id.* at 763-64.

15 *Id.*

16 See, *Island Assocs. v. Eric Group, Inc.*, 894 F. Supp. 200 (W.D. Penn. 1995).

17 *Meridian Mut. Ins. Co. v. Kellman*, 197 F.3d 1178, 1183 (6th Cir. 1999).

insured hired a pest control company to treat an apartment building for wasps. A tenant died in her apartment because she was not warned that she needed to evacuate during treatment. A bad faith action was brought against Truck Insurance for its denial of coverage based on the pollution exclusion.

The California Supreme Court noted the clause has received wide attention in other courts and that there was a lack of unanimity in interpreting the pollution exclusion. The Court's analysis focused on ascertaining the reasonable expectations of the insured "apart from the exclusion." The court concluded that an insured would have a reasonable expectation of coverage for ordinary acts of negligence resulting in injury. Thus, there will be coverage unless the exclusion plainly and clearly apprises the insured that ordinary negligence, such as spraying pesticide here, will not be covered.

Similarly, the court in *American States Ins. Co. v. Koloms*, 666 N.E.2d 699 (Ill. 1996), *aff'd*, 687 N.E.2d 72 (1997) affirmed a grant of summary judgment rejecting the application of a pollution exclusion where a number of people inhaled carbon monoxide from a faulty furnace a building owned by the Kolomses. Admitting that a literal reading of the pollution exclusion favored a reversal of the summary judgment to the Kolomses, the court nonetheless held that the clause was ambiguous. The Court noted that while a reasonable policyholder might construe carbon monoxide to be a pollutant in an industrial sense, the same cannot be said for carbon monoxide emitted from a faulty furnace. The court found support in decisions from other jurisdictions that restricted the pollution exclusion to traditional environmental claims.[18]

V. Conclusion

It is anticipated that these same challenges to the pollution exclusion will be made to claims involving methamphetamine labs; namely, (1) whether the chemicals from a meth lab qualifies as a pollutant or contaminant; (2) whether there is discharge or dispersal of a pollutant or contaminant; and (3) whether a reasonable insured would expect coverage under the specific situational facts and circumstances. Additionally, an analysis of the insured's role as being a cause of alleged injury should be undertaken to determine whether there was an occurrence.

With the historical perspective regarding the development of the absolute pollution exclusion and the varying judicial interpretations outside the context of environmental claims, it is anticipated significant litigation will continue.

[18] See, *Westchester Fire Ins. Co. v. City of Pittsburg, Kansas*, supra; *State Farm Mut. Auto. Ins. Co. v. Nissen*, 851 P.2d 165 (Colo. 1993), *Pipefitters Welfare Educ. Fund v. Westchester Fire Ins. Co.*, 976 F.2d 1037, 1043 (7th Cir. 1992); *Island Assocs. v. Eric Group, Inc.*, 894 F. Supp. 200, 204 (W.D. Penn. 1995).

RECENT CASE LAW...

Continued from page 6

Application, Russell Harrington, himself, was aware that in May 2003, the U.S. Department of Health and Human Services ("HHS") sought comments on the legality of ECOI-type policies under federal anti-kickback laws and economic credentialing. Harrington had retained outside counsel to draft the ECOI Policy to ensure that any economic credentialing policy did not violate anti-kickback and antitrust laws. Harrington attended a Federal Trade Commission hearing on April 11, 2003 at which Dr. James J. Kane, the CEO of the Little Rock Cardiology Clinic ("LRCC") and the Arkansas Heart Hospital, questioned Baptist Health's proposed ECOI Policy. On April 26, 2003, a Baptist Health Board of Trustee member expressed concerns about the legality of the ECOI Policy. While the existence of the new ECOI Policy was disclosed in the ERII and Darwin Applications, the controversy and antitrust issues pertaining to the ECOI Policy were not disclosed.

Shortly after the Platte River Policy incepted, on February 10, 2004, a group of cardiologists sued alleging the ECOI Policy violated federal anti-kickback statutes (the "Murphy Suit"). Platte River corresponded with Baptist Health on February 25, 2004 asking Baptist Health to keep Platte River apprised of all developments. After the renewal, in April of 2005, a doctor sued Baptist Health in Arkansas state court claiming again that the ECOI Policy was illegal (the "Cathey Suit"). During the monitoring of these matters, on June 27, 2006 coverage counsel for Platte River noted that there were issues "regarding prior knowledge allegedly not disclosed on the [ERII and Darwin] Applications."[9] Without responding to the prior knowledge issues raised or providing requested board minutes from the April 2003 Baptist Health meetings, as requested by Platte River in 2006, Baptist Health submitted a third ECOI Policy-related matter in November 2, 2006, this time, by LRCC. LRCC was the same entity that provided testimony to the FTC with Harrington in attendance three years earlier questioning the ECOI Policy (the Murphy

[9] *Id.* at 9.

Suit, the Cathey Suit and the LRCC Suits are hereinafter collectively the "ECOI Suits").

On January 17, 2007, Platte River denied coverage for the ECOI Suits and commenced a lawsuit seeking rescission, or a declaratory judgment of no coverage for the ECOI Suits. Platte River also sought recoupment of advanced defense fees. The Court granted Platte River's motion for summary judgment and rescinded the Platte River Policy on the grounds that Baptist Health misrepresented the scope of the risk.[10] The Court noted that the knowledge questions on the ERII and the Darwin Applications were unambiguous and that, at the time it answered the prior knowledge questions, Baptist Health knew and failed to disclose: (1) its investigation into and review of legal challenges to other hospitals' economic credentialing policies; (2) the Federal testimony and the HHS' request for comment on the legality of ECOI-type policies under federal anti-kickback statutes; and (3) Baptist Health's use of outside counsel to conduct a legal review of economic credentialing policies. In applying an objective applicant standard, the Court ruled that:

> A reasonable person would foresee that adoption of Baptist Health's ECOI Policy in these circumstances may or might result in or give rise to a claim. Claims were indeed filed and Harrington acknowledged that the ECOI Policy was adopted knowing that a claim could result. Baptist Health was not required to predict the precise nature of any such claim or specifically by whom the claim would be brought but it was required to notify Platte River that a claim may result in or arise out of its adoption of the ECOI Policy.[11]

The Court also noted that the Darwin Application asked for information on whether Baptist Health would be restricting staff admissions in the coming year for reasons other than performance, or whether Baptist Health had solicited a legal opinion on any practice as compliant with anti-kickback laws. Baptist Health answered these application inquiries in the negative, and the Court noted that Baptist Health failed its obligation of accurate disclosure for these questions as well since the ECOI Policy limited staff admissions on economic status of physicians.[12]

Notably, the Court rejected the Baptist Health's argument that Platte River itself should have researched and investigated the significance of economic credentialing policies such as the ECOI Policy, a copy of which was submitted with the ERII Application.[13] The Court reasoned that "there is no affirmative duty in Arkansas upon an insurance carrier to make an independent investigation to ascertain the truthfulness of the facts…in an insured's application…."[14] The Court stated, "[i]t was Baptist Health's responsibility, as set forth in the prior knowledge questions, to alert Platte River to the fact that such a policy may result in or give rise to a claim based on the circumstances surrounding the adoption of the ECOI Policy."[15] Accordingly, the

10 On May 14, 2009, Baptist Health filed a Notice of Appeal to the United States Court of Appeals for the Eighth Circuit. The parties filed a notice with the Court on October 2, 2009 that settlement had been reached.

11 *Baptist Health*, 2009 WL at 16.

12 *Id*. at 17.

13 *Id*.

14 *Id*. at 18. *See also, Unionamerica Ins. Co., Ltd. v. Ft. Miller Group, Inc*., No. 05-1912, 2009 WL 688873 at 7 (N.D. Cal. Mar. 16, 2009) (Under California law, "the insured has the obligation to "tell all it knows" about the risk, while the insurer has no obligation to investigate the accuracy or completeness of any of the information on the application.").

15 *Baptist Health*, 2009 WL at 18.

Court declared the Policy void *ab initio* and further held that Platte River could recover advanced defense fees and must return the premium with interest.[16]

J.P. Morgan Chase & Co.

In *J.P. Morgan Chase & Co.,* the Commercial Division of New York County Supreme Court analyzed a series of factors in defeating an insurer's claim of rescission as a matter of law.[17] JP Morgan Chase ("JPMC") was insured from November 30, 1997 – November 30, 2001 under a Bankers Professional Liability program (the "97-01 Program"). As the end of the Program effective dates neared, there were numerous news articles on the demise of Enron, and the Insurers on the expiring program sought notification of all Enron matters under the 97-01 Program as a pre-condition to renewal. JPMC provided the requested notice of Enron matters on November 29, 2001 ("Enron Notice").[18] As to the general public JPMC had also issued a press release on November 28, 2001 (the "Release"), detailing some of its Enron exposure and stating that it had $500 million in unsecured transactions, additional secured exposures including $400 million in secured transactions.[19]

Twin City Fire Insurance Company ("TC") had participated on the 97-01 Program. On November 30, 2001, TC issued a binder for $10 million of excess coverage for the going forward Policy Period of November 30, 2001 to November 30, 2002 based on Jam's submission of financial information and a list of pending claims (the "01-02 Program"). In the Enron Notice, JMPC repeatedly indicated that it had no knowledge of any wrongdoing in connection with Enron. In 2005, JPMC paid a settlement of $2.2 billion dollars in connection with Enron matters purportedly encompassed in the Enron Notice.

JPMC was sued in numerous actions by third-parties relating to its role as a trading partner with Enron, including suits by WorldCom and National Century Financial Enterprises ("NCFE") (collectively the "Enron Related Suits") that were submitted under the 01-02 Program to Twin City.

On May 31, 2006, JPMC commenced declaratory judgment suits seeking coverage for the Enron Related Suits, and Twin City asserted counterclaims seeking rescission of its 01-02 Program coverage on the grounds that "JPMC deliberately concealed information concerning the extent of its financial exposure to pre-pay transactions with Enron and misrepresented that it had no knowledge of wrongdoing…from its investors and professional liability insurers…taint[ing] its decision to renew coverage and participate in the [01-02 Program]."[20]

In analyzing TC's rescission counterclaims, the Court noted that under New York law an insurer "may rescind an insurance policy that was issued in reliance on material misrepresentations contained in the application where the subject matter of the misrepresentation is material to the risk, and the applicant knew of the falsity and made the representation in bad faith."[21] During discovery, the Court allowed TC to depose only those individuals at JPMC who had participated in collecting information for the Enron Notice, going no further than certain legal and risk department witnesses.[22]

Despite the fact the TC's underwriter had testified that JPMC's broker, Marsh, had indicated at the time of underwriting that JPMC's trading relationship with Enron would not have a material impact on JPMC's finances or operations,[23] the Court did not find that TC raised a triable issue of fact on rescission.[24] The Court highlighted the evidence that those JPMC employees who compiled the Enron Notice had no knowledge of any JPMC wrongdoing as of November 29, 2001, and that JPMC had not, at that time, taken any action to quantify third-party transaction risks.[25] The Court also appeared swayed by the fact that in 2009, the Second Circuit upheld dismissal of a securities fraud suit based on the same alleged misrepresentations TC complained of, namely JPMC's underestimating of its Enron exposure in the Release.[26]

The Court then looked critically at the aspects of the underwriting process and whether TC had demonstrated that the JPMC personnel responsible for compiling the details in the Enron Notice intended to

16 *Id*.
17 *J.P. Morgan Chase & Co. v. AIU Ins. Co*. Index No. 601904/06 (Sup. Ct. N.Y. Co., dated March 3, 2009 and filed March 25, 2009).
18 *Id*. at 4.
19 *Id*. at 2.
20 *Id*. at 6.
21 *Id*. at 8, quoting *Executive Risk Indem. Inc. v. Pepper Hamilton*, LLP 56 A.D.3d 196, 205-206, 865 N.Y.S.2d 25, 31 (1st Dept. 2008).
22 *J.P. Morgan Chase & Co. v. AIU Ins. Co*. Index No. 601904/06 at 20.
23 *Id*.at 14.
24 *Id*.at 16.
25 *Id*. at 13.
26 *Id*. at 15 ftnt. 8.

deceive TC.[27] The Court was critical of the following: (1) JPMC's Enron Notice and Release were not incorporated into a formal application; (2) there was no affidavit from a TC underwriter stating that public statements such as the Release were considered in the underwriting; and (3) JPMC did not warrant the accuracy of its statements to its insurers and TC.[28]

Although the Court set out a discussion on these underwriting elements of warranty, formal application, affidavits of incorporation of public statements, the Court did not find in favor of JPMC as a matter of law, but rather noted, it could not be determined as a matter of law that TC might have handled JPMC's renewal differently had JPMC accurately disclosed the magnitude of the Enron exposures in November of 2001.[29] The Court ultimately relied on an estoppel argument rather than rescission in deciding for JPMC. Under New York law the Court found that TC was subject to the standard that an insurer "…may be estopped from asserting its right to rescind based on fraudulent inducement and misrepresentation if it unreasonably delays notification or continues to accept to retain premiums."[30] The Court found that TC had waived its right to rescind, because TC knew of JPMC's alleged misrepresentations no later than the end of 2002, and did not seek rescission until 2006, all the while continuing to retain the policy premium for the 01-02 Program.[31]

Summary

In both *Platte River* and *J.P. Morgan Chase & Co*., the Courts examined a host of evidence in weighing a claim of policy rescission, demonstrating that any number of factors may become significant to the analysis. In *J.P. Morgan Chase & Co*., the Court detailed evidence presented by TC underwriters, but ultimately decided the rescission claim on the basis of timing, retention of the premium, and waiver. In contrast, the *Platte River* Court did not focus on the timing of the rescission, allowing the rescission defense to be raised three years after the first Claim notification, retention of the premium did not appear to be a convincing factor in *Platte River* as well, as the Court noted only at the end of the decision that Darwin is now required to tender the premium back to Baptist Health. The Court in *Platte River* also analyzed whether two applications with slightly differing wordings on the prior knowledge questioning created an ambiguity, a matter not at issue in *J.P. Morgan Chase & Co*. Lastly, litigation of the ECOI Suits underlying the coverage dispute in *Platte River* allowed Darwin to collect upper-management testimony on prior knowledge from underlying deposition testimony. In *J.P. Morgan Chase & Co*., TC was denied discovery of certain JPMC executive testimony on prior knowledge during the coverage litigation that was not otherwise given in the Enron matters, which settled well prior to the commencement of the coverage litigation.

Practitioners evaluating a rescission issue can deduce from these cases that any number of factors can weigh in support of or against a rescission argument and should consider: (1) the insured's knowledge of potential risks at the time of application or any time prior to inception of coverage from any source including underlying pleadings, affidavits, testimony before congress, testimony in other actions and any other public statements by the applicant or its representatives; (2) the questions posed by the insurer in the application process and follow up on the responses to such questions; (3) indications detailing the insurer's reliance on representations made in the underwriting process, incorporation or review of public filings, periodicals, or any questions posed to brokers, risk managers and other insureds; and (4) the insurer's and insured's conduct after claims are reported. As the *Platte River* and *JPMC* cases indicate, any number of factors can be persuasive to a court, and *Platte River* and *JPMC* are instructive in detailing the wide range of evidence courts consider under the applicable state law in evaluating and ruling on claims for rescission of insurance policies.

[27] *Id*. at 15.
[28] *Id*. at 8-10.
[29] *Id*. at 16.
[30] *Id*. (citations omitted)
[31] *Id*. at 18.

B.B. Wolf vs. Curly Pig

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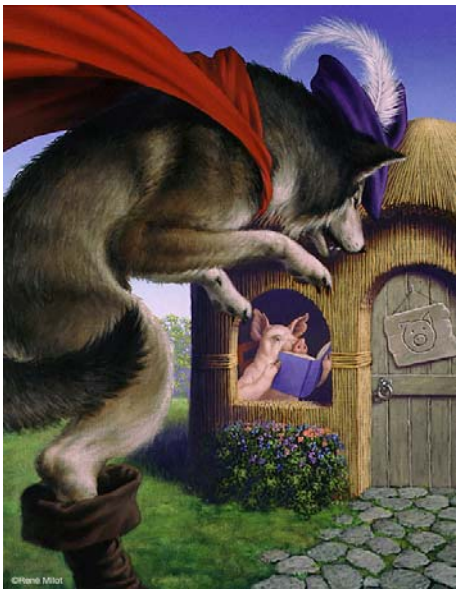

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BACKSEAT DRIVERS…

Continued from page 5

exercise of a contractual right to associate in the defense of any coverage claim, assuming its reinsurance contract contains such a clause (not all reinsurance contracts do). Typically, such a clause may provide that the ceding company, when so requested, afford the reinsurer an opportunity to be associated with it in the defense or control of any claim, suit or proceeding implicating the reinsurance contract. Depending on the contract, the reinsurer's involvement is often at its own expense. Some contracts require the ceding company to cooperate with the reinsurer in every respect in the defense and control of any such claim suit or proceeding. *See, e.g., Insurance Company of Ireland, Ltd. v. Mead Reinsurance Corp., et al.,* 1994 U.S. Dist. LEXIS 15690 at *23-*24 (S.D.N.Y. 1994)(quoting right of association provision in reinsurance contract).

A ceding company's failure to provide its reinsurers with a proper opportunity to associate in the defense of an insurance claim may result in a claim of prejudice by the reinsurer, who may then utilize that claim of prejudice as a basis to disclaim coverage under the reinsurance contract. *See, e.g., Insurance Company of Ireland, Ltd.,* 1994 U.S. Dist. LEXIS 15690 at *21-*25. Thus, while a corporate insured may be dealing directly with only the ceding company and its coverage counsel, there may well be a number of reinsurers who are all advocating their respective views on coverage issues behind the scenes.

Clearly, any such active participation by reinsurers has the potential to influence the ceding company's analysis of important legal points or other issues relevant to the ceding company's coverage position vis-à-vis the original corporate insured. Another potential result of active participation by numerous reinsurers in a coverage case may be to dilute the importance and influence of a historical relationship between a particular corporation and its insurer on a coverage decision. The relevant reinsurers may simply not share in that history and so be less willing to make compromises or favorable coverage determinations whenever part or all of a major claim or group of related claims falls within any arguably "gray area" of an insurance policy.

Other influences on the ceding company's actions involving reinsurance may be more subtle than simply crowding a lot of cooks into a particular kitchen when preparing a coverage position on a major claim. One decision that is, in one way, a notable account of a ceding company's various obligations to its reinsurer, and how those obligations should affect the handling a coverage claim by a corporate insured is *Suter v. General Accident Ins. Co. of America,* 2006 U.S. Dist. LEXIS 48209 (D.N.J. 2006), *vacated at parties' request by Goldman v. General Accident Ins. Co. of Am.*, 2007 U.S. Dist. LEXIS 70404 (D.N.J. 2007)(during the pendency of Integrity's appeal, the parties settled the case, a condition of the settlement being vacatur of the district court's decision and judgment).

To understand the full implications of the *Suter* decision's analysis, one should have a decent understanding of the complex facts that gave rise to both the insured's original insurance claim against the ceding company and the reinsurer's defenses to coverage based on both the risk reinsured and the ceding company's handling of the claim. The genesis of the case was underlying claims against Pfizer, Inc. ("Pfizer") arising out of the manufacture and sale of "Shiley" heart valves, made by a subsidiary of Pfizer. Generally speaking, the underlying claims against Pfizer fell "into three distinct categories: (a) "fracture" claims, involving people whose valves ha[d] failed, resulting in severe injury or death; (b) "working valve" or "anxiety" claims, involving persons who allegedly suffered emotional distress upon learning, post-surgery, of alleged defects in the valves (but whose valves ha[d] not failed); and (c) "re-operation" claims involving persons who qualified under predetermined medical criteria to undergo a second operation in which their valves were replaced." *Id.* at 34.

Pfizer chose to defend the claims itself and to later seek reimbursement from its various insurers. During the underlying litigations, Pfizer-Shiley denied any design or manufacturing defects and claimed that its heart valves were not more likely to fracture than other heart valves on the market. *See, e.g., Bowling v. Pfizer, Inc.*, 143 F.R.D. 141, 147 (S.D. Ohio 1992). Pfizer had considerable success in defending individual cases involving "anxiety" claims. As the *Suter* court noted:

> A retrospective of cases brought against Shiley-Pfizer rejected claims brought under theories of products liability, fraud, negligent failure to warn or strict liability based on failure to warn. Without evidence of product defect, the Shiley heart valve's allowed propensity for failure would not support recovery for emotional injuries. There is no reported case and no evidence on this record that any plaintiff with a

> functioning Shiley heart valve has ever prevailed against Shiley-Pfizer on the basis that the valve had a propensity to fail.

Suter, 2006 U.S. Dist. LEXIS 48209 at *17-*18.

An action, *Bowling v. Pfizer Corp.,* seeking class certification for all persons in the United States who had been implanted with the valve was filed in the United States District Court for the Southern District of Ohio. The District Court certified the class for settlement purposes. In evaluating the fairness of the settlement, the District Court observed that with respect to claims for emotional distress about possible product failure, the plaintiff class would have "little chance of success if tried on the merits." *Bowling,* 143 F.R.D. at 165. The District Court also noted that at least twenty-seven courts had granted summary judgment to Pfizer on the ground that a plaintiff cannot recover for fear or anxiety that a heart valve may fracture. *Id.* at 147. "Nonetheless, Pfizer entered into a settlement with the Bowling class, agreeing to pay hundreds of millions of dollars on account of claims by valve recipients whose valves had not yet failed, but who claimed to have suffered anxiety due to the prospect that they would fail." *Suter,* 2006 U.S. Dist. LEXIS 48209 at *20. As the District Court noted, there were many reasons for the class settlement:

> . . . the Defendants have had to defend numerous lawsuits involving the Bjork-Shiley convexo/concave heart valve since the mid-1980's. These lawsuits have cause Pfizer to not only bear legal costs, but they have diverted the attention of many of its employees away from their usual jobs to deal with litigation. In addition, the presence of pending litigation, with large sums of compensatory and punitive damages demanded, could jeopardize Pfizer's ability to attract investment. . . . Furthermore, Pfizer and Shiley have been the subject of an increasing number of critical news stories and reports . . .

Bowling, 143 F.R.D. at 147-148.

Pfizer sought insurance coverage for both its settlement and defense expenses, which eventually were said in 1999 to exceed $700 million. *Suter,* 2006 U.S. Dist. LEXIS 48209 at *38. In order to access its hundreds of millions of dollars in "occurrence limits" under its pre-1985 policies[2] Pfizer changed from a "injury in fact" trigger theory to a date of implant trigger for claims involving fractures that took place after October 1, 1985 and for the growing number of working valve/anxiety claims and reoperation claims. *Id.* at *43.

Among Pfizer's excess insurers from 1978 through 1985 was Integrity Insurance Company ("Integrity"). *Id.* at *8. General Accident Ins. Co. of America ("General Accident") facultatively[3] reinsured two of Integrity's policies issued to Pfizer. *Id,* at *11. These policies consisted of one policy in 1982 coverage year and one policy in 1983 coverage year. *Id.* The Integrity policies each had limits of liability of $3 million. *Id.* at *9. Both Integrity policies "followed form" to lower

[2] Changing conditions in the insurance market meant that coverage for product liability under "occurrence" based forms became much more difficult to obtain as many insurers switched to "claims made" forms by 1985. An "occurrence" base form provides coverage for claims that arise out of an "occurrence" (usually defined as an accident, etc.) during the policy period, regardless of when the claims are made. A "claims-made" form only provides coverage for claims made during the policy period, making it easier for an insurer to assess its potential overall liability to the insured at each renewal since the universe of all relevant claims would be known as of the expiring policy's termination date.

[3] "Facultative reinsurance covers only a particular risk or a portion of it, which the insurer is free to accept or not." *Christiana Gen. Ins. Co. v. Great Am. Ins. Co.,* 979 F.2d 268, 271 (2d Cir. 1992). Whereas, treaty reinsurance "obligates the reinsurer to accept in advance a portion of certain types of risks that the ceding company underwrites." *Id.*

level umbrella liability policies issued by Transit Casualty Co. ("Transit"). *Id*., at *10. General Accident reinsured both policies for $2 million of the policies' respective $3 million limit of liability. *Id,* at *11-*12.

Integrity had been declared insolvent and placed in liquidation in 1987. *Id*. at *7. There was no coverage litigation between Pfizer and Integrity, only discussions and correspondence in 1999. *Id*. at *37-*41. The Integrity Estate allowed Pfizer's claims in the amount of $3 million for the 1982 policy and $1,912,388.00 for the 1983 policy. *Id*. at *69. The Estate then billed General Accident for its share of the amounts paid. *Id*. at *69. General Accident disputed Integrity's reinsurance claims on the grounds that there was no "occurrence" during the policy periods, meaning that patients were not automatically "injured" when working heart valves were implanted. *Id*. at *2. General Accident also argued that Integrity did not take all proper and business like steps in allowing the claim. *Id*. at *2-*3.

The *Suter* court agreed with General Accident on both arguments. The *Suter* court's reasons for doing so illustrate some of the potential pitfalls and dangers, in terms of preserving reinsurance, for a ceding company in the interactions between the company and the insured over a claim. Therefore, they serve to explain some of the behaviors of ceding companies that corporate insureds may not fully understand or like.

Why Insurers May Chose to Litigate Certain Coverage Issues Rather than Reach Settlements at Less Cost to Everyone

A ceding company does have considerable discretion in handling and settling claims due to the "follow the fortunes" doctrine. The *Suter* court recognized the doctrine of follow the settlements, which it noted was an embodiment of the follow the fortunes doctrine in the context of settlements. *Id*. at 70, citing, *Commercial Union Ins*. *Co*. *v. Seven Provinces Ins*. *Co*., 9 F. Supp. 2d 49, 66 (D. Mass. 1998), *aff'd* 217 F.3d 233 (1st Cir. 2000), *cert*. *denied*, 531 U.S. 1146 (2001). The court stated that: "This doctrine 'binds a reinsurer to accept the cedent's good faith decisions on all things concerning the underlying insurance terms and claims against the underlying insured: coverage, tactics, lawsuits, compromise, resistance or capitulation.'" *Id*., *citing and quoting*, *British Int'l Ins*. *Co*. *v. Seguros La Republica, S.A.,* 342 F.3d 78, 85 (2d Cir. 2003).

However, a ceding company is not a completely free agent when it comes to deciding to either settle or litigate coverage issues with its corporate insureds. The *Suter* court also noted exceptions: ". . . a fraudulent or bad faith determination doesn't immunize a reinsured's determination. *Nor do payment that are clearly beyond the scope of the original policy or in excess of the reinsurer's agreed to exposure*." *Id*. at *70-*71 (internal quotation marks and citation omitted) (italics added). The *Suter* court further noted that "[t]he ceding insurer is required to make a good faith and reasonable, business like investigation." *Id*. at 73. To put it otherwise, "[b]ad faith in this context amounts to a showing of gross negligence, recklessness or *a showing 'that the settlement was not even arguably within the scope of the reinsurance coverage*." *Id*. at *74, *citing and quoting*, *Hartford Acc*. *& Indem*. *v. Columbia Cas*. *Co*., 98 F. Supp. 2d 251, 258 (D. Conn. 2000) (citations omitted) (italics added).

In our example, Integrity allowed the Pfizer claims by accepting Pfizer's proposed "date of implant" trigger, rather than litigating the issue of coverage trigger with Pfizer. Therefore, Integrity's reinsurer, General Accident, was free to argue in its own coverage action with Integrity that the trigger was incorrect and that the "working valve/anxiety" claims paid by Pfizer fell outside the scope of the Policy's coverage.

Pfizer had argued to Integrity that the trigger decisions in two breast implant coverage actions, *Dow Corning Corp*. *v. Continental Cas*. *Co*., 1999 Mich. App. LEXIS 2920, No. 200143 (Mich. App. 1999)(per curiam)(affirming trial court's conclusion that for coverage purposes injury occurred beginning on date of breast implants and progressed continuously) and *First State Ins*. *Co*. *v. Minnesota Mining & Mfg*., No. CX 97-9793 (Minn. Dist. Ct.) supported a date of implant trigger (which is to say, that both an "occurrence" and "bodily injury" happened when the heart valve was implanted). *Id*. at *37. Also cited by Pfizer were *Maryland Casualty Co*. *v. W.R*. *Grace & Co*., 23 F.3d 617 (2d Cir. 1994)(installation of asbestos product resulted in immediate property damage), and *Eljer Mfg*. *v. Liberty Mutual,* 972 F.2d 805 (7th Cir. 1992)(finding that installation of a plumbing system with a propensity to fail was immediate "property damage" regardless of actual failure).[4] *Id*. at 36.

However, Pfizer never informed Integrity that in 1996 a California trial court in a coverage action

[4] The United States Court of Appeals for the Seventh Circuit's reasoning in *Eljer Mfg*. *v. Liberty Mutual,* which was based on its understanding of Illinois law, was later wholly rejected by the Illinois Supreme Court in a case dealing with the same plumbing systems in *Travelers Ins*. *Company, et al*., *v. Eljer Manufacturing, Inc*., *et al*., 197 Ill.2d 278, 308, 757 N.E.2d 481, 496 (Ill. 2001)(the costs incurred by certain underlying plaintiffs, who replaced the insured's plumbing products before they failed so as to prevent future harm, were only "economic losses" uncovered by a CGL policy).

between Pfizer and its solvent insurers had decided that the *Maryland Cas*. and *Eljer* cases did not support application of a date of implant trigger for the heart valves. Accordingly, the California trial court denied Pfizer's cross motion for summary judgment seeking application of a date of implant trigger to all "working valve/anxiety" claims. *Dairyland Ins. Co. v. Shiley, Inc. and Pfizer, Inc.,* No. 718166, slip op. (Cal. Super. Ct. April 26, 1996)(the court also held that under California law implantation of the heart valve was not an "occurrence" during any of the policy periods at issue). Unfortunately for Integrity, a coverage opinion by outside counsel obtained by Transit and shared with Integrity, incorrectly stated that the Dairyland court "has determined that in the context of non-working valve claims a continuous trigger should apply." *Id*. at 57.

The *Suter* court agreed with General Accident, holding that the payments made to Pfizer were clearly beyond the scope of the reinsured Integrity policies, based on the relevant wording of the Transit polices to which they followed form. *Id*. at *75-*76. The court held that the Transit policies clearly only provided coverage for *an injury occurring during the policy periods*. For that condition to be fulfilled, the heart valve had to be regarded as causing injury immediately upon being implanted.

The Suter court's decision noted the only court, the *Dairyland* trial court, to expressly consider the date of implantation trigger for Shiley heart valves for coverage purposes had rejected this theory. *Id*. at *81-*82. Further, the *Suter* court brushed aside Integrity's attempted reliance on the case law cited by Pfizer to support a date of implant trigger, noting that "case law is not a substitute for medical evidence" when it came to meeting Integrity's burden to show some proof of injury during the policy period. *See, Id.,* at *82.

The *Suter* court then found that there was no actual medical evidence on the record that supported any analogy between the heart valve cases and asbestos or silicone cases, or the characterization of the Shiley heart valve as a continuous or progressively deteriorating bodily injury. *Id*. at * 76-*77. Such medical evidence had been requested by Integrity but Pfizer refused to produce it. *Id*. at *35. All Integrity could point to was an internal letter from one Transit employee to another that said that such evidence existed, together with an affidavit from an in-house counsel at Pfizer that the court found to be "conclusionary." *Id*. at *56, *83. The *Suter* court had previously noted Pfizer's consistent and continuous litigation posture that the Shiley valves were not defective. *Id*. at 36. Therefore, General Accident had successfully shown that the underlying claims paid by Integrity had not been within the scope of the reinsured Integrity policies. *Id*. at *75-*77.

There are situations where the law regarding the actual trigger of coverage for the underlying claims is not uniform and/or not fully developed and settled in all the various states potentially relevant to the ceding company's insurance contract with the original insured. In that case, a ceding company may find it necessary to litigate the relevant issues of fact or law in order to avoid a later claim by a reinsurer that the underlying claims simply were not within the scope of the ceding company's policy. As our example shows, Integrity's decision to rely upon Pfizer's legal argument regarding trigger, together with Transit's claims file, left Integrity vulnerable when General Accident decided to independently evaluate *and contest* the suitability of the "date of implantation" trigger used by Pfizer and Integrity to calculate Pfizer's coverage under its Integrity policies. This case illustrates why a ceding company may chose to litigate a coverage question even if the insurer actually finds the insured's coverage arguments to be rather persuasive.

Why Insurance Companies May Bring in Outside Experts and Demand Detailed Product Information During Claims Handling

As noted above, a ceding insurer had a legal obligation to its reinsurers to make a good faith, reasonable, business like investigation when handling claims. *Id*. at *73. "Bad faith" behavior by a ceding company occurs when the ceding company is grossly negligent or reckless in handling claims. *Id*.

The *Suter* court also held that Integrity's allowing of the Pfizer claim without having first obtained medical evidence from Pfizer ". . . that demonstrated that working mechanical heart valves merited the same classification as documented generators of progressive disease like silicone and asbestos" was "gross negligence." *Id*. at *83-*84. Moreover, the *Suter* court further held that Integrity's failure to ". . . obtain expert medical advice as to when injury actually occurred . . . breached Integrity's duty to General Accident to make a reasonable, businesslike determination as to whether the Shiley Heart valve claims should have been allowed." *Id*. at *84-*85.

A corporate insured may have a number of business and legal reasons for not easily volunteering

detailed information about an allegedly defective product. However, *Suter* indicates that a ceding company may be proceeding at peril to its reinsurance coverage if it does not do enough to try to obtain sufficient disclosure from its insured, through litigation if necessary. Further, *Suter* indicates that the ceding company may sometimes have to retain and involve qualified expert(s) to either properly interpret the product data obtained from the insured and/or to provide opinions based on publicly available data if necessary. From the insured's viewpoint, repeated dialogues and disclosures to its insurer's outside experts may seem to add an unnecessary layer of expense and activity to processing a claim, but the *Suter* case demonstrates why a ceding company should be cautious about the degree upon which it may rely on an insured's representations of fact concerning its own products. This may be particularly true where the position that an insured takes for coverage purposes regarding its product is contrary to its description of the product in the underlying litigation, as in our example involving Pfizer and Integrity.

Why Insurers May Need to Involve Reinsurers in Coverage Decisions For Settled Underlying Claims

As the *Suter* court noted, even if the Shiley heart valves could be said to be defective when implanted, the Integrity policies "are written not to provide coverage for a defective product but rather for a product that actually causes some injury." *Id*. *78 (internal quotation marks and citation omitted. The fact that Pfizer had settled with the plaintiffs with working valves, who alleged "anxiety," claims did not mean that a court deciding coverage issues, like the *Dairyland* or *Suter* courts, had to accept the theory that the plaintiffs were *injured* when they received the valves.

As in the Shiley heart valve situation, corporate insureds often settle claims for a variety of business reasons without going to trial on every case, particularly in mass tort cases involving claims by hundreds, thousands, or sometimes literally hundreds of thousands of actual or potential plaintiffs. The *Suter* case illustrates the various problems a ceding company can encounter with its reinsurers, if the ceding company allows coverage for its insured's settled product liability, when it has not obtained the reinsurer's advance consent to a proposed allowance or settlement of the corporate insured's coverage claim. Moreover, many reinsurance contracts now give reinsurers an express right to pre-approve coverage settlements. For the corporate insured, the time required for its insurer to "round the bases" of its reinsurers and obtaining their support for a proposed coverage settlement by responding to all the reinsurers' inquiries, legal questions or positions, requests for additional information that must be obtained from the insured, etc., may seem very long indeed.

Why Excess Insurers May Each Involve Outside Coverage Counsel

Doubtless many insureds feel frustrated by the involvement of outside coverage counsel retained by insurance companies to evaluate various coverage claims, thinking that insurance companies must surely be qualified to make coverage determinations on their own and that outside lawyers do not fully appreciate the parties' contractual relationships and business understandings. Similarly, a corporate insured may wonder why its various excess insurers do not simply "fall in line" with coverage decisions made by the "lead" primary or umbrella carriers in their coverage years, which are based, in part, on advice obtained by their outside legal counsel.

The *Suter* court was demonstrably unimpressed with Integrity's alleged reliance on Pfizer's incomplete legal citations and on Transit's claim handling file, including the legal opinions contained therein, in reaching Integrity's own coverage determination. The *Suter* court held that Integrity's failure ". . . to retain its own coverage counsel for an opinion as to the appropriate trigger of coverage . . . breached Integrity's duty to General Accident to make a reasonable, businesslike determination as to whether the Shiley Heart valve claims should have been allowed." *Id*. at *84-*85. In other words, Integrity owed its reinsurer a duty to retain competent coverage counsel to independently advise Integrity given the complexity and facts of the Shiley heart valve claims.

The *Suter* case illustrates the perils of passivity for the excess insurers, inasmuch as coverage counsel retained by the primary or umbrella insurers may make mistakes. The *Suter* case indicates that the ceding company cannot simply rely upon a lower level insurer's claims handling or coverage determinations in order to fulfill the ceding company's independent obligations to its own reinsurers under its reinsurance contracts to employ reasonable, businesslike methods in handling claims. The ceding company must be able to fully *and independently* assess the coverage claim in a reasonable, business like manner, using outside counsel or experts as required.

Overall Observations

In sum, the *Suter* court held that "Integrity's allowance of the Pfizer claims under all the circumstances surrounding the Shiley heart valve was grossly negligent and amounted to bad faith." *Id*. at *85-*86. Accordingly, General Accident was not obligated to Integrity under the follow the settlements provision of the facultative reinsurance contracts. *Id*. at *86. Thus, the *Suter* case is a good example of how an insurer's allowance of its insured's coverage claims can potentially cost it much more than it bargained for, if the claim has not been handled in a manner consistent with industry standards.

As in the *Suter* case, ceding companies often retain less than half of the risk posed by particular insurance policies — sometimes much less. Thus, ceding companies have substantial economic incentive to implement and follow the claims handling practices that can be defended as "reasonable" and "businesslike" in any coverage disputes with reinsurers. A proper understanding by corporate insureds and their coverage counsel of the various legal and contractual standards to which ceding companies may be held, should facilitate both communication and the presentation of coverage claims in the manner best calculated to obtain a faster coverage determination from the ceding company and/or any required reinsurer approvals.

FINANCIAL MELTDOWN...

Continued from page 1

broker-dealer literature and promotional materials provides some sense of assurance, but there are significant limits to SIPC protection, the most commonly known of which is the $500,000 ceiling on claims.

To protect against catastrophic losses over and above the SIPC ceiling, there is a unique and specialized form of insurance called excess SIPC coverage. This coverage theoretically steps in when the limits of SIPC protection are exhausted. It is theoretical because no reported claim has ever been paid on such policies. With the Lehman Brothers bankruptcy that may change.[4] At this juncture, however, there are no reported cases that address, much less construe, an excess SIPC policy.[5] Moreover, the collapse of Bernie Madoff's Ponzi scheme (which had no excess SIPC coverage) raises significant issues relating to the need for and protection of large institutional and high net-worth individual investors by way of excess SIPC coverage.

[4] *See* Zachery Kouwe, *Billions in Lehman Claims Could Bury an Elusive Insurer*, The New York Times (July 31, 2009).

[5] One reason there may be no reported cases is that recent excess SIPC policies issued by an industry captive (Customer Asset Protection Company) are subject to binding arbitration and strict confidentiality provisions. *See* Note 54, *infra*.

I. The Underlying Coverage – SIPC Protection.

The unique aspect of excess SIPC coverage is that the underlying protection is not a traditional insurance policy, but rather a complicated statutory liquidation process and an industry-funded insurance program for the protection of investors. Since exhaustion of SIPC protection is a necessary prerequisite for triggering excess SIPC coverage, it is therefore important to understand the SIPA regulatory requirements, as well as the SIPC liquidation procedures and claims resolution process.

Scope of SIPC Coverage.

SIPA was passed in 1970 to protect investors in the event of a failure of a securities broker-dealer.[6] SIPC is a nongovernmental corporation created by SIPA established for the purpose of, among other things, "providing financial relief to the customers of failing broker-dealers with whom they had left cash or securities on deposit."[7] SIPC does not offer the same blanket protection as FDIC.[8] Rather, SIPA protection is limited in scope and does not attempt to make all customers whole.[9] It is largely dependent upon fitting within the specific terms and conditions of SIPA.

SIPA provides protection for claimants who qualify as "customers" of a broker-dealer.[10] It protects customers of registered broker-dealers who have entrusted those broker-dealers with cash or securities in the ordinary course of business for the purpose of trading and investing.[11] SIPA expressly excludes from the definition of "customer" creditors or lenders as opposed to investors.[12] Also, where there is an introducing broker utilizing a clearing broker to settle and complete trades on a fully disclosed basis, a claimant would not be a "customer" of the introducing broker, but rather the clearing broker.[13] Even where a claimant technically qualifies as the customer, such claimant may nevertheless be denied customer status where it would not achieve SIPA's legislative purpose.[14]

SIPA only protects "customer property" which is defined to mean "cash and securities … at any time received, acquired or held by or for the account of a debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted."[15] Under SIPA, the term "securities" is broadly defined to include traditional investment vehicles.[16] More unusual investment vehicles, however, are within the scope of

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6 *See SIPC v. Stratton Oakmont, Inc. (In re Stratton Oakmont, Inc.)*, 257 B.R. 644, 650 (Bankr. S.D.N.Y. 2001) *rev'd on other grounds by* No. 01-CV-2812 RCC, 2003 WL 22698876 (S.D.N.Y. Nov. 14, 2003) (SIPA "was enacted in response to the failure of many brokerage firms during the financial crises of 1969-1970."). The Senate Report on SIPA explained that its purpose was "to protect individual investors from financial hardship; to insulate the economy from the disruption which can follow the failure of major financial institutions; and to achieve a general upgrading of financial responsibility requirements of brokers and dealers to eliminate, to the maximum extent possible, the risks which lead to customer loss." S.Rep. No. 1218, 91st Cong., 2nd Sess., 4 (1970), quoted in *In re Investors Center, Inc.*, 129 B.R. 339, 341 (Bankr. E.D.N.Y. 1991); *see also* Harold S. Bloomenthal, 1 Sec. Law Handbook §19.21 (2008).

7 *SIPC v. Barbour,* 421 U.S. 412, 413, 95 S.Ct. 1733, 44 L.Ed.2d 263 (1975); *SIPC v. Bernard L. Madoff Investment Securities LLC,* 401 B.R. 629, 636 n. 2 (Bankr. S.D.N.Y. 2009); 15 U.S.C. § 78ccc (a)(1) & (b).

8 SIPC, *What SIPC Covers and What It Does Not Cover*, *at* http:www.sipc.org/how/covers.cfm ("SIPC is not the FDIC. The Securities Investor Protection Corporation does not offer to investors the same blanket protection that the Federal Deposit Insurance Corporation provides to bank depositors.").

9 *See In re Brentwood Securities, Inc.*, 925 F.2d 325, 330 (9th Cir. 1991) (SIPC "does not comprehensively protect investors from the risk that some deals will go bad or that some securities issuers will behave dishonorably."); *In re Stalvey & Assoc., Inc.*, 750 F.2d 464, 473 (5th Cir. 1985) ("Congress believed that the SIPA was only an interim step that would not provide complete protection from losses incurred by the failure of broker dealer firms."); *SEC v. Packer, Wilbur & Co.*, 498 F.2d 978, 983 (2nd Cir. 1974) ("SIPA was not designed to provide full protection to all victims of a brokerage collapse. Its purpose was to extend relief to certain classes of customer."); *SIPC v. Stratton Oakmont, Inc.*, 229 B.R. 273, 278 (Bankr. S.D.N.Y. 1999) ("SIPA offers only limited protection and membership in SIPC does not guarantee every investor's loss."); *In re Adler Coleman Clearing Corp.*, 195 B.R. at 273 ("SIPC's role in a SIPA liquidation proceeding is limited by statute; it does not attempt to make all customers whole."); *Matter of Bevill, Bresler & Schulman, Inc.*, 83 B.R. 880, 886 n. 3 (D.N.J. 1988) ("SIPC's role is carefully delineated, and the corporation does not attempt to make all customers whole.").

10 15 U.S.C. § 78lll(2) ("The term 'customer' of a debtor means any person (including any person with whom the debtor deals as principal or agent) who has a claim on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral security, or for purposes of effecting transfer.").

11 *See SIPC v. Executive Securities Corp.*, 556 F.2d 98, 99 (2nd Cir. 1977).

12 15 U.S.C.§ 78lll(2)(B) (excluding from the definition of customer "cash or securities which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor."); *see also Stafford v. Giddens (In re New Times Securities Services, Inc.),* 463 F.3d 125, 127-129 (2nd Cir. 2006) (noting the distinction between "customers" and those in a lending relationship with the debtor ("lenders"), and holding that promissory notes with fixed maturity and interest rates were unprotected debt instruments).

13 *See* 17 U.S.C. § 300.200; *SIPC v. Stratton Oakmont, Inc.*, 229 B.R. at 279 (holding that claimants were not "customers" of the introducing broker who utilized a clearing broker on a fully disclosed basis).

14 *See Mishkin v. Siclari (In re Adler, Coleman Clearing Corp.),* 277 B.R. 520, 558 (Bankr. S.D.N.Y. 2002) ("[T]he caselaw has made clear that fitting within the four corners of that [customer] definition does not automatically entitle a claimant to customer status.")

15 15 U.S.C. § 78111(4).

16 Pursuant to SIPA, the term "security" means:

any note, stock, treasury stock, bond, debenture, evidence of indebtedness, any collateral trust certificate, preorganization certificate or subscription, transferable share, voting trust certificate, certificate of deposit, certificate of deposit for a security, or any security future as that term is defined in section 78c(a)(55)(A) of this title, any investment contract or certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or mineral royalty or lease * * * any put, call, straddle, option, or privilege on any security, or group or index of securities * * * or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase or sell any of the foregoing, and any other instrument commonly known as a security.

SIPA only to the extent that they are registered with the Securities and Exchange Commission ("SEC") under the Securities Act of 1933.[17] Accordingly, SIPA does not protect commodity futures contracts and currency or investment contracts unless registered with the SEC.

Finally, SIPC does not protect investors from market losses, including losses during the pendency of a SIPC proceeding.[18] It also does not cover individuals who were sold worthless stocks and other securities.

SIPC Membership.

Membership in SIPC is required by law. A broker or dealer automatically becomes a member of SIPC upon registration as a broker or dealer with the SEC under Section 15(b) of the Securities Exchange Act of 1934.[19] If a SIPC member's registration with the SEC is terminated, the broker-dealer's SIPC membership is automatically terminated. SIPC loses its power to protect customers of former SIPC members 180 days after the broker-dealer ceases to be a member of SIPC.[20] In such situations, the investor would have no protection whatsoever.

SIPC Fund.

SIPC administers a fund from which advances are made to satisfy claims of customers.[21] It consists of amounts received by SIPC from members, as well as cash on hand or deposit amounts invested in U.S. government or agency securities or lines of credit.[22] Each member pays an assessment based on a percentage of gross revenues or other relevant factors considered by SIPC.[23] In addition, SIPC has the power to borrow money from banks and other financial institutions pursuant to a line of credit or other agreement.[24] In certain circumstances, SIPC can even borrow up to $1 billion from the SEC.[25] The SIPC fund currently has assets of approximately $1.6 billion.[26]

SIPC Liquidation Proceedings.

When the SEC or the Financial Industry Regulatory Authority ("FINRA"), a self-regulatory authority, advises SIPC of a problem, SIPC may initiate a customer protection proceeding, called a "liquidation proceeding."[27] In order to initiate such a proceeding, the SIPC must make a determination that a member has failed or is in danger of failing to meet its obligations and meets one or more of the following conditions: (1) the member is insolvent within the meaning of the Bankruptcy Code or is unable to meet its obligations as they become mature; (2) the member is the subject of a proceeding in which a receiver, trustee or liquidator has been appointed; (3) the member is not in compliance with applicable requirements or rules with respect to financial responsibility or hypothecation of customer securities; or (4) the member is unable to make computations as may be necessary to establish compliance with financial responsibility or hypothecation rules.[28]

SIPC typically files an application for a protective order in the appropriate U.S. district court.[29] Once the court issues a protective order and appoints a trustee, the case is removed to bankruptcy court.[30] A SIPC liquidation proceeding is essentially a bankruptcy proceeding where eligible "customers" have priority

17 *Id*. ("[T]he term 'security' does not include any currency, or any commodity or related contract or futures contract, or any warrant or right to subscribe to or purchase or sell any of the foregoing."); *see also* SIPC, *How SIPC Protects You – Understand the Securities Investor Protection Corporation*, *at* http://www.sipc.org/how/brochure.cfm; *Ahammed v. SIPC (In re Primeline Securities Corp.)*, 295 F.3d 1100, 1109 (10th Cir. 2002) (holding that a "pooled investment" was not a "security," because it was not registered with the SEC and thus claimant's deposits for the investment were not deposits "for the purpose of purchasing securities").

18 *See* 15 U.S.C. § 78lll(11); *see also SEC v. Albert & Maguire Securities Co., Inc*. 560 F.2d 569, 572 (3rd Cir. 1977) (SIPA does not protect against market fluctuation); SIPC, *What SIPC Covers and What It Does Not Cover*, *at* http:www.sipc.org/how/covers.cfm ("Most market losses are a normal part of the ups and downs of the risk-oriented world of investing. That is why SIPC does not bail out investors when the value of their stocks, bonds and other investments falls for any reason. Instead, SIPC replaces missing stocks and other securities where it is possible to do so ….").

19 *See* 15 U.S.C. § 78ccc(a)(2)(A); SIPC, *The Investor Guide to Brokerage Firm Liquidation: What You Need to Know … And Do*, *available at* http://www.sipc.org/pdf/SIPC_brochure_Investors_Guide_to_BD_Liquidations.pdf (hereinafter "SIPC Investor's Guide"); Statement of Stephen P. Harbeck, President and CEO, SIPC, before the Committee on Financial Services, U.S. House of Representatives, at 1, *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/harbeck010509.pdf (Jan. 5, 2009) (hereinafter "Harbeck Statement").

20 *See* 15 U.S.C. § 78eee(a)(3)(A).

21 15 U.S.C. § 78ddd.

22 15 U.S.C. § 78ddd(a)(2).

23 15 U.S.C. § 78ddd(c)(2).

24 15 U.S.C. § 78ddd(a)(3).

25 15 U.S.C. § 78ddd(g).

26 Harbeck Statement, *supra* note 18, at 1.

27 15 U.S.C. §§ 78eee(a)(3) & (b); 78lll(10). Notably absent from the lineup of recent SIPC liquidation proceedings is the SEC's action alleging that R. Allen Stanford and others executed a massive, ongoing fraud through various companies he controlled. Complaint, *SEC v. Stanford International Bank, Ltd*., No. 3:09-cv-00209-N (N.D.Tex. Feb. 16, 2009). Notwithstanding the fact that two of the defendants were registered with SIPC, no relief was sought under SIPA and there is no pending SIPC liquidation proceeding. Apparently, a number of defrauded customers are petitioning to have SIPC cover their losses.

28 15 U.S.C. § 78eee(a)(3) & (b)(1).

29 15 U.S.C. § 78eee(a)(3).

30 15 U.S.C. §§ 78eee(b)(4) & 78fff(b).

claims to "customer property" of the debtor's estate.[31] Customers must meet two filing deadlines in order to properly perfect their claim. The first is the deadline set by the bankruptcy court, which could be as little as 30 days.[32] The second deadline, imposed by SIPA, is that a completed claim form must be submitted to the bankruptcy court within six months after notice is published.[33] Failure to meet either of these deadlines could be fatal to a claim.[34]

The SIPC Customer Protection Process.

Basically, there are three classes of recovery in a SIPC proceeding. First, customers of a failed brokerage firm are entitled to receive all securities that are registered in their name or are in the process of being registered ("customer name securities").[35] Such claims are likely to be limited since most securities held by a broker-dealer are not registered in the customer's name.

The second class of claims to be satisfied are "net equity" claims of a customer.[36] In general, such claims are the dollar amount of the customer's account less the amounts owed by the customer to the broker-dealer.[37] Net equity claims are satisfied on a *pro rata* basis out of "customer property" (sometimes referred to as the "customer estate").

Finally, if "customer property" is insufficient to pay customer net equity claims, the claims will be satisfied from the SIPC Fund up to a maximum of $500,000 per customer, including $100,000 for cash claims.[38] If the claim exceeds these amounts, the customer becomes a general unsecured creditor and the excess claim is satisfied out of the general estate of the defunct broker-dealer on a *pro rata* basis with other unsecured general creditors.[39] This is the point at which excess SIPC coverage would cover the claim.

SIPC enjoys a considerable measure of success in protecting qualifying customers. Through the end of 2008, SIPC reports that it has commenced 322 liquidation proceedings.[40] During that period, cash and securities distributed for the accounts of customers totaled approximately $160 billion (approximately $159.7 billion from the debtors' estates and $323.8 million from the SIPC Fund).[41] SIPC also reports that of the more than 625,100 claims satisfied in completed or substantially completed cases as of December 31, 2008, a total of 350 were for cash and securities in excess of the SIPC limits of coverage.[42] According to SIPC, these unsatisfied claims total approximately $46.3 million, or one-tenth of one percent of all satisfied claims.[43] While these numbers suggest that the historical excess SIPC exposure (*i.e.*, that which would be covered by an excess SIPC policy) is very small, they do not include the Lehman Brothers Inc. or Bernard L. Madoff Investment Securities LLC liquidation proceedings.[44]

31 A SIPA proceeding is essentially a bankruptcy liquidation designed to achieve the special purposes of SIPA. *In re Alder Coleman Clearing Corp.*,195 B.R. at 270 ("SIPA liquidations generally involve customer claims and claims of general unsecured creditors, which are satisfied out of a customer estate and general estate, respectively. The customer estate – which is not available to satisfy the claims of general creditors – is a fund consisting of customer-related assets."); *see also In re Alder, Coleman Clearing Corp.*, 277 B.R. at 571 n. 1.

32 SIPC, *Seven Questions Investors Ask Most Often*, *at* http://www.sipc.org/how/brochure.cfm#four; *see also In re Lehman Brothers Inc.*, Case No. 08-01420 (SMP) SIPA (Bankr. S.D.N.Y.), Commencement of Legal Proceedings (December 1, 2008) (requiring customers who wish to be eligible for maximum protection under SIPA to submit claims within 60 days of the notice).

33 15 U.S.C. § 78fff-2(a)(3) ("[n]o claim of a customer or other creditor of the debtor which is received by the trustee after the expiration of the six-month period beginning on the date of publication of notice under paragraph (1) shall be allowed …."); SIPC, *Seven Questions Investors Ask Most Often*, *at* http://www.sipc.org/how/brochure.cfm#four.

34 *See In re Chicago Partnership Board, Inc.*, 236 B.R. 249, 257 (Bankr. N.D.Ill. 1999) (holding that the SIPA deadline for filing claims is mandatory and absolute and may not be extended by the exercise of some power of equity).

35 15 U.S.C. § 78lll(3). *See In re Bevill, Bresler & Schulman, Inc.*, 59 B.R. 353, 368 (definition of "customer name security" is confined to securities that the broker-dealer "could not negotiate or otherwise misappropriate absent some form of aggravated misconduct, such as forgery"); *In re Bell & Beckwith*, 104 B.R. 842, 858 (Bankr. N.D. Ohio 1989) ("SIPA's definition of customer name securities protects only those securities which cannot be negotiated.").

36 The term "net equity" is defined to mean the "dollar amount of the customer account determined by – (A) calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase on the filing date, all securities positions of such customer (other than customer name securities reclaimed by such customer); minus (B) any indebtedness of such customer to the debtor on the filing date; plus (C) any payment by such customer of such indebtedness to the debtor which is made with the approval of the trustee and within such period as the trustee may determine (but in no event more than sixty days after the publication of notice under section 78fff-2(a) of this title." 15 U.S.C. § 78lll(11). SIPA only permits the satisfaction of net equity claims and not the payment of damages for conversion, breach of contract, fraud or other theories of recovery. *See In re Bell & Beckwith,* 937 F.2d 1104, 1106 (6th Cir. 1991); *In re Alder Coleman Clearing Corp.*, 195 B.R. at 273; *In re Bell & Beckwith,* 124 B.R. 35, 36 (Bankr. N.D.Ohio 1990).

37 15 U.S.C. § 78lll(11). Typically, when SIPC places a brokerage firm into liquidation, the financial worth of a customer's account is calculated as of the filing date of the proceeding.

38 15 U.S.C. § 78fff-3(a).

39 15 U.S.C. § 78fff-2(c)(1); *In re Stratton Oakmont, Inc.*, 257 B.R. at 650 ("General creditors of the broker-dealer, customers with claims not satisfied by the broker-dealer or SIPC, and those who do not qualify as customers share on a pro rata basis any property available in the estate of the liquidated broker-dealer along with SIPC, which is subrogated to the customer claims that is satisfies.").

40 *See* SIPC, 2008 Annual Report, at 6, *available at* http://www.sipc.org/pdf/SIPC%20Annual%20Report%202008%20FINAL.pdf#xml=http://sipc.org.master.com/texis/master/search/mysite.txt?q=2008+annual+report&order=r&id=f8090072cc28ecac&cmd=xml.

41 *Id.*

42 *Id.* at 7.

43 *Id.*

44 *See* Discussion *infra*. Section IV.

II. Types of Coverage and Trigger of Coverage.

There are basically three types of excess SIPC coverage. One type, called "net equity" covers each eligible customer account up to the account's total value. A second type is called "aggregate limit" coverage. This is similar to net equity insurance, but there is a limit per customer account and an aggregate limit on the total payable for all accounts. A third type provides an aggregate limit for any one customer, but does not impose a cap on the total amount payable in the event of liquidation. All three forms are keyed to a "net equity" claim in excess of SIPC ceilings.

Generally, three things must happen before excess SIPC coverage is triggered. First, there must be a financial failure and liquidation of a broker-dealer pursuant to SIPA. Second, SIPC must have paid each client up to the ceiling permitted by SIPA (*i.e.*, the functional exhaustion of the limit in the underlying policy). Given the length of a SIPA liquidation proceeding, it may be years before a claim on an excess SIPC policy is ripe for submission. Finally, there has to be a loss within the terms and conditions of the policy.

III. The Customer Asset Protection Co. (CAPCO) Excess SIPC Surety Bond.

In 2003, several traditional excess SIPC insurers left the market, reportedly out of concerns over Enron and other corporate governance scandals.[45] In December 2003, fourteen large financial institutions created a captive insurer called Customer Asset Protection Company ("CAPCO").[46] The CAPCO Excess SIPC Surety Bond ("CAPCO Bond") provides "unlimited" protection to compensate customers for missing cash and securities.[47] The CAPCO Bond expressly incorporates the statutory terms and conditions of SIPA, including the definitions of "Customer," "Customer Property," "Net Equity," and "Securities."[48] The sole obligee under the CAPCO Bond is the Customer, not the broker-dealer, except if the customer itself is a broker, dealer or bank.[49]

The CAPCO Bond provides coverage as follows:

> In the event that SIPC files an application for a decree during the Bond Period in accordance with Section 5(a) of SIPA[50] with respect to the Principal, and any Customer of the Principal discovers a loss of Securities and/or cash held by the Principal during such Bond Period, the Company, on behalf of the Principal, agrees to provide payment or, at the Company's sole option, replacement of Securities in an amount equal to the total Net Equity (calculated as of the Filing Date under SIPA) of any Customer of the Principal; provided, such protection shall be excess over all receipts by a Customer with respect to the Customer's Net Equity, whether from the Principal, a Trustee or SIPC and whether funded by Customer Property, SIPC advances, the general estate of the Principal or otherwise ("Net Equity Receipts").[51]

Note that there are two preconditions to triggering coverage. First, SIPC must file an application for a protective order during the Bond period. Second, the customer must "discover" the loss during the Bond Period. The Surety Bond does not define what constitutes discovery, but presumably most customers will discover the loss when notified by the trustee.[52] While

45 *See* Joseph B. Teaster, *To Insurers, a Long, Free Ride is Looking Risky*, The New York Times (August 9, 2003) ("What has rattled the insurance companies now, insurance brokers and experts say, are the aftereffects of the disaster at Enron and other recent corporate governance and accounting scandals.") The insurers providing excess SIPC coverage were Travelers Property Casualty, Radian Asset Assurance and American International Group. *Id*. This coverage was provided on an "unlimited" or "full-net-equity" basis. *See* Toddi Gutner, *If Your Brokerage Goes Broke – How solid is coverage for losses over $500,000?* Business Week (Nov. 22, 2004).

46 *See New York Insurer Formed for 'Excess SIPC' Protection*, Business Wire (Dec. 22, 2003). The fourteen firms that formed CAPCO were the following: A.G. Edwards; Pershing – a subsidiary of The Bank of New York; Bear Stearns; Credit Suisse First Boston, Edward Jones; National Financial Services – a Fidelity Investments company; Goldman Sachs; JP Morgan Chase; Leg Mason Wood Walker Jr.; Lehman Brothers; Morgan Stanley; Robert W. Baird & Co.; Raymond James & Associates; and Wachovia Securities. *Id*.

CAPCO Participants with Excess SIPC coverage include: Ridge Clearing and Outsourcing Solutions, Inc.; Credit Suisse Securities (USA) LLC; Edward D. Jones & Co., L.P.; National Financial Services LLC; Goldman Sachs & Co.; Goldman Sachs Execution & Clearing, L.P.; JPMorgan Clearing Corp.; Lehman Brothers Inc.; Neuberger Berman LLC; Morgan Stanley & Co., Inc.; Raymond James and Associates; Robert W. Baird & Co.; Pershing LLC; First Clearing, LLC; and Wachovia Securities, LLC.

47 *See* CAPCO, *General Information – About CAPCO*, *at* http://www.capcoexcess.com/USA/aboutCAPCO.html; CAPCO, *CAPCO Sample Excess SIPC Surety Bond*, *available at* http://www.capcoexcess.com/USA/pdfs/sipcbond.pdf (hereinafter "CAPCO Bond").

48 CAPCO Bond, § B(8) ("All capitalized terms, if not defined herein, shall have the same meaning as used in SIPA.") Because the CAPCO Bond incorporates SIPA and the SIPC liquidation process, it reserves the right to renegotiate or cancel the policy in the event of a change in the law. CAPCO Bond, § B(1) ("Should any provision of SIPA be altered so as to affect the protection afforded by this Surety Bond, the Company shall have the option of accepting the alterations, renegotiating this Contract with the Principal, or serving a cancellation notice 90 days prior to the date of cancellation ….")

49 CAPCO Bond, § B(2) ("The Customers of the Principal are the sole obligees under this Surety Bond, and only the Customers shall be entitled to exercise any right of the obligees hereunder, except as may otherwise be specifically set forth herein.").

50 15 U.S.C. § 78eee(a).

51 CAPCO Bond, § A(1).

52 *See* 15 U.S.C. § 78fff-2(a)(1) ("Promptly after the appointment of a trustee, such trustee shall cause notice of the commencement of proceedings under this section to be published in one or more newspapers of general circulation in the form and manner determined by the court, and at the same time shall cause a copy of such notice to be mailed to each person who, from the books and records of the debtor, appears to have been a customer of the debtor with an open account within the past twelve month, to the address of such person as it appears from the books and records of the debtor.")

SIPA requires prompt notice to customers, there will undoubtedly be a gap between the appointment of a trustee and notice to customers.[53] It is, therefore, possible that a claim might be denied where the discovery occurred after the expiration of the bond period.

The phrases "loss of Securities" and "loss of cash" are not found in SIPA. As discussed above, a SIPC liquidation is triggered by failure to meet financial conditions and other factors, not the loss or disappearance of securities or cash. These phrases could be interpreted as requiring additional preconditions to coverage; namely, that the broker-dealer must have had possession of the securities or cash and subsequently lost them.[54] Where the broker-dealer never had possession of the securities or cash, as, for example, when the broker-dealer issues fraudulent confirmations or account statements, the insurer may contend that there was no loss and hence no coverage.

In addition, the CAPCO Bond is subject to a number of conditions and limitations, including the terms, definitions, conditions and limitations of SIPA (except as otherwise provided in the Surety Bond itself).[55] The Company is only obligated to make payment upon the occurrence of the following events: (1) the appointment of a Trustee; (2) a settlement between a claimant and the Trustee or the final determination of the Net Equity of the Customer by the Trustee; (3) payment or delivery of Securities and/or cash to the Customer in satisfaction of its Net Equity Claim up to the SIPC limits; (4) final distribution by the Trustee to the Customer from Customer Property; (5) final distribution by the Trustee to the Customer from the general estate of the Principal; (6) the receipt by the Company of a written claim from a Customer on the required form attesting to satisfaction of preconditions; and (7) an assignment of claims to the Company.[56] In short, the SIPC claims process and bankruptcy proceeding must be completed in its entirety, including final distribution from the general bankruptcy estate, before the insurer is obligated to make good on its obligation.

The CAPCO Bond also contains a number of exclusions, most of which are based on SIPA. It does not cover, among other things, (1) any loss for which a Customer's Net Equity claim against a Principal has been denied by the Trustee; (2) any loss of repurchase agreements, reverse repurchase agreements or loans made to the Principal; (3) any loss resulting from the diminution in the market value of a Security; (4) any loss of any kind or nature whatsoever that is not a loss of cash or Securities; and (5) any loss by any Customer deemed by SIPC, the Trustee, any duly constituted court or tribunal, or the Company, to have wrongfully caused or contributed to the loss and/or the insolvency of the Principal.[57]

IV. The Financial Meltdown.

In 2008, SIPC faced what it characterized as "unprecedented events" – the liquidation proceedings relating to Lehman Brothers Inc. in September 2008 and the liquidation of Bernard L. Madoff Investment Securities LLC in December – both of which it characterized as presenting "significant challenges."[58]

A. Lehman Brothers, Inc.

Lehman Brothers Inc. ("LBI") filed bankruptcy on September 14, 2008.[59] On September 19, 2008, the Court issued an order granting the application of SIPC for issuance of a Protective Decree adjudicating that customers of LBI were in need of protection under SIPA and appointed a trustee for liquidation of the business pursuant to section of SIPA.[60] Since then, the trustee has undertaken to transfer accounts, assess the assets available to the estate, investigate and analyze trading activity, and resolve customer claims.[61] Customers were required to file claims by June 1, 2009.[62] In what the trustee has characterized as the

53 *See e.g., In re Lehman Brothers Inc,* Case No. 08-01420 (SMP) SIPA (Bankr. S.D.N.Y.), Commencement of Legal Proceedings (December 1, 2008) (protective order entered on September 19, 2008 and notice by trustee issued on December 1, 2008).

54 All disputes regarding interpretation or performance of the Surety Bond are subject to binding arbitration in accordance with the Commercial Arbitration Rules of the American Arbitration Association. CAPCO Bond, § B(13); CAPCO Excess SIPC Surety Bond Claim Form, § IX, *available at* http://www.capcoexcess.com/USA/pdfs/sipcclaim.pdf. Both the Principal and the Claimant are required to keep all details of the arbitration and the underlying dispute confidential. *Id*. A failure of the Claimant to maintain confidentiality constitutes a forfeiture of the Claimant's claim against CAPCO. *Id*.

55 CAPCO Bond, § B(1).

56 CAPCO Bond, § B(2)(a)-(g).

57 CAPCO Bond, § A(4).

58 Harbeck Statement, *supra* note 18, at 2.

59 *In re Lehman Brothers Inc,* Case No. 08-01420 (SMP) SIPA (Bankr. S.D.N.Y.).

60 *SIPC v. Lehman Brothers Inc*., Case No. 08-CIV-8119 (GEL).

61 The activities of the trustee are described in the Trustee's First Interim Report. Trustee's First Interim Report for the Period September 19, 2008 through May 29, 2009, *In re Lehman Brothers Inc*., Case No. 08-01420 (JMP) SIPA (Bankr. S.D.N.Y. May 29, 2009) (hereinafter "Trustee's Report"), *available at* http://chap11.epiqsystems.com/clientdefault.aspx?pk=978bd245-11be-4d4b-83db-d6a3283b2962&l=1.

62 *Id*. Ex. 9.

"largest SIPA claims process in history" the trustee received over 11,000 claims.[63] As of that date, the trustee reported that he had determined 2,100 claims: allowing 95 claims, denying 927 claims, and denying and reclassifying 1,078 customer claims to general creditor claims.[64] Based on these statistics, less than five percent of the claims actually qualify for SIPC protection. The trustee also reported that he met with and provided updates to representatives of CAPCO, LBI's excess SIPC carrier.[65] The trustee is still in the process of determining the total value of customer property available for distribution and the total net equity of all allowed customer claims.[66] Until that process is completed and there is a final distribution from the general bankruptcy estate, no claim on the CAPCO Surety Bond would be ripe for submission, much less payment.

Apart from the restrictions on coverage, there are two other potential impediments to recovery on the CAPCO Bond. First, the bond provides that in the event of a "material misrepresentation" in the application process, the bond "shall be rendered null and void from inception."[67] Where the stakes are high, the insurer will likely scrutinize the application to see if there is a way to void or rescind coverage.[68] Coverage battles over this issue may take years to resolve. Even if the coverage issues are resolved in favor of the insured, it may be a hallow victory since it appears that CAPCO may not have the wherewithal to satisfy the claims.[69]

B. Bernard L. Madoff Investment Securities LLC.

The Bernie Madoff Ponzi scheme is reputed to be one of the most complicated and far-reaching financial frauds in U.S. history. On December 15, 2008, the U.S. District Court appointed a trustee for liquidation of the Bernard L. Madoff Investment Securities LLC ("BLMIS") pursuant to SIPA and removed the matter to bankruptcy court for further disposition.[70] This proceeding is highly unusual since there are basically no reliable records by which to reconstruct transactions.[71] As of mid-May, 2009, a total of 8,848 customer claims had been filed in connection with 3,565 customer accounts at BLMIS.[72] While the potential claims against BLMIS are huge, SIPC contends that the call upon its fund is "limited" because SIPA limits the maximum advance SIPC may make per customer claim.[73] Furthermore, the Madoff Ponzi scheme operated through a number of "feeder" funds. The Court noted that distributions under SIPA would go to those who invested in BLMIS directly as its "customers" rather than the substantial number of those whose losses stemmed from investments made through intermediaries.[74]

It appears that BLMIS had no excess SIPC coverage. Even if it had excess SIPC coverage, many

63 *Id*. ¶ 36.

64 *Id*. at ¶ 37.

65 *Id*. at ¶ 159. The CAPCO Bond requires the principal or its successor to promptly notify the insurer of any condition which is reasonably likely to result in payment under the bond. CAPCO Bond, § B(4). The CAPCO Bond provides, however, that the "Trustee and SIPC shall have no rights hereunder, except to the extent assigned to the Trustee or SIPC by any Customer." CAPCO Bond, § B(2).

66 Statement Regarding Determination of Customer Claims and Distributions, *In re Lehman Brothers Inc*., Case No. 08-01420 (JMP) SIPA (Bankr. S.D.N.Y. July 1, 2009), *available at* http://chapter11.epiqsystems.com/ViewDocument.aspx?DocumentPk=E5AB5858-ACAF-4763-8E76-98F806FDB77D.

67 CAPCO Bond, § B(1).

68 The CAPCO Bond is governed and construed in accordance with the laws of the State of New York. CAPCO Bond, § B(11). An insurer's right to void a policy is codified in the New York Insurance Law. New York State Insurance Law, § 3105(a) ("A representation is a statement as to past or present fact, made to the insurer by, or by the authority of, the applicant for insurance or the prospective insured, at or before making of the insurance contract as an inducement to the making thereof."). A misrepresentation is not considered material "unless knowledge by the insurer would have led to a refusal to make such contract." *Id*. § 3105(b). Under New York law, rescission may be an available remedy for the insurer even if the material misrepresentation was innocent or unintentional. *See Curanovic v. New York Central Mut. Fire Ins. Co.,* 307 A.D.2d 435, 436 (New York Sup. Ct. App. Div. 2003) (citing *Nationwide Mut. Fire Ins. Co. v. Pascarella,* 993 F.Supp. 134, 136 (1998)).

69 *See* Zachery Kouwe, *Billions in Lehman Claims Could Bury an Elusive Insurer*, The New York Times (July 31, 2009) ("By some industry estimates reviewed by the insurance department, Capco could face nearly $11 billion in claims but has only $150 million with which to meet them."); Letter from Senator Robert Menendez to The Honorable Timothy Geithner, Secretary of the Treasury (June 15, 2009) ("It is also worth mentioning that several of the largest broker dealers may face significant financial exposure through their membership in CAPCO (Customer Asset Protection Company). This captive insurance vehicle was created and designed to cover losses in the event of a member firm going bankrupt. It has become clear that this entity is thinly capitalized with insufficient funds to cover potential claims, opening the need for additional funding from the other members and potentially posing systemic risk.")

70 *See SIPC v. Bernard L. Madoff Investment Securities LLC,* Civ. 08-10791 (S.D.N.Y. Dec. 15, 2008). In this case, the factual predicate for the exercise of SIPC's jurisdiction was evidence presented by SEC and FINRA that the firm owed customers $600 million worth of stock that it did not have on hand. Statement of Stephen P. Harbeck, President and Chief Executive Officer, SIPC before the Committee on Banking, Housing and Urban Affairs, United States Senate (January 27, 2009) ("Harbeck Statement II"), at 6, *available at* http://banking.senate.gov/public/_files/HarbeckStatementSenateBanking12709.pdf.

71 SIPC, *SIPC: $61 million in Commitments Made to Madoff Claimants, with $100 Million Level Expected to Be Reached by Memorial Day* (May 14, 2009), *available at* http://www.sipc.org/media/release14May09.cfm (BLMIS Trustee Irving H. Picard said: "Due to the fact that every customer statement was a fiction, the first task was to reconstruct the books and records of BLMIS from scratch. This entails reconstructing every customer account from the ground up using BLMIS records, bank statements, email, records from third parties as well as documents received from customers through the customer claims process.")

72 *Id*.

73 Harbeck Statement II, *supra* note 66, at 7.

74 *S.E.C. v. Madoff*, No. 08 Civ. 10791 (LLS), 2009 WL 980288, at *1 (S.D.N.Y. April 10, 2009).

of the losses might not be covered. Since a large number of investors invested through intermediaries, they would not qualify as BLMIS "customers" and accordingly would not qualify for SIPC protection. Such investors would therefore not be covered under the CAPCO Bond. Moreover, as noted above, the CAPCO policy requires a loss of securities or a loss of cash. Where the securities were not purchased in the first instance, the insurer may contend that there is no coverage. Finally, as noted above, in the event of a "material misrepresentation" in the application, the CAPCO Bond is null and void from inception. Since the Madoff Ponzi scheme was a fiction, it is hard to imagine that the insurer would not contend that there had been a material misrepresentation in its application.

V. Post-Meltdown Excess SIPC Coverage.

Lehman Brothers Holdings, Inc was the parent of three broker-dealers who were CAPCO members. Shortly after Lehman Brothers filed bankruptcy, Standard & Poors ("S&P") placed CAPCO on CreditWatch.[75] On December 10, 2008, S&P downgraded CAPCO and reaffirmed its negative outlook.[76] The following day, CAPCO announced that its currently outstanding Excess SIPC Surety Bonds would not be renewed at their termination on February 16, 2009.[77] Consequently, many broker-dealers were forced to seek alternative coverage.

FINRA highlighted excess SIPC protection as one of the areas of particular significance to its 2009 examination program.[78] In particular, FINRA advised:

In light of the financial events of the past year, FINRA will review the disclosures provided to customers with regard to excess SIPC insurance. Firms that have not replaced excess SIPC surety bond coverage that was offered through the Customer Asset Protection Company (CAPCO) are expected to notify customers of this reduction in coverage. If firms have made alternative arrangements for excess SIPC coverage, the new arrangements should be clearly disclosed to customers, including the dollar amount of protection available to each customer.[79]

Many broker-dealers currently represent that they have excess SIPC coverage through "Lloyd's of London."

Reportedly, the London Market coverage ("Lloyd's Bond") applies an aggregate limit of liability and excess limits ranging from $100 million of aggregate protection (with a per customer limit of $5 million) to an aggregate policy limit of $1 billion (with per customer limits of up to $150 million for securities coverage and $1.9 million in cash coverage).[80] Broker-dealers largely summarize their coverage in promotional materials in terms of sub-limits per customer and aggregate limits of the financial institution.[81] Virtually no other information is provided, except that coverage may be provided through various Lloyd's syndicates or the overall financial strength of Lloyd's.[82] Additional questions are referred to the Lloyd's of London web site, which provides no information about Excess SIPC coverage.[83]

The Lloyd's Bond is written on an "all risk" basis subject to a number of conditions. In particular, the policy provides that the "insurance shall indemnify the Assured against All Risks of Physical Loss or Damage

75 *See* Standard & Poor's RatingsDirect, *Customer Asset Protection Co. "A+" Rating Placed On CreditWatch Negative* (Sept. 16, 2008) *available at* www.standardandpoors.com/ratingsdirect.

76 *See* Standard & Poor's RatingsDirect, *Customer Asset Protection Co. Rtgs Lowered to 'BB' from 'A+'; Rtgs Remain On CreditWatch Neg.* (Dec. 10, 2008) *available at* www.standardandpoors.com/ratingsdirect.

77 CAPCO, "Comment On S&P Report of December 10, 2009" (Dec. 11, 2008). At CAPCO's request, S&P ultimately withdrew its ratings assessment. *See* Standard & Poor's RatingsDirect, *Customer Asset Protection Co., Downgrade to "B-"; Ratings To Be Withdrawn* (Feb. 10, 2009) *available at* www.standardandpoors.com/ratingsdirect; Standard & Poor's RatingsDirect, *Customer Asset Protection Co., Ratings Withdrawn At Company's Request* (Feb. 10, 2009) *available at* www.standardandpoors.com/ratingsdirect.

78 FINRA Examination Proprieties Letter (March 9, 2009), on file with author.

79 *Id.* The CAPCO Bond also provides that in the event of non-renewal, "it shall be the responsibility of the Principal to duly notify its Customers and other investors of the discontinuance of coverage unless a succeeding company provides similar replacement protection without a lapse in coverage." CAPCO Bond, § B(1). It provides, however, that such non-renewal is nevertheless effective and that CAPCO has no obligation to notify customers or other investors of the discontinuance of coverage. *Id.*

80 *See* Willis HRH, *Beyond SIPC*, Executive Risks Practice First Word, at 1 (May 11, 2009), *available at* http://www.willis.com/Documents/Publications/Services/Executive_Risks/2009/First_Word_4_Beyond_SIPC.pdf; Lloyd's Bond, on file with author, at 1. In particular, the Lloyd's Bond provides that "the limit of liability of the Insurers hereunder as to any one account shall in no event exceed the limit per customer as set forth under the "'Sum Insured'". Lloyd's Bond, Condition 4.

81 *See e.g.*, Banc of America Investment Services, Inc. ($1.9 million for cash awaiting reinvestment; $1 billion aggregate loss limit for all customer claims); Fidelity (no per account dollar limit on coverage of securities, per account limit of $1.9 million coverage of cash awaiting investment and a total aggregate limit of $1 billion); Merrill Lynch ($1.9 million for cash; aggregate loss limit of $600 million); Morgan Stanley (protection for all clients up to the remaining net equity securities balance, subject to the firm cap of $1 billion); Raymond James (sub-limit of $1.9 million per customer for cash; aggregate limit of $750 million); Robert W. Baird & Co., Inc. (sub-limit of $1.9 million per customer for cash; aggregate limit of $250 million for all claims of customers); RBC Wealth Management (securities and cash protection up to $99.5 million per SIPC qualified account (of which $900,000 may be cash); maximum aggregate limit of $400 million); Wells Fargo (coverage up to $149.5 million (including up to $900,000 in cash) per client; aggregate limit of $600 million).

82 Raymond James represents that the Excess SIPC coverage is fully protected by the Lloyd's trust funds and the Lloyd's Central Fund. *See*, Raymond James, How Raymond James Protects Your Account.

83 *See* www.lloyds.com. A specimen policy is not available on the Lloyd's website. There are some summary descriptions of the coverage in promotional materials. The paucity of information about the policy may be the result of the Lloyd's Bond's restrictions on advertising. Lloyd's Bond, Condition 8.

which results in loss of securities and/or cash to the customer(s) as identified on the records of the Broker/Dealer or otherwise established to the satisfaction of the Insurers."[84] Similar to the CAPCO Bond, there must be a physical loss or damage resulting in loss of securities or cash. As with the CAPCO Bond, the Lloyd's Bond is expressly tied to SIPA requirements, including the filing of a SIPC liquidation proceeding during the policy period, and the exhaustion of the SIPC limit of liability and no replacement of securities or payment by the trustee, or from customer property, monies advanced by SIPC or the general estate.[85]

In addition to underlying SIPC eligibility requirements, the Lloyd's Bond provides as follows:

> There must be theft, misplacement, destruction, burglary, embezzlement, abstraction, or failure to obtain and maintain the special reserve bank account as required by rule 15c 3-3 (or any successor rule) of the Securities and Exchange Commission under the Securities and Exchange Act of 1934, as amended, or the wrongful acceptance or use of total credits under the formula referred to in such rule. The failure by a trustee, acting pursuant to the SIPA and the SIPC rules, to allocate all of the securities to which a customer was entitled in the pro rata distribution of customer property in those cases where customer property was found to be missing due to the perils mentioned in the beginning of this paragraph is insured if it results in a physical loss of securities to the customer.[86]

Thus, as with the CAPCO Bond, the Lloyd's Bond has a separate set of eligibility requirements, including that the loss must be occasioned by theft, misplacement, destruction, burglary, robbery or embezzlement. These terms are not defined in the policy, but are commonly used in other types of coverage.[87]

As is common in the London market, each of the subscribers is severally – not jointly – liable on the policy. In particular the policy provides:

> The liability of a (re)insurer under this contract is several and not joint with other (re)insurers party to this contract. A (re)insurer is liable only for the proportion of liability it has underwritten. A (re)insurer is not jointly liable for the proportion of liability underwritten by any other (re)insurer. Nor is a (re)insurer otherwise responsible for any liability of any other (re)insurer that may underwrite this contract.[88]

Thus, the customer faces the additional risk that one or more of the subscribers to the Lloyd's Bond may not have the financial wherewithal to respond to a claim.

VI. Conclusion.

Excess SIPC coverage is widely touted in the securities industry as providing significant additional protection over and above SIPC protection. The huge limits referenced in promotional materials suggest that institutional and high net-worth investors have ample protection from large and stable insurers in the event of a catastrophic loss. The reality is that the excess SIPC coverage is more of an advertising differentiator for broker-dealers than actual protection for their customers. The coverage does not come into play unless and until there is a SIPC liquidation proceeding, an investor qualifies as a customer and otherwise meets specific SIPA requirements, and an eligible claim exceeds the SIPC ceiling and it not otherwise recovered or paid out of the general estate of the debtor. It may be years before the underlying SIPC proceeding is fully resolved. Only when that process is completed would a customer be entitled to seek compensation under an excess SIPC policy and then, only to the extent that the claim meets the separate terms, conditions and limitations imposed by the excess SIPC policy itself. Apart from these terms, the insurer may well seek to void coverage in its entirety on grounds of a material misrepresentation in the application or other grounds. Even if the investor were to clear these hurdles, the financial strength of the insurer may diminish or frus-

84 Lloyd's Bond, at 2.

85 Lloyd's Bond, Conditions 1-4. In particular, Condition 4 provides, in part, as follows:

It is understood that the Insurers' obligation hereunder is to provide replacement or payment of that portion of the securities portion of the Net Equity of the customer of the Broker/Dealer as defined by SIPA and the rules and regulations thereunder that is not paid or otherwise satisfied by the trustee (appointed under Section 5(b)(3) of SIPA), from customer property monies advanced by the SIPC, or the general estate of said Broker/Dealer[.]

As with the CAPCO Bond, the Lloyd's Bond provides that in the event of changes in the applicable SIPA law (including legislative acts and administrative acts and court decisions), the parties agree to discuss suitable changes. Lloyd's Bond, Condition 17. In the event the parties fail to agree, the Bond operates as if the change had not occurred. *Id*.

86 Lloyd's Bond, Condition 3.

87 *See e.g*., Commercial Crime "Theft, Disappearance and Destruction Coverage Form" – Coverage Form C (ISO Form CR 00 04 10 90) ("Covered Causes of Loss" means "Theft", disappearance or destruction. Form C, § A.1.b); Coverage Form J "Securities Deposited with Others Coverage Form" (ISO Form CR 00 11 10 90) ("Covered Causes of Loss" are "Theft," Disappearance or Destruction. Form J § A.2.a-c)

88 Lloyd's Bond, (Re)Insurer's Liability Clause.

trate ultimate recovery. Certainly, the insurer's underwriting process provides some measure of assurance, but given these limitations, investors ought not to place much stock in the theoretical protection offered by excess SIPC coverage.

2010 TIPS CALENDAR

January

14-17 **Annual TIPS Midwinter Symposium on Insurance, Employment and Benefits** — **Hyatt Regency Coconut Point Resort and Spa, Bonita Springs, FL**
Contact: Debra D. Dotson – 312/988-5597

26-29 **FSLC Midwinter Meeting** — **Westin St. Francis Hotel, San Francisco, CA**
Contact: Felisha A. Stewart – 312/988-5672

February

3-9 **ABA Midyear Meeting** — **The Swan Hotel, Orlando, FL**
Contact: Felisha A. Stewart – 312/988-5672

April

8-9 **2010 Emerging Issues in Motor Vehicle Product Liability Litigation** — **Arizona Biltmore Resort & Spa, Phoenix, AZ**
Contact: Donald Quarles – 312/988-5708

9-10 **19th Annual Toxic Torts Spring CLE Meeting** — **Arizona Biltmore Resort & Spa, Phoenix, AZ**
Contact: Debra D. Dotson – 312/988-5597

17-21 **TIPS/ABOTA National Trial Academy** — **Grand Sierra Resort & Spa, Reno, NV**
Contact: Donald Quarles – 312/988-5708

May

6-7 **FSLC Spring Meeting** — **Loews New Orleans Hotel, New Orleans, LA**
Contact: Donald Quarles – 312/988-5708

12-16 **TIPS Spring Leadership Meeting** — **Ritz-Carlton Hotel, San Juan, PR**
Contact: Felisha A. Stewart – 312/988-5672