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## *Financial and Economic Crisis – Law Firms*

# D&O, E&O and Fidelity Insurance And The Crisis *Recovering From Insurance Companies*

*The Editor interviews Martin H. Myers, Partner, Jones Day.*

**Editor: What are the most significant types of claims for recovery against insurance companies being triggered by the financial crisis?**

**Myers:** The crisis is obviously spawning very significant claims. Typically, a significant percentage of those claims will be covered by insurance, particularly directors & officers liability (D&O) and errors & omissions (E&O) policies – for third party claims, and Fidelity Bonds and Crime/Dishonesty Policies – for first party claims.

**Editor: Do you have any specific examples?**

**Myers:** Sure. For example, financial institutions, funds and securities firms that placed money with entities such as The Stanford Group or Madoff are seeing claims by the investors or contributors of the money for alleged malfeasance, negligence and other conduct related to the placement of funds with those entities. These types of “third party” claims are typically covered by the D&O and E&O policies carried by such financial institutions. Litigation between financial institutions and investment firms over mortgage backed securities and collateralized debt obligations also frequently trigger D&O, E&O and other coverage.

**Editor: Who would you represent in such situations?**

**Myers:** We represent only the insured seeking a recovery against the insurance company. We have a policyholder side practice.

So, for example, if a bank or fund is accused by an investor of having negligently entrusted a billion dollars to Madoff, then we would represent the bank or financial institution in pursuing insurance for the investor’s claim. If an investment firm and a bank are locked in litigation over alleged wrongful acts in the issuance, packaging or handling of mortgage-backed securities, either side may have applicable D&O or E&O insurance. Large construction and infrastructure projects have stalled, and parties are asserting claims. These are very active areas of our practice.

A whole range of entities face significant insured exposures stemming from this crisis.

**Editor: Typically, would these claims be asserted both against the entity insured and against its individual directors and officers under the D&O or E&O policy?**

**Myers:** Yes. In fact, while D&O policies as originally conceived covered only the individual directors and officers, it has been the case for quite some time that both the E&O and D&O coverage will usually apply to the entity’s own liability. There was a development over the last seven or eight years which arose out of some of the big scandals of the early 2000s – Enron and WorldCom – which led to a very large surge in the purchase of what is called “Excess Side A DIC” or “independent directors” D&O coverage, which is basically coverage that applies only to claims against the outside or “innocent” directors.



**Martin H. Myers**

If it is found that one or more inside people cannot be insured or committed an actual fraud, the Excess Side A coverage is triggered and may “drop down” to protect only the innocent outside directors. Insurers also have offered allegedly “non-rescindable” coverage for such directors.

**Editor: Do you help clients negotiate with insurers to obtain appropriate coverage?**

**Myers:** I would say that something in the range of 20 percent of our practice involves advising on policy purchase decisions and insurance issues in transactions. This includes “manuscripting,” which is writing policy language which covers a client’s particular needs or situation, as well as assisting in negotiations with insurers.

**Editor: Have you found flexibility on the part of the insurance companies in negotiating changes in standard policy language?**

**Myers:** Historically, over the last 10 years the D&O and E&O markets were “soft” – meaning coverage was relatively inexpensive with a lot of competition among insurers and some flexibility in changing coverage. Against this backdrop and because of the expertise we have developed, we have had a lot of success in substantially enhancing the coverage that our clients obtain.

**Editor: One aspect of the crisis is that there is a chain of targets for potential claims starting with the origination of the mortgage, the sale of that mortgage to an investment bank, which packages it and other mortgages into a Collateral-**

*Please email the interviewee at [mhmyers@jonesday.com](mailto:mhmyers@jonesday.com) with questions about this interview.*

**ized Debt Obligation (CDO) that is finally sold to the ultimate investor. Is there a potential for insurance recovery in each link of this chain if the CDO proves toxic?**

**Myers:** Yes. But, CDOs are only one type of a broader class of securities based on mortgages or mortgage-backed securities. At each step in the development of such securities and their sale and purchase there are different layers of insurance carried by the various parties. Also, in many situations, the parties will have obtained a form of “financial guarantee” insurance for levels of investors in the securities. The participants and counterparties in credit default swaps (CDS) and other derivatives may also have claims under their D&O and E&O coverage. Which party you represent will determine the type of coverage claim you make.

**Editor: Who ends up with the ultimate liability?**

**Myers:** There is potential exposure at each step, so it is likely to be dispersed among insurers in different ways. Another factor here is that the finance arms of insurance companies have often been participants as investors or parties in CDOs, credit default swaps and other derivatives. So, insurers not only face exposure for the claims being made under the policies they have issued, but their financial arms also face financial exposure in their roles as parties to or participants in these instruments. This is a significant, relatively new frontier in insurance recovery work.

**Editor: Given the financial pressures on employees as a result of the current recession, I would expect there to be an increase in employee crime.**

**Myers:** Yes, the current financial crisis is likely to result in more employee-dishonesty and fidelity losses. This is another area that is growing in importance. For example, if a bank employee intentionally allows a third party to siphon \$10 million out of various accounts, the bank may recover under its first-party fidelity bond, or its crime or employee dishonesty policies.

**Editor: Do bankruptcies trigger insurance recovery issues?**

**Myers:** Yes. Typically we will represent a party or parties in a bankruptcy matter seeking coverage for large claims asserted by a trustee. We represent many debtors

and other parties who are the subject of significant claims, sometimes by bankruptcy trustees in the context of a bankruptcy proceeding. I had a large case for a semi-conductor manufacturer several years ago where a bankruptcy trustee pursued the company for a purchase of assets from a bankrupt competitor. There is more of that now in real estate context. A significant amount of insurance recovery work historically has revolved around large property interests. And, as finance obligations come due, the commercial real estate markets may see additional bankruptcies, and there will be claims involving the owners and financial entities that have held significant interests.

**Editor: What would be the nature of those claims?**

**Myers:** Some of it right now involves stalled and failed projects. Many projects were already underway or getting underway when the financial crisis began. This has led to significant litigation with respect to claims asserted under various types of policies and bonds. Large real estate and infrastructure projects will frequently involve different types of bonds backing the obligations of various parties so the bonds are often called into play in a failed or significantly stalled project.

**Editor: Are you involved in going after the bonding company?**

**Myers:** Yes. Those types of bonds are a form of fidelity insurance and they are typically issued or backed by a large insurance organization.

**Editor: We have been talking principally about your activities with respect to handling third party claims. What about first party claims?**

**Myers:** First party claims relate to direct losses suffered by the insured where the insurance proceeds are paid directly to the insured as opposed to insurance against a liability to a third party. A significant part of our business is asserting first party claims by financial and technology companies. A good example from the technology realm would be asserting a claim on behalf of a hardware manufacturer against an insurance company for recovery of damages resulting from a fire at a manufacturing plant which results not only in a tremendous loss in facilities, equipment and product but also in a loss of business income as a result of the shutdown of the plant.

**Editor: How did you develop a specialty in technology related insurance claims?**

**Myers:** Many of the clients I work with were once basically startups that developed into some of the country’s largest technology companies. My own practice grew up in Silicon Valley. As the risk management community grew and evolved in Silicon Valley, I developed significant expertise in the claims and issues that technology companies face and an appreciation of how those companies approach risk management and the history that got them there.

I have provided a significant amount of policy advice and manuscripting help to large technology firms, especially for complex technology risks. I have been one of the leaders over the last 10 years in helping the technology community – in Silicon Valley and elsewhere – develop better and stronger coverage for their unique needs. And, I have been part of some very interesting and unusual insurance products. Perhaps the most unusual was a tax loss insurance policy that a hard drive manufacturer purchased as part of a merger with a significant competitor in the early 2000’s. Essentially, when Maxtor, which was then the number two disk drive maker, bought what was then the number three disk drive maker, Quantum, it faced some potential tax problems relating to the structure of the transaction. We negotiated a roughly \$340 million package of insurance against the risk that the transaction would become taxable. In addition to a lot of knowledge of insurance and the insurance industry, it required a significant amount of knowledge of the disk drive industry.

**Editor: Considering the complexities involved in handling insurance recoveries for technology companies and the size of the problems relating to the crisis, how does your firm cope with the amount of business currently being generated?**

**Myers:** Jones Day is a firm that understands how and where to appropriately deploy resources. We have a very deep group of insurance recovery lawyers and we call upon each others’ expertise – and the expertise of our colleagues in other practices – frequently. As the volume of work expands, we are able to manage it by using existing resources. Because of the volume of situations we handle, we seldom face situations that are entirely new or unique. This works to the advantage of clients because we are able to handle matters expertly, expeditiously and cost effectively.