CPCU SOCIETY INSURING YOUR SUCCESS

Consulting, Litigation & Expert Witness Interest Group

Volume 16 • Number 1 • June 2009

Make Your Interest Group Selection Now to Be Included on the New Mailing List

To continue receiving a printed newsletter or to opt for electronic notification of the latest issue, you *must* choose a primary area of interest — if you have not yet done so. Go to www.cpcusociety.org, log in and click on "Interest Groups." For assistance, call the Member Resource Center at (800) 932-CPCU, option 4. Of course, as a paid Society member, you have electronic access to all interest group newsletters.

Message from the Chair

by Vincent "Chip" Boylan Jr., CPCU

Vincent "Chip" Boylan Jr., CPCU, is senior vice president of HRH of Metropolitan Washington, a subsidiary of Willis HRH. He is past president and a former education director of the CPCU Society's District of Columbia Chapter. Boylan has been a member of the CLEW Interest Group Committee for more than nine years and has served as the CLEW webmaster. Currently, he is chairman of the Insurance Agents & Brokers of Maryland, that state's affiliate of the National Association of Professional Insurance Agents.

For five consecutive years, the Consulting, Litigation & Expert Witness (CLEW) Interest Group has achieved Gold Circle of Excellence Award recognition from the CPCU Society. (Last year we earned Gold with Distinction.) Our entire interest group receives this honor, but it is the time and effort of CLEW Interest Group Committee members and individual activities of CLEW members that together meet the program's criteria.

Each spring, dozens of CLEW members respond to our call for details about their professional and volunteer activities that serve the insurance community and enhance the CPCU designation. The variety of endeavors and the commitment level displayed by CLEW Interest Group members are remarkable.

Here are just a few examples of the activities of CLEW Interest Group members:

J. Phillip Bryant, CPCU, J.D., along with seven other attorneys from his

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What's in This Issue

Message from the Chair

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firm, Rabbitt, Pitzer & Snodgrass of St. Louis, Mo., presented a mock trial during the CPCU Society St. Louis Chapter's All-Industry Day on April 15, 2008. Bryant arranged for an actual accident reconstruction expert and a sitting U.S. District Court judge to play their respective professional roles during the trial.

J. Scott Simmonds, CPCU, ARM, CMC, of Saco, Maine, published three insurance books (*How to Bid Your Insurance, Simmonds on Workers' Comp Insurance,* and *Simmonds on Bank Insurance*); spoke to 15 groups on insurance, risk management and business management issues; and served as an adjunct instructor at York County Community College.

In addition to teaching prelicensing exam classes, **Russell T. Sporer, CPCU,** of Ottumwa, Iowa, served as a member of Iowa's Commission for Affordable Health Care. This Commission conducted extensive study and submitted recommendations to the Iowa State Legislature on making health care more affordable and more accessible to citizens of Iowa. Substantial legislation was passed as a result of the Commission's work.

Jill Gidge, CPCU, CIC, CISR, CRIS, of Nashua, N.H., taught a variety of insurance classes throughout New England, including 34 flood insurance seminars; is a facilitator of CPCU Society Center for Leadership courses; is a designated Construction Risk and Insurance Specialist (CRIS) instructor; is a national Independent Insurance Agents & Brokers of America (IIABA) certified E&O instructor; and is on the editorial board of the *CSR Advisor,* published by the Standard Publishing Company.

Many of you are engaged in similar projects and programs as well as others that may be quite different. The dedication of CLEW Interest Group members to such diverse undertakings reminds me of the following quote by the late actor, Christopher Reeve: "Either you decide to stay in the shallow end of the pool or you go out in the ocean." CLEW Interest Group members clearly spend much time sailing the deep blue sea!

Recent CLEW Interest Group Programs

- **Chip Boylan, CPCU; Stanley L. Lipshultz, CPCU, J.D.; Donn P. McVeigh, CPCU, ARM; Robert L. Siems, CPCU, J.D.;** and **Lawton Swan, CPCU, CLU, ARM,** presented symposiums entitled, "How to Start Your Own Consulting Business" and "Order in the Court," in Chevy Chase, Md., on Oct. 29 and 30, 2008, respectively.
- **Akos Swierkiewicz, CPCU,** organized the "So You Want to Be an Expert Witness?" webinar, which ran on May 6, 2009.

Denver Annual Meeting Seminars

- **Stanley L. Lipshultz, CPCU, J.D.; Robert L. Siems, CPCU, J.D.,** and **George M. Wallace, CPCU, J.D.,** are leading "Mock Trial 2009 — Rocky Mountain Heist … Or Certificates of Insurance, Additional Insureds and Other Myths," on Sunday, Aug. 30, from 8 to 11:35 a.m. *(Filed for CE credit.)*
- **Nancy D. Adams, CPCU, J.D.; Gregory G. Deimling, CPCU, ARM, AMIM; Donald S. Malecki, CPCU;** and **Kathleen J. Robison, CPCU, ARM, AIC,** will present "What's Happening In Your Neighborhood — Condominium, Co-Op and Homeowner Associations," on Monday, Aug. 31 from 1:30 to 5:05 p.m. *(Filed for CE credit.)* This fast-paced game show presentation will cover the unique exposures, insurance issues and coverage forms affecting this large and growing residential housing segment. ■

Editor's Notes

by Jean E. Lucey, CPCU

Jean E. Lucey, CPCU, earned her undergraduate degree in English and graduate degree in library science through the State University of New York at Albany. After a brief stint as a public school librarian, she spent six years at an independent insurance agency outside of Albany, during which time she obtained her broker's license and learned that insurance could be interesting.

Serving as director of the Insurance Library Association of Boston since 1980, Lucey attained her CPCU designation in 1986. She is a member of the CLEW Interest Group Committee.

On behalf of the CPCU Society's Consulting, Litigation & Expert Witness Interest Group, I am pleased to present this edition of our newsletter.

CLEW Interest Group Chair **Vincent "Chip" Boylan Jr., CPCU,** has succinctly summarized our interest group's activities as well as the activities of a number of our members. We'd like to know more about what others — including you — are doing and to share that information with your fellow consultants, litigators and/or expert witnesses.

We are happy that people read these pages and grateful when they take the time and make the effort to participate, whether it takes the form of a "feature article" or a response to something someone else has contributed. Two such responses — one an illustrative case and one a short letter — are included in this newsletter.

Fellow CLEW Interest Group member **Frank Licata, CPCU,** offers some practical advice about communicating with clients regarding their investments in this age of Bernie Madoff. I'm afraid that Madoff's methods of doing business (or not doing it, as the case may be) cannot be assumed to be unique to him. Investors (and their advisors) beware.

Chip mentioned **J. Phillip Bryant, CPCU, J.D.,** in his summary of CLEW Interest Group member accomplishments. Bryant has also provided us with a cogent and timely article about the risks that landowners face in the context of injuries to employees of independent contractors hired to work on their premises.

I know that I — and I'll bet many of you — would not consider an issue of this newsletter complete were it to lack a contribution from **Donald S. Malecki, CPCU.** Happily, you can consider this issue complete, as he addresses the subject of the policy condition known as "Control of Property."

Lastly, there is always most certainly room for disagreement on the particulars of how to address economic and societal problems. The writer of an editorial published in the March 1939 issue of *Best's Insurance News*, and reprinted here, looked beyond petty differences to express what he felt to be the singular role of insurance professionals in the economy and, indeed, society. When we think of the A.M. *Best Reports* and related publications, it's nice to remember that there was in fact a person named **Alfred M. Best,** who held strong views and the impetus to express them. ■

Letter to the Editor

In response to "When the Phone Rings … Twelve Questions for Prospective Expert Witness Assignments," an article by **Kevin M. Quinley, CPCU, ARM, AIC,** that appeared in the December 2008 issue of the Consulting, Litigation & Expert Witness Interest Group newsletter, **Donald A. Way, CPCU, CLU, ARM,** of Thoits Insurance Service Inc. in San Jose, Calif., commented:

> Good article, but I would suggest that — ***before*** counsel gets into details — the expert should ***first*** complete a conflict check and ***second*** secure data regarding timing of discovery, reports, depositions and trial (if known.)

Editor's note: Following up, Kevin Quinley certainly agrees that these issues are key elements in the decision-making process. Quinley comments that while he addresses them in Questions 3 — "Who is the opposing party? (Any conflict?") and 5 — "What is the due date for the expert report?", perhaps they could be renumbered as Questions 1 and 2 to stress their importance. ■

New Interest Group Member Benefit

by CPCU Society Staff

Beginning Jan. 1, 2009, *every* Society member became entitled to benefits from every interest group for no extra fee beyond the regular annual dues, including access to their information and publications, and being able to participate in their educational programs and functions.

An Interest Group Selection Survey was e-mailed to members beginning mid-November. By responding to the survey, members could identify any of the existing 14 interest groups as being in their primary area of career interest or specialization. If you did not respond to the survey and want to take full advantage of this new member benefit, go to the newly designed interest group area of the Society's Web site to learn more about each of the interest groups and indicate your primary area of career interest. You will also see options to receive your interest group newsletters.

Currently, there are 14 interest groups: Agent & Broker; Claims; Consulting, Litigation & Expert Witness; Excess/Surplus/Specialty Lines; Information Technology; International Insurance; Leadership & Managerial Excellence (former Total Quality); Loss Control; Personal Lines; Regulatory & Legislative; Reinsurance; Risk Management; Senior Resource; and Underwriting.

As part of the Interest Group Selection Survey, members also were asked to express their interest in the following proposed new interest groups: Actuarial & Statistical; Administration & Operations; Client Services; Education, Training & Development; Finance & Accounting; Human Resources; Mergers & Acquisitions; New Designees/Young CPCUs; Nonprofits & Public Entities; Research; Sales & Marketing; and The Executive Suite.

Members who missed the Survey may update their selections on the Society's Web site or by calling the Member Resource Center at (800) 832-CPCU, option 4. Members can also order printed newsletters for nonprimary interest groups at an additional charge. ■

The **Agent & Broker Interest Group** promotes discussion of agency/brokerage issues related to production, marketing, management and effective business practices.

The **Claims Interest Group** promotes discussion of enhancing skills, increasing consumer understanding and identifying best claims settlement tools.

The **Consulting, Litigation & Expert Witness Interest Group** promotes discussion of professional practice guidelines and excellent practice management techniques.

The **Excess/Surplus/Specialty Lines Interest Group** promotes discussion of the changes and subtleties of the specialty and non-admitted insurance marketplace.

The **Information Technology Interest Group** promotes discussion of the insurance industry's increasing use of technology and what's new in the technology sector.

The **International Insurance Interest Group** promotes discussion of the emerging business practices of today's global risk management and insurance communities.

The **Leadership & Managerial Excellence Interest Group** promotes discussion of applying the practices of continuous improvement and total quality to insurance services.

The **Loss Control Interest Group** promotes discussion of innovative techniques, applications and legislation relating to loss control issues.

The **Personal Lines Interest Group** promotes discussion of personal risk management, underwriting and marketing tools and practices.

The **Regulatory & Legislative Interest Group** promotes discussion of the rapidly changing federal and state regulatory insurance arena.

The **Reinsurance Interest Group** promotes discussion of the critical issues facing reinsurers in today's challenging global marketplace.

The **Risk Management Interest Group** promotes discussion of risk management for all CPCUs, whether or not a risk manager.

The **Senior Resource Interest Group** promotes discussion of issues meaningful to CPCUs who are retired (or planning to retire) to encourage a spirit of fellowship and community.

The **Underwriting Interest Group** promotes discussion of improving the underwriting process via sound risk selection theory and practice.

Taking Another Dip in the (Risk) Pool

submitted by Jean E. Lucey, CPCU

Editor's note: Going back to the March 2008 issue of the Consulting, Litigation & Expert Witness Interest Group newsletter, a reader sent the following case as illustrative and supportive of the ideas expressed by **Daniel C. Free, CPCU, J.D., ARM,** in his article, "The Deep End of the (Risk) Pool: A Lifeguard's View."

Recommended for Full-Text Publication

Pursuant to Sixth Circuit Rule 206

File Name: 08a0229p.06

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

ASSOCIATED INDUSTRIES OF KENTUCKY, INC.,

Plaintiff-Appellant,

v.

UNITED STATES LIABILITY INSURANCE GROUP,

Defendant-Appellee.

No. 07-5662

Appeal from the United States District Court

for the Western District of Kentucky at Louisville.

No. 05-00270-Charles R. Simpson, III, District Judge.

Argued: March 11, 2008

Decided and Filed: June 27, 2008

Before: SILER, MOORE, and McKEAGUE, Circuit Judges.

Counsel

ARGUED: R. Kent Westberry, LANDRUM & SHOUSE, LLP, Louisville, Kentucky, for Appellant. Michael R. McDonner, O'BRYAN, BROWN & TONER, PLLC, Louisville, Kentucky, for Appellee. ON BRIEF: R. Kent Westberry, Jennifer A. Peterson, LANDRUM & SHOUSE, LLP, Louisville, Kentucky, for Appellant. Michael R. McDonner, Andrew N. Clooney, O'BRYAN, BROWN & TONER, PLLC, Louisville, Kentucky, for Appellee.

Opinion

SILER, Circuit Judge. Plaintiff Associated Industries of Kentucky ("AIK") appeals the grant of summary judgment in favor of defendant United States Liability Insurance Group ("U.S. Liability"). AIK sought a declaratory judgment ruling that U.S. Liability had a duty to defend AIK against several lawsuits in state court and a duty to cover any liabilities that might arise from the lawsuits. The district court held that U.S. Liability had no duty to defend AIK from the lawsuits, which arose from the operation of AIK's group self-insurance fund, AIK Comp. A contractual provision stated that U.S. Liability had no duty to defend AIK against lawsuits arising out of the operation of "any insurance plan or program." We agree with the district court that AIK Comp is an insurance program covered by the contractual exclusion provision and that U.S. Liability does not have a duty to defend AIK from the lawsuits in state court. Therefore, we AFFIRM.

Background

AIK is a trade association that represents business and industry in Kentucky. It offers a variety of services to its members, and it serves as the sponsoring trade association for AIK Comp, a group self-insurance fund operated pursuant to Ky. Rev. Stat. § 342.250 et seq. Kentucky authorizes self-insurance funds to serve as a vehicle for participants to pool their liabilities for workers' compensation benefits. A self-insurance fund operates the same way that any other insurer would — it collects premiums from employers in exchange for assuming their workers' compensation liabilities. However, a self-insurance fund differs from a typical insurer in one aspect. If the self-insurance fund cannot meet its obligations, each participant remains jointly and severally liable for the fund's outstanding liabilities.

In April 2004, AIK Comp notified the Kentucky Office of Workers' Claims that an audit of its loss reserves revealed that it understated its necessary reserves by a wide margin. AIK Comp had an initial deficit of $40 million, but the deficit now stands at over $90 million. To cover the deficit, AIK Comp charged additional assessments to its participants. Several AIK Comp participants refused to pay the additional assessments. Participants brought four related lawsuits in state court against AIK. The lawsuits alleged that AIK controlled and administered AIK Comp in a fraudulent and negligent manner. Specifically, the participants alleged that AIK set the AIK Comp premiums at artificially low levels to entice more participants to join the fund, thus creating the widening deficit. Three of the lawsuits have since been consolidated into a new class action with reformulated claims.

After the participants brought the lawsuits, AIK turned to its insurer, U.S. Liability, to defend the lawsuits and to cover the liabilities. U.S. Liability insured AIK and had a duty to defend AIK from lawsuits, but there was an exclusion provision for any claims resulting from the offering or administration of any insurance plan or program. The exclusion provision read:

> In consideration of the premium paid, it is agreed that the Company shall not be liable to make any payment for Loss or Defense Costs in connection with any Claim made

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Taking Another Dip in the (Risk) Pool

Continued from page 5

> against any Insured based upon, arising out of, directly or indirectly resulting from, in consequence of, the offering or administration of any insurance plan or program.

Asserting this contractual exclusion provision, U.S. Liability refused to defend AIK against the participants' lawsuits.

In response, AIK sought a declaratory judgment from the district court, arguing that U.S. Liability had a duty to defend it and to indemnify it. The district court granted summary judgment in favor of U.S. Liability, holding that AIK Comp was an insurance program, so the exclusion applied and U.S. Liability had no duty to defend AIK from the lawsuits.

Analysis

We review de novo a district court's grant of summary judgment. *Ciminillo v. Streicher,* 434 F.3d 461, 464 (6th Cir. 2006). In doing so, we apply the law of Kentucky in this diversity action. *Erie R.R. Co. v. Tompkins,* 304 U.S. 64, 78 (1938). In Kentucky, insurance contract interpretation is a matter of law. *Stone v. Ky. Farm Bureau Mut. Ins. Co.,* 34 S.W.3d 809, 810 (Ky. Ct. App. 2000) (citing *Morganfield Nat. Bank v. Damien Elder & Sons,* 836 S.W.2d 893, 895 (Ky. 1992)). An insurance company must defend its insured if the underlying allegations "potentially" or "possibly" bring the action within the scope of the insurance contract. *James Graham Brown Found., Inc. v.* No. 07-5662 *Associated Industries of KY v. U.S. Liability Ins. Group* Page 3 *St. Paul Fire & Marine Ins. Co.,* 814 S.W.2d 273, 279 (Ky. 1991). The terms of insurance contracts "have no technical meaning in law" and we interpret them "according to the usage of the average man and as they would be read and understood by him." *Id.* Kentucky employers are required to obtain workers' compensation insurance. Ky. Rev. Stat. § 342.630. However, certain large or financially capable employers are allowed to self-insure. 803 Ky. Admin. Regs. 25:021.

AIK's sole argument is that U.S. Liability must defend it from the state court lawsuits because "AIK Comp is not 'insurance' within the ordinary meaning of the term." AIK claims that AIK Comp is not an "insurance plan or program" covered by the contractual exclusion provision because AIK Comp is self-insurance and the participants remain jointly and severally liable for any liabilities that AIK Comp cannot cover. We do not find this argument persuasive and we do not think the Supreme Court of Kentucky would adopt this reasoning. While there is a difference between group self-insurance and what might be called traditional insurance, the AIK Comp group self-insurance fund offered "insurance" as defined by Kentucky law because the fund shifted risks.

Kentucky law defines insurance, in relevant part, as "a contract whereby one undertakes to pay or indemnify another as to loss from certain specified contingencies or perils called 'risks.'" Ky. Rev. Stat. § 304.1-030. Individual self-insurance means that an entity bears all of its own risks and purchases no insurance at all. Therefore, individual self-insurance is not "insurance" within the meaning of Kentucky law because it does not involve "a contract whereby one undertakes to pay or indemnify *another* as to loss from . . . 'risks.'" *Id.* (emphasis added). Unsurprisingly, AIK points to several decisions from other states holding that individual self-insurance is not insurance because it does not involve the shifting of risk to another. *See, e.g., Bowens v. Gen. Motors Corp.,* 608 So. 2d 999,1003 (La. 1992) ("This court has held that 'self-insurance is, in actuality, not insurance at all'"); *Am. Nurses Ass'n v. Passiac Gen. Hosp.,* 471 A.2d 66, 69 (N.J. Super. Ct. App. Div. 1984) ("so-called self-insurance is not insurance at all"). However, AIK Comp does not offer individual self-insurance. Instead, AIK Comp is a group self-insurer that pools the risks of numerous participants. Unlike an individual self-insured, group self-insurance participants shift their risks to another, the group self-insurance fund.

AIK points to *Hoffman v. Yellow Cab Co. of Louisville,* 57 S.W.3d 257 (Ky. 2001), and *Reeves v. Wright & Taylor,* 220 S.W.2d 1007 (Ky. 1949), for the proposition that all self-insurance is not insurance. In *Hoffman,* the Supreme Court of Kentucky held that Kentucky's law governing automobile insurers does not apply to individual self-insurers. 57 S.W.3d at 259-61 (rejecting argument that self-insured is liable for uninsured motorist benefits the same as if it had procured a liability insurance policy). Similarly, in *Reeves,* the Supreme Court of Kentucky held that a lessor of automobiles is not engaged in the insurance business when he procures a certificate of self-insurance in lieu of a liability insurance policy. 220 S.W.2d at 1010. *Hoffman* and *Reeves* are distinguishable because both cases involved businesses that individually self-insured over the amount of the relevant claim and retained the risk of loss without shifting any relevant risks to another. Although individual self-insurance is not insurance within the meaning of Ky. Rev. Stat. § 304.1-030, AIK Comp is group self-insurance, not individual self-insurance. The Supreme Court of Kentucky has not addressed the question of whether a self-insured group that pools risks provides "insurance" to its members.

AIK argues that AIK Comp is not insurance because the participants do

not transfer all of their risks to the fund. Instead, they remain jointly and severally liable for any shortfalls the fund may suffer. Thus, AIK contends, AIK Comp does not provide insurance but merely serves as a vehicle for members to pool risks to a limited degree. In support of its argument, AIK cites *Iowa Contractors Workers' Comp. Group v. Iowa Ins. Guar. Ass'n,* 437 N.W.2d 909 (Iowa 1989). There, a group self-insurance fund for contractors secured excess coverage to hedge against the risk of an unexpectedly large number of workers' compensation claims. *Id.* at 911. The fund later paid out a large number of claims and its excess coverage insurer became insolvent. *Id.* at 912. In search No. 07-5662 *Associated Industries of KY v. U.S. Liability Ins. Group* Page 4 of relief, the fund turned to the Iowa Insurance Guaranty Association, a state-created entity that protected insureds from insurer insolvency. *Id.* However, Iowa law prevented "insurers" from recovering from the Guaranty Association. *Id.* at 915. The Guaranty Association denied the fund's claim, reasoning that the fund was an insurer. *Id.* The Supreme Court of Iowa disagreed, finding that the workers' compensation group self-insurance fund fell outside the narrow statutory definition of an insurer. *Id.* at 915-16. The joint and several liability of the fund's participants meant that the participants retained some of the risk, distinguishing the arrangement from traditional insurance. *Id.* at 916. "While it is true that the Group does assume some risk, it does not assume all of the risks" because of the joint and several liability provision. *Id.* at 917. The group self-insurance fund was not insurance because it involved risk distribution or risk spreading, not risk transfer. *Id.*

Other courts have rejected Iowa's reasoning. *See Md. Motor Truck Ass'n Workers' Comp. Self-Ins. Group v. Prop. & Cas. Ins. Guar. Corp.,* 871 A.2d 590 (Md. 2005); *S.C. Prop. & Cas. Ins. Guar. Ass'n v. Carolinas Roofing & Sheet Metal Contractors Self-Ins. Fund,* 446 S.E.2d 422 (S.C. 1994). In the Maryland decision,

the court held that a group self-insurance fund with a joint and several liability provision for participants similar to that of AIK Comp. was an insurer. *Md. Motor Truck Ass'n,* 871 A.2d at 598. Regarding group self-insurance:

> … the retained risk is transferred from the individual (member) to the group and is spread throughout the group. The member may share with the other members joint and several liability for the overall, aggregate obligations of the group, but it is relieved of any direct obligation for payment of particular claims made against it. That is much more akin to the nature and concept of insurance than to that of non-insurance.

Id. at 595-96. The court rejected Iowa's distinction between risk transference and risk distribution. *Id.* at 598. Because all claims made against a participant were investigated, settled, litigated, and, if necessary, paid by the group self-insurer, not the participant, the group self-insurance fund fell within the definition of an insurer. *Id.*

Similarly, the Supreme Court of South Carolina held that a group self-insurance fund with a joint and several liability provision was an insurer because "there was a substantial transfer of risk." *S.C. Prop. & Cas. Ins. Guar. Ass'n,* 446 S.E.2d at 425.

> A single employer self-insured merely retains its own risk that an event will occur which will render it liable. Since insurance traditionally involves a transfer of risk from one entity to another, it is conceptually difficult to consider a single employer self-insured an insurer. In contrast, the members of a group self-insurer such as Roofers Fund transfer a portion of their risk to the group, and in turn assume a risk that belongs to the other members of the group.

Id. (internal citations omitted) (emphasis in original).

We find the reasoning of the Iowa court unpersuasive and we do not think Kentucky would follow it. Instead, we think the Supreme Court of Kentucky would follow the reasoning of the courts in Maryland and South Carolina. Group self-insurance with a joint and several liability provision involves the shifting of risks to the fund, and, in the case of insolvency, among the participants. While the participants may not shift their collective risks to an unrelated outside third party as typically occurs in a traditional insurance contract, they shift their risks to the fund. If the group self-insurance fund becomes insolvent, the risk from an individual participant is shifted to other participants because of the indemnity agreement. The indemnity agreement does not somehow shift the individual risk of each individual participant and only that risk back to that individual participant. Instead, the entire group is responsible for the collective liabilities of each individual No. 07-5662 *Associated Industries of KY v. U.S. Liability Ins. Group* Page 5 participant, and this arrangement is still risk shifting among participants. This risk shifting means that AIK Comp offered insurance as defined by Ky. Rev. Stat. § 304.1-030.

AIK Comp offered insurance because it involved risk shifting from the participants to the fund, and, in case of fund insolvency, among the participants. U.S. Liability does not have a duty to defend AIK from any lawsuits arising from the offering of an insurance program due to the contractual exclusion provision.

AFFIRMED. ■

After the Madoff Scandal — How to Manage the Risk to Your Investments

by Frank Licata, CPCU

Frank Licata, CPCU, president of Licata Risk Advisors Inc., has more than 20 years' experience in the risk management field, including a decade-long engagement with one of the country's largest independent risk management consulting firms. He is president of the CPCU Society's Boston Chapter and a member of the Consulting, Litigation & Expert Witness Interest Group.

Editor's note: This article appears on the Web site of Licata Risk Advisors Inc. (www.licatarisk.com) and is reprinted with permission.

Are your invested funds secure? We're not talking about possible market losses (you're willing to assume those risks — it's part of the game), but rather losses from fraud. You'll be amazed to know that those losses are not necessarily recoverable. It depends on whom you're doing business with, what type of contractual arrangement you have with them, and what type of insurance they carry. As usual, the risks need to be managed. What follows is an actual letter/report we issued to a client a couple of years ago (with all names scrubbed off, of course). If you or your clients have funds invested, we think you will find it very interesting and very important:

Re: Security of Invested Funds

Dear Client:

We reviewed the issue of security of funds in custody of various investment advisors, and have comments and recommendations.

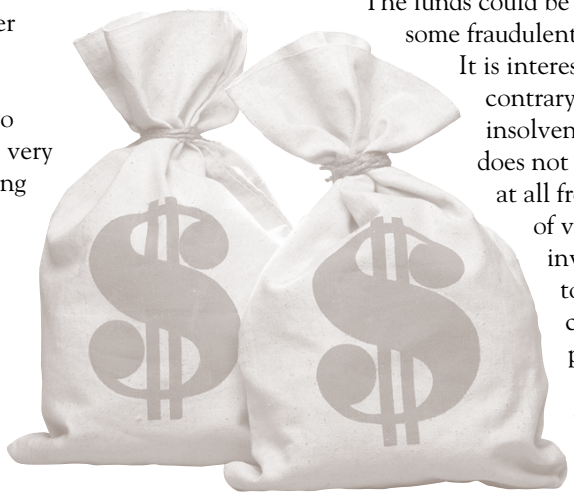
Our review did not consider market risk, but rather focused on two areas of concern: (1) Insolvency of the firms which have custody of the funds, and (2) Theft or fraud.

We asked the following firms for information re their insurance coverage and reviewed their contracts with you: xxxxxx, xxxxxx and xxxxx. xxxxx never did provide any information to us, while the other two organizations were very cooperative in trying to accommodate our requests. We discussed with them contract changes which would be possible if we requested same. In addition we approached the following organizations on a no-names-given basis to determine what insurance they carry and to discuss their contract terms to serve as a benchmark: xxxxx, xxxxx and xxxxx.

Overview

In general, it is best to break the invested assets into small packets, with the funds distributed among as many different firms as possible. For example, breaking $100 million into 10 packets of $10 million each would reduce the amount subject to any single loss. However, we understand there may be issues of cost or control that argue in the other direction. If the funds are not divided, the risk has to be managed.

The risk of insolvency is the more easily handled issue of the two, in that funds can be put in segregated (fiduciary) accounts and/or that very high SIPC and Excess SIPC insurance limits are generally carried by the investment firms. With fiduciary accounts, the investor money is not commingled with general assets — and so should be secure in the event of a failure of the institution — and SIPC (the Securities Investor Protection Corporation) insures investor funds against loss due to insolvency of investment firms. Because this risk is more easily mitigated than the fraud risk, we think it's best to focus on the fraud risk at this time.



The funds could be stolen via some fraudulent scheme. It is interesting that, contrary to the risk of insolvency, this risk does not get managed at all from the point of view of the investor, if left to usual and customary practice. Also, there are reported cases where theft has occurred,

and the firms have not stepped up to make their clients whole.

This risk could be addressed in two ways: (1) Via crime insurance which is carried by the investment firm, and (2) Via the contract between the firm and the investor.

Crime Insurance Carried By Investment Firm

Crime insurance terms and conditions — and limits — varied drastically among the firms we looked at, but all had one thing in common: The named insureds under the policies are the investment firms, not the investors. In other words, the coverage is for the benefit of the firm, not the individuals whose funds are at risk. The policies do cover loss of investor funds to the extent that the firm is legally liable for the loss, but again only for the benefit of the firm. If the contract with the investment firm effectively limits the firm's liability, that would prevent the insurance coverage from being triggered. Thus, the contract language is important and ties in with the insurance issue.

The crime insurance limits carried by the various firms are as follows:

xxxxx: $5 million

xxxxx: $15 million

xxxxx: $20 million

xxxxx: $100 million

xxxxx: $125 million

The limits shown above are aggregate limits, which are limits that apply to all loss in total within the one-year-policy period. Therefore, the limits are not dedicated to any one customer's funds or to any one event.

It would be ideal for the investment firm to provide first party crime coverage for our benefit, at their expense. Such first party coverage, depending on its terms, could provide us reasonable protection without considering the question of liability. We asked xxxxx to quote insurance on that basis. The quote was not helpful in that limits were too low and price was unrealistically high. They did not offer to absorb the premium.

Terms and conditions delineating coverage are also an important issue, of course. We have only reviewed the actual policies of xxxxx and xxxxx. The xxxxx policy appears to have gaps; the xxxxx policy provides what we consider adequate coverage.

The insurance is important to us because it can provide a fund out of which the firm can make the investor whole, if they are not allowed to escape liability via the contract terms.

The Contracts between You and the Investment Firms

Below are the relevant sections of the contracts with the existing firms:

xxxxx

On Page 2, the following language appears:

> "The Investment Manager shall not be under any liability for acting upon Client instructions or communications, whether written, verbal or via facsimile, that it believes to be correct."

This attempts to relieve the Bank from liability for accepting fraudulent instructions, even if the Bank is negligent.

The paragraph following the one quoted above reads as follows:

> "The Investment Manager will not be under any liability for any act or failure to act with respect to investment management or other services pursuant to this Agreement except in the case of bad faith, gross negligence or willful disregard of its duties. In addition, the Investment Manager will not be subject to liability to the Client, the Account, or any other party with respect to any act or omission of any broker, dealer, custodian or other agent, provided that the Investment Manager exercised reasonable care in selecting such party."

This language is a general release of liability, except for egregious acts. We would have no recourse in the event of ordinary negligence with respect to the Investment manager's own acts. With respect to acts of others named, there is an attempt to limit the Bank's liability. xxxxx did agree to amend the above standard from gross negligence to ordinary negligence.

xxxxx

> Article 9 is a limitation of liability which is not as harsh as the one demanded by xxxxx, in that xxxxx will accept liability for their own negligence. To succeed in a claim

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After the Madoff Scandal — How to Manage the Risk to Your Investments

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against xxxxx, we would have the burden of proving negligence.

xxxxx

The contract is silent with respect to liability. The lack of a limitation of liability can be an advantage, possibly allowing us recourse due to their custody of the funds, absence of negligence notwithstanding.

Below is a summary of the treatment of the issue by specimen contracts provided by three other firms, after negotiation by us:

xxxxx

Not liable except for gross negligence or willful misconduct. However, xxxxx understands our request for amendments and pledges to achieve same; they want a meeting with the client.

xxxxx

The contract is silent with respect to liability. Similar to xxxxx.

xxxxx

Similar to xxxxx, except xxxxx agrees to provide an exception for fraud. This could be the broadest of all the agreements with respect to fraud in that the burden of proving negligence is absent. xxxxx also pledges to meet our requirements with respect to contract language, but requests a meeting.

The above comments address the issues in summary. The contracts may need discussion/amendment in various other areas to make them tight. We defer to your attorneys, of course, with respect to the last word on contract language. Alternatively, we could involve attorneys who work with us on a daily basis.

In summary, the insurance coverages and contract terms vary widely. If the funds are not split into smaller bundles, more attention should be paid to managing the risk. There are options out there, some much better than others in this respect. We believe some changes should be made to effect better security for the funds. I look forward to discussing it at our upcoming meeting.

Sincerely, ■

Landowner Liability for Injuries to Employees of Independent Contractors

by J. Phillip Bryant, CPCU, J.D.

J. Phillip Bryant, CPCU, J.D., is a principal of Rabbitt, Pitzer & Snodgrass PC, in St. Louis, Mo. Before joining the firm, he was a claims adjuster for several years. Bryant earned his CPCU in 1994 and his J.D. from Saint Louis University School of Law in 1999. He is admitted to the Missouri and Illinois Bars and also admitted to practice in the United States District Court of the Eastern District of Missouri and the Southern District of Illinois. Bryant is a member of the CPCU Society's St. Louis Chapter and the Consulting, Litigation & Expert Witness Interest Group.

Owners of land, or their property managers, often hire independent contractors to perform work on the premises. But if an employee of that independent contractor is injured and is covered by workers compensation, can he effectively claim premises liability against the landowner? Many jurisdictions hold that the contractor's employee cannot sue the landowner, but exceptions to that general rule may apply. Other states invoke a similar rule but without a direct connection to the applicability of workers compensation. This article mentions only states that base their analyses on the presence of workers compensation coverage.

Assume a homeowner hires a contractor to replace the roof. The contractor's employee falls to the ground, sustaining serious injury. Alternatively, consider a common scenario that a business hires a janitorial firm to clean its offices afterhours. Is the business liable to the firm's employee if he trips and falls over loose carpet? Either one of these injured people may consider making claims for premises liability against the landowner.

If the injured worker is subject to the jurisdiction's workers compensation laws, the worker may be precluded from suing the landowner in tort, subject to exceptions. For instance, under Missouri law, the general rule is that a landowner is not liable for injuries to the employees of independent contractors for work done on the premises if the employees are covered by the independent contractor's workers compensation insurance. In Missouri, that is true even in cases where the landowner was directly negligent. The rule is adopted to reflect the "economic reality" of the workers compensation system.

Where a contractor's employees are covered by workers compensation, the amount that the contractor charges the landowner includes the cost of the contractor's workers compensation insurance. To make a landowner liable for the injuries suffered by the independent contractor's employees would, in effect, force the landowner to pay for the same injury twice. The key issue is whether the independent contractor was subject to workers compensation laws, not whether the injured employee actually recovered workers compensation benefits.

In Kansas, a hole that had been cut into the floor of a meat packing plant was obscured by debris. A contractor's employee stepped into the hole injuring her ankle and knee. That employee collected workers compensation benefits and filed a separate lawsuit in which she alleged that the property owner was negligent in maintaining a dangerous condition and in failing to warn of the dangerous condition. The Kansas court followed Missouri's rationale to bar a cause of action against a landowner in these circumstances except in cases in which the landowner exerts sufficient control over the details of the work.

A California court denied recovery against a homeowner by an independent contractor's worker when that employee fell from a ladder and was burned by hot tar. That court noted that the employee was subject to workers compensation coverage and the doctrine of peculiar risk afforded no basis for the employee to seek recovery of tort damages from the homeowner who hired the contractor but did not cause his injuries.

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Landowner Liability for Injuries to Employees of Independent Contractors

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In Wisconsin, during the demolition of a property owner's building, an independent contractor's employee was injured when he fell through the roof. That court held that an employee of an independent contractor was precluded from receiving workers compensation benefits from his employer and also maintaining a tort action against the person who employed the contractor unless that person was affirmatively negligent with respect to the employee.

As with most any rule, exceptions may apply. A common exception to this rule is that the landowner may be liable when the landowner substantially controls the physical activities of the employees involved or the manner in which the work is done. Questions may then arise, given the particular facts, of the amount of control exercised by the landowner needed to reach a level of substantial control to make him/her liable.

It has been found that a landowner present at a job site solely to insure that construction would proceed properly was a degree of supervision inadequate to impose liability on the landowner. In a separate case, a landowner was found not to have exhibited the required degree of substantial control merely because the landowner chose a type of paint that was not available in a safety spray.

A landowner who spoke to a worker about being sure there was adequate insulation around pipes under the floor joists and not to insulate around a ceiling fan was found not to have substantially controlled the worker's activities. That landowner made no effort to tell the worker how to do his job, how he was to proceed, or in what order the job should proceed.

The property owner's selection of a project manager who allegedly committed negligent acts was found not to be substantial control. Even though a landowner insisted that windows of a tall building be washed from the outside rather than the inside, the landowner was found not to have exhibited substantial control when the window washer made a claim for injuries following his fall.

Holding a worker's ladder and handing a wrench to him were found to not reach a level of substantial control. A landowner who suggested a location for the placement of a cable along a roof beam did not exhibit substantial control.

A landowner who told workers the location of a damaged utility pole and supplied cable to perform splicing did not exhibit the required substantial control. A landowner did not exert substantial control even though the landowner created drawings for the workers to follow, approved a sequence of construction, and dictated how the workers were to install cables.

Some states recognize an exception sometimes called the Peculiar Risk Doctrine or the "inherently dangerous" exception. This exception requires that, at the time of engaging the contractor, the principal should foresee that the performance of the work or the conditions under which it is to be performed will, absent precautionary measures, probably cause injury. Such work has been described as work necessarily attended with danger, no matter how skillfully or carefully it is performed. That is, work is inherently dangerous if the danger exists in the doing of the activity regardless of the method used.

If proper precautions can minimize the risk of injury, many jurisdictions do not consider the activity to be inherently dangerous. For example, it has been found that working with asbestos can be perilous, but that is not enough to render the job inherently dangerous. Consider the case of an employee killed while working in a deep trench when the sides caved in. It was held that trenching is not intrinsically dangerous work. Although working in a trench can be dangerous, the use of proper procedures renders the work relatively safe.

Examples of inherently dangerous activities include working with toxic gases or transporting nuclear waste. The states that impose liability for inherently dangerous activities do so because of public policy concerns. The employer of the contractor is not permitted to shift the responsibility for the proper conduct of the work associated with abnormally dangerous activities to the contractor.

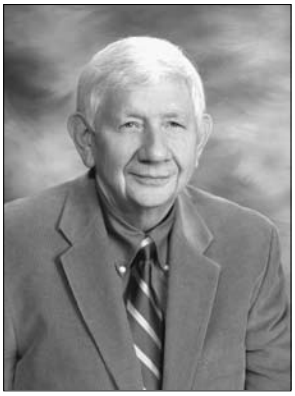
Of those states that recognize the peculiar risk doctrine, it typically does not apply if the dangerous condition is obvious to the contractor. Some states refuse to apply the peculiar risk exception if the purportedly dangerous condition was the part of the premises on which the contractor was working. The rationale is that the contractor was notified of the dangerous condition when it contracted to repair that matter.

California and Missouri do not permit actions against landowners for injuries to employees of independent contractors covered by workers compensation who are injured while performing inherently dangerous activities. Wisconsin does permit actions when the independent contractor's employee is injured while performing inherently dangerous activities.

In the event that the employee of an independent contractor who is subject to workers compensation laws makes a claim for injuries against a landowner, an analysis should be made of the extent of control that the landowner exercised over the worker's activities or over the job site. A determination may also be warranted if the worker was engaged in an inherently dangerous activity at the time of his/her injury. ■

Q&A with Donald S. Malecki, CPCU

by Donald S. Malecki, CPCU



Donald S. Malecki, CPCU, is a principal at Malecki Deimling Nielander & Associates LLC, based in Erlanger, Ky. During his 45-year career, he has worked as a broker, consultant, archivist-historian, teacher, underwriter, insurance company claims consultant, and as publisher of *Malecki on Insurance,* a highly regarded monthly newsletter.

We were informed, or we might have read somewhere, that the Control of Property Condition found in the property forms of the Insurance Services Office (ISO) and some insurers could serve as a Separation of Insureds Condition, much like what is found in many liability policies. The specific condition found, for example, in the ISO Commercial Property Conditions Form CP 00 90 reads:[1]

> Any act or neglect of any person other than you beyond your direction or control will not affect this insurance.
>
> The breach of any condition of this Coverage Part at any one or more locations will not affect coverage at any location where, at the time of loss or damage, the breach of condition does not exist.

The reason we ask is because of a claim which we think might be covered in light of the Control of Property Condition. The situation is this: A building owner permitted a tenant to do some extensive internal improvements to better suit the tenant's operations. The work, however, was so poorly performed that it actually resulted in extensive damages to the owner's property, requiring a substantial amount of money to rectify. When the owner submitted a claim to its insurer, it was denied on the basis of faulty, inadequate or defective workmanship, construction, repair, renovation of any part of the property at the described premises. Is this true that the Control of Property Condition has the same effect as the Separation of Insured Condition or have we been misinformed?

By the way, Property Form CP-100 of the American Association of Insurance Services (AAIS) also contains a condition entitled "Control of Property" that reads: "The Commercial Property Coverage is not affected by any act or neglect beyond your control."[2]

If you had the time and the proper resources to conduct research tracing the history of this condition, you would likely come to the same conclusion as what you may have heard or read. Early insurance history points out not only the need for a control provision, but also another one dealing with divisibility. The latter part of the above quoted condition makes clear that if, for example, the named insured owns and insures two buildings on one policy and coverage is breached at one of the locations because of vacancy or unoccupancy, coverage remains unaffected at the other location. It was recommended in the early 1900s that fire policies be endorsed so as to be considered both divisible and several, as if separate policies had been issued on each building or its contents or both.

In one 1922 publication to assist insurance agents, it was recommended that fire policies be amended with a provision stating: "This insurance shall not be invalidated by the act or neglect of any other occupant of the within described premises, providing such act or neglect is not within the knowledge or control of the insured."[3] The reason given for this recommendation was that some authorities, at that time, held that a breach of a policy condition by any tenant of a building adversely affected all insurance coverages applicable to the covered building.

When the Special Multi-Peril package policies were introduced in 1960 for the "better-than-average risks," they automatically included a "no control" provision that consisted of what is referred to today as the "control" condition, plus the "divisibility" clause. Interestingly, both the 1966 and 1973 editions of the "no control" provision were more limited in scope than the "control" condition of the AAIS and ISO forms. The "no control" portion of these package policy conditions stated that the insurance would not be prejudiced by any act or neglect of the owner of any building, if the insured is not the owner, or by the act or neglect of any occupant (other than

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Q&A with Donald S. Malecki, CPCU

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the insured) of any building, when such act or neglect of the owner or occupant is not within the control of the insured.

The title "no control" apparently gave way to "control of property" in the early 1980s. The Special Risk Property Form CF 00 13, carrying an edition date of January 1983, for example, contained both a Control of Property and Divisible Contract Clause reading:

> **2. Control of Property:** This insurance shall not be prejudiced by any act or neglect of any person (other than the named insured), when such act or neglect is not within the control of the named insured.
>
> **3. Divisible Contract Clause:** If this policy covers two or more buildings, the breach of any condition of the policy in any one or more of the buildings covered or containing the property covered shall not prejudice the right to recover for loss occurring in any building covered or containing the property, where at the time of the loss, a breach of condition does not exist.

As a matter of interest, the Divisible Contract Clause has since been eliminated with its provisions currently forming the second part of the Control of Property Condition of current ISO forms.

If the current ISO or AAIS Control of Property Condition were to read like it did in the 1920s, when it had to be specifically included in fire policies, insurers would have a better argument for denying claims such as the one mentioned earlier. The reason is that earlier provisions made policies several only for the act or neglect of another occupant of the described premises, provided such act or neglect was not within the knowledge or control of the insured. Under current standard forms, however, the Control of Policy Condition states that any act or neglect of any person beyond the direction and control of the named insured will not affect the insurance.

This latter provision, furthermore, does not place a time limit on when that act or neglect has to take place. Property insurance, similar in some ways to liability insurance, provides coverage at the time of physical loss or damage to covered property and not when the faulty work was actually performed. So, the fact that work was performed on covered property years prior to the physical loss or damage should be of no relevance, unless a court were to decide that the physical loss or damage was simultaneous to when the faulty work was performed on the covered property. (This is a subject that requires more space than can be devoted here.)

To answer your question concerning the specific loss scenario, there should be no basis for an insurer's denying the claim based on faulty or negligent work, unless, of course, the named insured has some direction or control over the work as it was being performed. These conditions, as forming a part of the AAIS and ISO forms in effect, serve the same purpose as the Separation of Insureds Condition of the commercial liability forms.

One of the problems insureds are likely to encounter when raising the Control Condition is the specific lack of a Separation of Insureds Condition. Courts must be made to understand that severability of interest was always intended in policies and that inserting such a provision was not to broaden coverage but merely to clarify what was always intended. With a Control Condition, as it currently reads in property policies, a Separation of Insureds Condition is not necessary. Unfortunately, convincing the court is likely to require an attorney who is well-versed in the subject and not someone who simply interjects this condition as one of the arguments and hopes it will be accepted. The chances of that happening range from nil to none.

In closing, it should be mentioned that those who need answers to questions that require research, or who need old or new documents on the subject of insurance and risk management, should keep the Insurance Library Association of Boston in mind. This library has a small staff of skilled researchers whose fees are very reasonable, considering the results of their efforts. The library director, in fact, is **Jean E. Lucey, CPCU,** the editor of this consistently fine publication. ■

Endnotes

1. ISO Commercial Risk Services, Inc. Copyright, 1983, 1987.
2. American Association of Insurance Services. Property Form CP-100.
3. *The Agents Key to Fire Insurance,* 3rd ed. New York: The Spectator Company, 1922.

A Timeless Editorial

submitted by Jean E. Lucey, CPCU

Editor's note: The following editorial was written by Alfred E. Best in 1939 for *Best's Insurance News,* the publication of the Alfred M. Best Company Inc. that later became *Best's Review®. Best's Insurance News,* March 1939.

Insurance Fundamentals

Living as we are in an unsettled world, it is comforting to realize that the insurance business is based upon and has always adhered to certain fundamental principles upon which the greatness of our country has been built. The business of insurance as we know it began when a group of merchants and shippers sat around a table and agreed to divide the loss if a ship and cargo owned by one of them was lost at sea. This agreement was necessarily based on the recognition of two things: first, good faith on the part of those entering into it, and second, their ability to meet their obligations. From that beginning the principle of insurance has developed into the greatest business in this country, without which general business activities would cease. Scores of different kinds of contracts are being issued, but throughout this development the business has never wavered from its adherence to sound ethical and economic principles.

What are these principles upon which our country and the business of insurance have grown great? To work, to save, to pay our debts and treat every man honestly and fairly. The philosophy of the insurance business is well summed up in the clause which will be found in every reinsurance contract, reciting that it is not to be construed technically, but as an "honorable engagement."

We all know that society cannot exist unless reliance may be safely placed upon promises and contracts. Yet, as we examine conditions throughout the world, including our own country, we see momentous events determined by brutal force, instead of reason and fair play. We

see Governments ruthlessly violating their most solemn agreements. Remembering what we have always considered as the fundamentals of a sound and ethical society — to work, to save, to meet obligations, to treat everyone fairly — we find in our own country teachings which by those tests are bad economics, bad finance, bad psychology and bad morals: bad economics because unsound theories retard recovery by making it impossible to plan for the future, and by unfair competition with private enterprise; bad finance because of reckless extravagances incurred; bad psychology because this propaganda undermines self-reliance and self-respect; and bad morals because they laugh at repudiation. Yet under this barrage of propaganda, insurance men may without egotism feel proud of the fact that they still adhere to the old tried and sound principles of business and ethics.

In trying to determine our duties to our country as insurance men, what better course is there than to continue to uphold sound business and ethical principles? Regardless of what others may do, let us work, save, meet our debts and be honest; let us know thoroughly the business in which we are engaged, and let us think first of the public in considering problems affecting the insurance business, rather than trying shortsightedly to promote selfish interests at the expense of the public.

Finally, let us not miss any opportunity to impress upon others the present principles which govern our business, and the importance of carrying those principles into all lines of activity — social, business and political. However difficult this task may seem, the story cannot be told too often, and some of the seed is bound to fall upon fertile ground. ■

Consulting, Litigation & Expert Witness Interest Group
Volume 16 • Number 1 • June 2009

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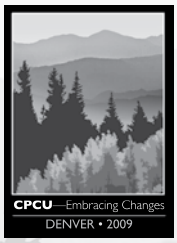

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