CPCU SOCIETY INSURING YOUR SUCCESS

Coverage, Litigators, Educators & Witnesses Interest Group

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Message from the Chair — Notice Anything Different?

by Vincent "Chip" Boylan Jr., CPCU

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

Hopefully, you immediately noticed the newsletter banner above, which displays the new name of our interest group: **Coverage, Litigators, Educators & Witnesses Interest Group.** While we are still "CLEW," the CLEW Interest Group Committee decided to change the words in our name to encompass and reflect:

- Our long-established constituency (consultants, attorneys and expert witnesses).
- Other segments of the Society that we hope to attract (educators).
- Our primary "interest" (coverage).

While consultants, litigators and expert witnesses are certainly still in our bailiwick, two new words in our name deserve further explanation.

Coverage

Invariably, we have found that those interested and involved in our interest group are focused on coverage issues. Can the exposure be covered? How can it be covered? What's the best way to design or structure the coverage? And of course, after a claim, was it covered? These are questions asked everyday by our traditional core constituency, consultants, attorneys and expert witnesses. We came to realize that many others within the CPCU community shared our concentration on coverage aspects of insurance. Clearly, underwriters, agents and brokers, claim adjustors, and other insurance professionals have much to gain and to offer by interacting with the CLEW Interest Group. Starting our name with "coverage" proclaims to CPCU Society members that CLEW is a resource for those who wish to join us in our never-ending search for coverage nirvana!

Educators

CLEW Interest Group members have always been educators of one fashion or another. Examples include consultants advising clients, attorneys persuading juries and witnesses offering expert opinions. Many CLEW members serve as educators in leading continuing

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education classes, conducting seminars and making presentations in a variety of forums. These activities enable others both within and outside the insurance industry to acquire information vital to successful insurance and risk management programs. Therefore, adding "educators" to our name is a natural expansion of our scope. Furthermore, our new name creates the opportunity to attract CPCUs who are professional educators. We want to attract involvement of those:

- Hailing from the insurance and risk management department of a university or other educational institution.
- Engaged in training activities at insurance carriers and other organizations.
- Leading the educational endeavors of industry trade associations and similar groups.

This is another segment of the CPCU Society membership whose participation in the CLEW Interest Group will benefit us all as we learn from each other.

CLEW and the other Society interest groups exist for the benefit of all society members. Please let your fellow CPCUs know about our name change and invite them to visit our website, read our newsletters and reap the bounty of what many CPCUs have sowed.

Another Note

Nancy D. Adams, CPCU, J.D., a long-time and active member of the CLEW Interest Group Committee, has been nominated for the office of CPCU Society secretary. By the time this newsletter hits the street, Nancy will likely have been elected. She will take office at the conclusion of the CPCU Society Annual Meeting and Seminars in Las Vegas. While Nancy's election will cause us to lose the services of a valued member of our committee, we wish her well in her new role and thank her for her priceless contributions to CLEW. ■

CPCU Society Annual Meeting and Seminars

Oct. 22–25, 2011 • Las Vegas, Nev.

CPCU-Loman Golf Tournament

Oct. 21 • 7:30 a.m.–2 p.m. (check-in begins at 6:30 a.m.)

Support the CPCU-Loman Education Foundation by participating in the Third Annual CPCU-Loman Golf Tournament. All proceeds will support the Foundation's mission to advance education in the fields of insurance, risk management and risk bearing through programs such as the matching scholarship program. The tournament will be held at the Siena Golf Club in Las Vegas.

More information is available on the Foundation's website, cpculoman.cpcusociety.org. Click on "CPCU-Loman Golf Tournament."

The official registration and financial information of the CPCU-Loman Education Foundation may be obtained from the Pennsylvania Department of State by calling toll-free within Pennsylvania, (800) 732-0999. Registration does not imply endorsement.

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.

I suspect that most of us, wherever we are, have experienced an "extreme" summer season, with more heat (of a weather nature, that is) to come. Yet, there is a different quality to the air, some diffusion of light, which lets us know that fall is on its way. And the fall season being a traditional time to return to school, it's appropriate that we have available to us some most instructive materials from contributors **Stanley L. Lipshultz, CPCU, J.D.; Donald S. Malecki, CPCU;** and **Randy J. Maniloff, J.D.**

I have the pleasure of serving on the committee of the CPCU Society Coverage, Litigators, Educators & Witnesses Interest Group with Mr. Lipshultz, and have direct familiarity with his professional approach to all things insurance (as well, I assume, to all things!). Many of you will know him from his service to the CPCU Society in a variety of roles, including that of a judge in CLEW mock trials presented at a number of CPCU Society Annual Meetings and Seminars. But you don't have to enjoy a "special relationship" with him to glean important knowledge and information from his discussion of special relationships in the context of agents' and brokers' dealings with clients. This is a subject that is crucial for all producers to understand, and Mr. Lipshultz has given us all an excellent summary of it and some of its nuances.

Donald Malecki, of Malecki Deimling Nielander & Associates LLC, is a stalwart of the Coverage, Litigators, Educators & Witnesses Interest Group, and neither that interest group, nor the Society as a whole, would be what it is without his participation. His publications include a range of CPCU and other textbooks, as well as insurance treatises on particular lines of coverage, and *The Additional Insured Book*, now in its sixth edition, and *The MCS-90 Book (Truckers Versus Insurers and the Government Makes Three)*, now in its second edition. With his colleague **Gregory G. Deimling, CPCU, ARM, AMIM,** he also is a stalwart of the Insurance Library Association of Boston, lending his support in ways too numerous to mention in these notes. Many of you may be familiar with his *Malecki on Insurance*, a monthly publication that always seems to target extremely timely issues, and always does so in a most able and comprehensive fashion. His treatment herein of Ponzi/Madoff schemes and coverage under commercial crime policies is a typical example of his thoughtful attention to contemporary issues, and I thank him for sharing it with our readers.

Some of you may recall in our last newsletter that I reviewed a book called *General Liability Insurance Coverage: Key Issues in Every State*, which has proven to be a very popular addition to the collection of the Insurance Library. This book was co-authored by **Jeffrey W. Stempel, Ph.D., J.D.**, and Randy Maniloff. Mr. Maniloff is a partner at the law firm of White and Williams in Philadelphia. He is a prolific writer and speaker in the field of insurance law, and I am happy to say that perusal of his publication, *Binding Authority: Insurance Coverage Decisions: Issued Today-Impact Tomorrow*, reveals that dealing in matters that may seem somewhat arcane to many people have not blunted his sense of humor. I never have any ideas for his picture caption contests, but always laugh at his winning choices! Mr. Maniloff has graciously allowed me to share a recent issue of *Binding Authority* in this newsletter, and I hope that you enjoy his treatment of the "granddaddy" of all CGL issues — the duty to defend. ■

What Makes the 'Special Relationship' So Special?

by Stanley L. Lipshultz, CPCU, J.D.

Stanley L. Lipshultz, CPCU, J.D., is a consultant and expert witness. He has been in the insurance industry for more than 40 years, including 30 years as a defense attorney for agents and brokers. Lipshultz is a past president of the CPCU Society District of Columbia Chapter and has served the Society as chair of the Diversity Committee; chair of the Coverage, Litigators, Educators & Witnesses Interest Group; and governor. He has been a speaker at numerous CPCU Society Annual Meetings and Seminars, and frequently makes presentations to agents and brokers.

The *special relationship* has been recognized by courts for a long time although not always utilized. However, allegations of the existence of the special relationship have become ubiquitous, finding their way into almost every claim against the insurance agent or broker depending upon the jurisdiction. A majority of states have passed the National Association of Insurance Commissioners (NAIC) Model Producers Act defining insurance agents and brokers collectively as insurance producers.[1]

Plaintiffs manage the concept to support a general duty to provide advice or as a separate cause of action alleging an additional legal threshold duty to provide some type of advice. Defendants use its absence as a negative defense to protect the producer from an egregious burden of furnishing advice to clients regarding the selection of "adequate" limits or the purchase of arcane insurance coverages that might be available and somehow applicable to the risk and its exposures. See: *Bruner v. League Insurance Company*, 164 Mich. App. 28, 416 N.W.2d 318 (1987), *Rawlings v. Fruhwith*, 455 N.W.2d 574 (N.D., 1990), *Southwest Auto Painting and body Repair, Inc. v. Binsfeld*, 183 Ariz. 444, 904 P.2d 1268, (Ariz. App. Div.1, 1995), *Trupiano v. Cincinnati Insurance Company*, 654 N.E.2d 886 (Ind. App. 1995), *Murphy v. Kuhn*, 660 N.Y.S. 2d 371, 90 N.Y.2d 266, 682 N.E.2d 972 (1997), *Harts v. Farmers Ins. Exchange*, 461 Mich.1, 597 N.W.2d 47(1999), *Peter v. Schumacher Enterprises, Inc.*, 2001 Alaska 160 (2001), *Sadler vs. The Loomis Company*, 139 Md.App. 374, 776 A.2d 25, 1 (2001), *Sintros v. Hamon*, 810 A.2d 553 (N.H., 2002), *Zaremba Equip. v. Harco National Insurance Company*, 280 Mich. App.16, 761 N.W.2d 151, (2008), *Axis Construction Corp. v. O'Brien Agency, Inc.*, 2009 NY Slip Op 32491 (N.Y. Sup. Ct.10/21/2009), (N.Y. Sup. Ct., 2009).

> Almost universally, an insurance agent's legal duty is to follow their client's instructions, obtain the best insurance available at the most commercially reasonable price and terms using reasonable skill and ordinary diligence. There is no additional "legal" duty to provide unsolicited advice: ". . . it is well settled that agents have no continuing duty to advise, guide, or direct a client to obtain additional coverage." *Murphy v. Kuhn,* supra, at 375.

Under certain circumstances, however, a special relationship can be created between the insured and the insurance producer, thereby altering the producer's legal duty by adding the duty to provide advice to the insured.[2]

Before discussing the criteria necessary to establish the special relationship, it is important to understand what the special relationship is and what it is not.

The special relationship is not a basis for post-loss underwriting. Assertions of the special relationship usually include allegations (i) that the producer should have advised the insured to purchase certain specific coverage or adequate limits, (ii) that if the insured had been so advised, the coverage and/or limits could and would have been purchased and, (iii) that if the coverage had been purchased and available,[3] the result would have been that an underinsured or disputed claim would have been paid by the insurer.

The special relationship can be used to impose additional duties on the producer, but only if the facts permit it. Assertions of a special relationship are often added to a complaint against a producer without a scintilla of factual underpinning.

When considering whether to bring an action against an insurance producer based upon the special relationship concept, the assertion that the producer was an "expert" should have a logical nexus to the insurance being procured. For example, an insurance producer who procures a package policy for a restaurant, dry cleaner, office building or other common type of business ordinarily does not need special expertise to procure such insurance and is ordinarily not an "expert" despite allegations to the contrary. The "expert" appellation is more appropriate in areas of specialized coverages not dealt with on a regular basis by most insurance producers, such as motor truck cargo, ocean marine, or aviation exposures.

The legal decisions uniformly distinguish between advice as to coverages and recommendations as to limits. The Maryland Court of Special Appeals dealt with the subject of the special relationship in *Sadler vs. The Loomis Company,* 139 Md.App. 374, 776 A.2d 25, (2001). Evelyn Sadler had been a client of the Murray Agency[4] through her family business as well as personally for more than 50 years, purchasing both homeowners and automobile insurance. Up until the Loomis Company purchased the Murray agency in 1987, there were regular meetings with a producer who delivered the policies. This practice stopped with the Loomis purchase, contact thereafter being limited to times when Sadler had a particular question concerning her insurance.

On May 13, 1996, Sadler had an at fault accident with a motorcyclist, Timothy Prophet, resulting in amputation of one of the motorcyclist's legs. At the time of the occurrence, Sadler had automobile liability limits of $100,000.00.[5] In 1999 Sadler settled Prophet's claim for $1,000,000 which included the $100,000 from her automobile insurer. Sadler then sued Loomis, claiming it was negligent because it was aware of her financial position and "failed to provide her with periodic quotes as to the cost of additional protection, or sufficient information to enable her to make an informed decision as to the appropriate level of liability coverage."[6] The Court held "that, in the absence of a special relationship, an insurance agent or broker has no affirmative, legally cognizable tort duty to provide unsolicited advice to an insured regarding the adequacy of liability coverage.[7]

The court opined that:

> A "special relationship" within the insurance industry is an important concept. A special relationship in the context of insurance requires more than the ordinary insurer-insured relationship. It may be shown when an insurance agent or broker holds himself or herself out as a highly skilled insurance expert, and the insured relies to his detriment on that expertise. A special relationship may also be demonstrated by a long term relationship of confidence, in which the agent or broker assumes the duty to render advice, or has been asked by the insured to provide advice, and the adviser is compensated accordingly, above and beyond the premiums customarily earned. (Citations Omitted)[8]

Citing with approval from *Parker v. State Farm Mut. Auto. Ins. Co.,* 630 N.E.2d 567, 569-570 (Ind.Ct.App. 1994) the Court continued:

> [It] is the nature of the relationship, and not merely the number of years associated therewith, that triggers the duty to advise. Some of the factors relevant to developing entrustment between the insured and the insurer include: exercising broad discretion to service the insured's needs; counseling the insured concerning specialized insurance coverage; holding oneself out as a highly-skilled insurance expert, coupled with the insured's reliance upon the expertise; and receiving compensation, above the customary premium paid, for expert advice provided. (Internal citations omitted).[9]
>
> The producer has no legal duty to advise the insured unless there are special circumstances or a special relationship exists. In discussing the duty to advise of possible additional coverage needs, New York's highest court in the case of Murphy v. Kuhn, pithily stated: "[Insurance agents] are not personal financial counselors and risk managers, approaching guarantor status."[10]

The general rule is well stated in a 1997 California appellate decision, *Fitzpatrick v. Hayes*[11]

> [A]s a general proposition, an insurance agent does not have a duty to volunteer to an insured that the latter should procure additional or different insurance coverage. ... The rule changes, however, when — but only when — one of the following three things happens: (a) the agent misrepresents the nature, extent or scope of the coverage being offered or provided ... (b) there is a request or inquiry by the insured for a particular type or extent of coverage ... or (c) the producer assumes an additional duty by either express agreement or by "holding himself out" as having expertise in a given field of insurance being sought by the insured.

The analysis used by the Court of Appeals of Arizona in Southwest Auto Painting and Body Repair, supra, ostensibly provides the practitioner with a means to sidestep the difficulty in establishing the special relationship. By framing the producer's failure to provide advice as a standard of care issue, there would be no need to rely on the special relationship: the finder of fact could find that a failure to provide advice is a clear violation of the standard of care not dependent upon the special relationship.

Although not explicitly addressed in the above-cited cases, when an insurance producer purports to act as a risk manager, either demonstrably or by default, a special relationship can be created.[12] However, there is a clear delineation between a risk analysis performed by an insurance producer and a risk management assessment performed by a risk manager. The approaches used by producers and risk managers are deceptively similar, but the methodology and analysis of the risk

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manager is considerably more extensive, and, the outcome is decidedly different. In order to understand the scope of the risk manager issue, a definition of risk management is instructive:

> Risk Management is the systematic, problem-solving process used to identify and treat the pure loss exposures of an organization or individual; has six steps: identify loss exposures, analyze or measure loss exposures, consider the risk treatment alternatives, select the best combination of risk treatment alternatives, implement the decision and monitor the program.[13]

Under most circumstances an insurance producer is not a risk manager unless they have received training and/or have been certified as a risk manager. A risk manager is an individual who, by education and/or training has: (a) a background in insurance; (b) an ability to identify all patent as well as latent exposures; (c) knowledge of the available various risk transfer methods and when it is appropriate to implement each; and, (d) an operating knowledge of insurance coverages available to the sector in which the risk manager is employed. There are, however, marked differences between the insurance producer and the risk manager. Insurance is the most commonly accepted form of risk transfer and is the exclusive method employed by the insurance producer on behalf of a client. A Risk manager, on the other hand has a number of risk transfer and risk treatment methods not usually offered by the insurance producer, namely: (1) Loss control; (2) avoidance; (3) retention; (4) non-insurance transfer, i.e., indemnity, hold harmless agreements; and (5) insurance. In other words, a Risk manager tries to avoid using insurance, the goal being to reduce the cost of risk, not sell insurance. Compare these tasks with the goal of an insurance producer whose sole function is to protect the client through the exclusive use of insurance.

Even though the insured may believe that the producer is functioning as a risk manager, unless agreed to in advance, the producer assumes no risk management duties in the legal sense. Whether the producer is considered to be a risk manager depends, at least in part, upon how the consumer/insured perceives the role of the producer and whether this perception is expressed to the producer by the insured and/or by the producer to the insured. Full disclosure by the insured or prospective insured of the parameters of his or her reliance is a prerequisite in those instances where the insured claims that the producer agreed to act as a risk manager.

Historically, the client has perceived the producer as a risk manager. Most clients equate the assistance provided by an insurance producer as "risk management" services and do not know what that entails. In other words, the producer acts by default as a risk manager and the insured forms the opinion that risk management services are being provided. Neither acknowledges that risk management is happening. Pressures, such as insurance market conditions, competition, mergers of companies with subsequent reduction of markets, and mergers of agencies have forced the producer to imitate a risk manager in many commercial account situations, and to a lesser extent, personal lines accounts. In these instances the application of the factual circumstances to the legal duty will be determinative of the producer's liability.

> Risk analysis is an everyday part of what [independent agents] do. It has always been a part of what they do on behalf of a commercial client. ...[14]

The producer is protected by the body of laws noted above. These set forth the seminal duties of a producer and acquit the producer of responsibility for rendering unsolicited advice to a client. The responsibility for decisions concerning the selection of insurance coverages offered by the producer and the selection of limits rests solely with the insured. In most jurisdictions, it is the responsibility of the customer to read the policy to determine that the coverages and limits are those that have been requested.

Federal plaintiffs will have a difficult time pleading the special relationship as well as avoiding a 12(b)(6) motion. Unlike most state plaintiffs, federal plaintiffs will have a difficult time overcoming a motion to dismiss the special relationship allegations because of the holdings in *Bell Atlantic Corp. v. Twombly,* 129 S.Ct. 1937, 173 L.Ed2d 868 (2007) and *Ashcroft v. Iqbal,* 550 U.S. 554, 127 S.Ct. 1955, 167 L.Ed2d 870 (2009).[15] Plaintiffs will be required to provide a set of facts that support the allegations of a special relationship. Allegations such as that: the producer held themselves out as an "expert"; the insured depended upon the producer and his/her expertise; the producer was previously an insurance underwriter; the producer recommended that the insured purchase certain coverages, but failed to suggest others, are simply not sufficient based upon the case law in most jurisdictions.

Real-World Examples: Below are illustrative allegations from a state and a federal lawsuit which purport to represent a colorable claim that a special relationship existed between the insurance producer and the client.

In the first example filed in state court, the client/policyholder was the owner of a restaurant, the building housing the restaurant, and substantial business personal property:

> Through Defendants' actions and interactions with the Plaintiffs, Defendants cultivated and created a special relationship with the Plaintiffs, such that Plaintiffs reasonably relied upon the advice and recommendations of the Defendants to select and produce an appropriate type and amount of insurance coverage for their business and property. Defendants undertook to counsel Plaintiffs on their specialized insurance coverage

> needs and Defendants were given broad discretion to procure insurance that would protect [defendants].

The policyholder started in the restaurant business in 2002 when he assumed a lease and purchased an ongoing restaurant. In 2005 the policyholder purchased a building and moved his restaurant to this new location. From 2002 until the end of 2007, the policyholder utilized the producer referred by the person from whom the insured purchased the business. At the end of 2007, the policyholder changed producers to the defendant. In early 2009 the building housing the restaurant was substantially destroyed by fire and the business personal property was totally destroyed. According to the insured's public adjuster, the building and business personal property were significantly underinsured.[16]

In this lawsuit the producer was accused of not only failing to advise the policyholder to purchase higher limits for the building as well as its contents, but also not to have known the values of each without any input from the policyholder. The special relationship is alleged to have originated from the producer's marketing efforts as well as having dined at the restaurant several times before being requested to procure coverage. The coverages in place were appropriate but the limits accepted by the policyholder were not, resulting in an alleged underpayment by the insurer for the building and the business personal property. The producer had secured policies for two policy periods, a total of sixteen months prior to the fire loss. The insured alleged it was underinsured.[17]

The insured restaurant owner stated he had never read any insurance policy provided to him by either the previous producer or the one he sued. With the approval of the insured, the defendant insurance producer used the limits of the expiring policy as a baseline for the building limit for the policy he procured for the plaintiff. The producer asserted that he reviewed the policy, including limits, with the insured both before the policy was procured as well as when the policy was delivered and at the subsequent renewal. When pressed during his deposition for particulars that might support a special relationship, the policyholder was unable to identify a single fact to support a special relationship as defined by applicable case law. Allegations were made in the Complaint that payments were made to the producer in addition to the commissions received from the insurer, allegations which turned out to be fabricated and ultimately withdrawn. Additionally, the policyholder stated that he did not give the producer the power to make any decisions with respect to insurance.

Through the plaintiff simply suggesting in his complaint that a "special relationship was cultivated" a dismissal on the pleadings may be avoided, but these unsubstantiated allegations cannot ultimately meet the evidentiary burden imposed on the plaintiff to prove a genuine special relationship. The case settled prior to trial.

A second example involves a federal district court multimillion dollar lawsuit filed against an insurance producer by a religious order[18] for underinsured losses suffered by its religious school in New Orleans caused by hurricane Katrina. Both the order and the school were plaintiffs:

> Defendant represents that it specializes in insurance coverage for religious, charitable and academic institutions. Defendant represents that it understands "the unique challenges of managing the risks that the academic world addresses every day" and purports to "deliver innovative solutions to meet those demands." Defendant also represents that it specializes "in providing long-term, stable, and affordable solutions of risk management and insurance

> programs" for religious and charitable organizations.
>
> For over fifty years, Defendant has been the insurance broker, consultant and advisor for the Plaintiffs. At all times relevant hereto, Defendant has held itself out and represented to the Plaintiffs and The School as having special expertise in the insurance requirements of religious and academic institutions, particularly Catholic institutions.
>
> At all times relevant hereto, Defendant has understood, acknowledged, and represented that it had a special relationship with [both] The School and the Plaintiff whereby Defendant had a professional and contractual obligation to review coverage for Plaintiff and The School, evaluate that coverage and recommend any necessary or useful changes in policy limits, scope of coverage, or type of coverage, all in order to make sure that The School and the Plaintiff had the necessary and requisite insurance coverage to protect their interests.
>
> Defendant intended and knew that The School and the Plaintiffs relied on Defendant's expertise and trusted that Defendant would regularly review their insurance coverage and make all necessary

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> and expected recommendations and would, due to their special relationship, do nothing to harm The School and the Plaintiff.
>
> [NEGLIGENCE AGAINST AGENT] Professional insurance brokers, advisors, and consultants such as Defendant are considered fiduciaries and are, therefore, held to a standard of care higher than the ordinary standard of care. Defendant, as an insurance broker and/or consultant with a long-term, special relationship with The School and the Plaintiffs, was obligated to exercise fiduciary duties of good faith, reasonable skill and diligence in dealing with The School and the Plaintiff.

The producer in this lawsuit had not procured business interruption coverage for the religious school, and the loss claimed was alleged to have been in excess of two million dollars. An interesting facet of the claimed damages for the business income loss was that many of the students who had been relocated to other areas of Louisiana, as well as other states, did not return to New Orleans, thus decreasing the available student base with a subsequent continued loss of tuition income. The School was able to continue to function by first relocating to a facility in an undamaged area outside of New Orleans, and then reopening once repairs had been accomplished. A separate issue concerned the scope of the business interruption claim and whether this was appropriate to factor in to the overall claim.

Another factual dispute focused on whether the Order had been offered time element coverage and declined to purchase it. In order to avoid this issue, considerable emphasis by the plaintiff was placed on the special relationship in an attempt to establish that defendant simply should have provided it, consequently rendering the factual dispute moot. Plaintiff held its ground on the special relationship issue through the paper discovery phase, but it unraveled during depositions of the priests who were responsible for procuring the insurance through the producer. Using the guidance set out in *Sadler, supra*, defense counsel was able to illuminate the abject failure of a factual predicate necessary to establish the special relationship. In order to support a finding that a special relationship existed, the designated representative of the Order provided four examples: the producer had procured flood insurance post-Katrina; it had periodically reviewed with the Order the values it had set for its various properties; it had addressed the Order's concern over sexual abuse coverage and limits; and it had raised and discussed terrorism coverage. The deponent could not point to a single instance when the defendant was made aware of the potential existence of the special relationship. Prior to filing several dispositive motions, including one based on *Iqbal, supra*, the parties settled the matter.

In summary, care should be used by the practitioner in deciding whether to add allegations that a special relationship supports claims of breach of contract and negligence as well as the other available tort remedies. Relying upon the special relationship creates an additional workload for both parties, and without the appropriate factual base can lead to an embarrassing situation, either during deposition, motions, hearings, or at trial. ■

Endnotes

(1) The term "producer" is used to denote either an insurance agent or broker herein.

(2) Even when the special relationship is found to exist, the selection of limits is universally the function of the insured, not the insurance agent or broker.

(3) Most practitioners assume that the alleged missing coverages and/or higher limits are readily available which may not be accurate and should be confirmed.

(4) The original agency name was E. Churchill Murray, later Murray, Martin & Olsen.

(5) Sadler's home was valued at over $600,000 and was insured for $231,000.

(6) 139 Md.App. at 374.

(7) Id. at 374,410

(8) Id. at 393

(9) Id. at 394

(10) 660 N.Y.S.2d at 375

(11) 57 Cal.App.4th 916, 67 Cal.Rptr.2d 445, 452 (1997).

(12) Arguably agreeing to act as a risk manager would bring the producer within the ambit of the general rule set out in Fitzpatrick v. Hayes cited on this page, particularly paragraph (c).

(13) Burnham's Insurance Dictionary, Burnham (2009)

(14) Madelyn Flanagan, Assistant vice president for research, IIAA, quoted in Roquet, *Deregulation Could Put Agents on the Spot, National Underwriter,* September 4, 2000.

(15) For an in depth discussion of the effects of these two cases See: *Convoluted Court*, Leslie Gordon, *ABA Journal,* January 2011, p. 16

(16) The insurer estimated the loss to be approximately five percent higher than policy limits for the building. The public adjuster calculated that the building was underinsured by more than one half.

(17) The insurer estimated the loss to be approximately five percent higher than the policy limits for the building. The policyholders' public adjuster calculated that the building was underinsured by more than one half.

(18) The religious order was located in Maryland and made all decisions with respect to procuring insurance for a School located in New Orleans. The school was a separate corporate entity, but was governed by the order's six member General Council. The Council also functioned as the board of trustees of the School, which had very little input into the selection of insurance coverage and limits.

Cu-Miss: United States Supreme Court Passes on Chance to Address CGL Coverage Issues

by Randy J. Maniloff, J.D.

Randy J. Maniloff, J.D., is a partner in the Commercial Litigation Department of White and Williams LLP in Philadelphia, Pa. He concentrates his practice in the representation of insurers in coverage disputes over primary and excess obligations under a host of policies. Maniloff is the co-author of *General Liability Insurance Coverage: Key Issues in Every State* and is a frequent contributor of articles to *Mealey's Litigation Report: Insurance,* among other publications, addressing a variety of insurance coverage topics. He is a frequent lecturer at industry seminars.

Editor's note: This article originally appeared in the June 4, 2011, issue of White and Williams LLP's *Binding Authority*; and is reprinted with permission.

"*General Liability Insurance Coverage: Key Issues in Every State*" really dodged a bullet this week. Consider this potential catastrophe. The premise of "Key Issues" is that the treatment of insurance coverage issues varies widely from state to state. So if you are handling claims on a national basis, and don't have a 514 page book at the ready, providing a detailed statement of the law for 20 issues, for all 50 states, then man you are just playin' with fire. But earlier this week something happened that could have brought it all tumbling down.

On Tuesday the United States Supreme Court could have gone where it has never gone before — addressing insurance coverage under a general liability insurance policy. And not just any issues. The granddaddy-of-them-all Court could have addressed the standard for determining an insurer's duty to defend (the number one most important CGL coverage issue) and interpretation of the pollution exclusion (at the top of many people's list of favorite issues). Thankfully the court declined the invitation to do so by denying a petition for writ of certiorari in *Seattle Collision Center, Inc. v. American States Ins. Co.*, 79 USLW 3578 (U.S. May 31, 2011) (No. 10-1189). If the United States Supreme Court gets into the business of interpreting coverage issues under CGL policies — eliminating the state-by-state differences — then "General Liability Insurance Coverage: Key Issues In Every State" becomes the Betamax. Not to mention that I'm Googling MBA schools.

Imagine if the United States Supreme Court addressed insurance coverage issues. I can see the confirmation process now for a new Justice: U.S. Senator to candidate: "Madam, Please tells your views on *Roe v. Wade* and *Montrose*."

Granted I'm taking literary license when describing what the high court could have done with the duty to defend and pollution exclusion in *Seattle Collision Center, Inc. v. American States Ins. Co.* [But no literary license was taken with the playin' with fire part.] But given that CGL issues are so unbelievably far outside the scope of the U.S. Supreme Court's mandate, the simple fact that the court was asked to hear a case, whose resolution was tied to the duty to defend standard and interpretation of the pollution exclusion, is worth looking at.

By the way, when I went on Westlaw to get the Petition for Cert. brief in *Seattle Collision Center v. American States*, this little box popped up stating that the document was outside my firm's subscription and there is an extra charge to access it. But because no expense is spared to bring you *Binding Authority*, I clicked Yes to whether I still wanted it. I have no idea what that cost. But I'm sure I'll find out from someone when the bill comes in.

Here is what *Seattle Collision Center, Inc. v. American States Ins. Co.* is all about [taken from Seattle Collision Center's Brief in Support of its Petition for Cert.]. Seattle Collision Center was sued in Washington state court, by a neighboring landowner, under the Washington Model Toxic Torts Act, for an alleged release of "perc" onto the neighbor's property. Collision Center sought coverage from certain CGL insurers, including American States (Safeco). Safeco denied coverage based on the Absolute Pollution Exclusion. Collision Center and another insurer resolved their own coverage dispute and settled the underlying claim. This settlement still left Collision Center with certain unpaid defense costs, for which Collision Center alleged were owed by Safeco.

In coverage litigation between Collision Center and Safeco, the Washington District Court and Ninth Circuit Court of

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Cu-Miss: United States Supreme Court Passes on Chance to Address CGL Coverage Issues

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Appeals both concluded that Safeco had no duty to defend Collision Center on account of the Absolute Pollution Exclusion.

Collision Center's argument, against the applicability of the Absolute Pollution Exclusion, was that the complaint in the underlying action sought consequential damages, i.e., natural resource damages — which differ from remediation damages. Thus, Collision Center argued that the damages sought were within the exception to the Pollution Exclusion for liability for damages for "property damage" that the insured would have in the absence of a request or demand that it test for or clean up pollutants or in the absence of a claim or suit by or on behalf of a governmental authority for damages for testing or cleaning up pollutants [I'm paraphrasing the Pollution Exclusion here].

In general, Collision Center argued that the lower courts erred for two reasons.

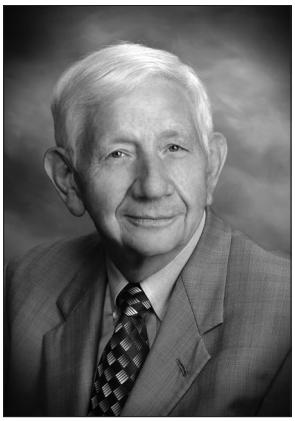
First, Collision Center and Safeco both submitted non-Washington cases to support their position on the applicability of the exception to the Pollution Exclusion for natural resource damages. The District Court, while recognizing that no Washington court had addressed the issue, concluded that the Pollution Exclusion precluded coverage for *both* remedial action damages and natural resource damages. However, Collision Center argued that, under Washington law, when Washington courts have not ruled on a particular legal issue on which coverage depends, there is a "legal uncertainty," which works in favor of providing a defense to the insured. Thus, Collision Center argued that the District Court improperly substituted its own view of Washington law concerning the interpretation of the Pollution Exclusion for consequential damages (natural resource damages), instead of simply concluding that, on account of the "legal uncertainty," a defense was owed.

Second, the Ninth Circuit held that the complaint in the Underlying Action sought only past and future remedial action damages. In other words, the Ninth Circuit concluded that the complaint in the Underlying Action didn't even seek consequential damages (natural resource damages) — which was Collision Center's only argument to avoid applicability of the Pollution Exclusion, since Collision Center conceded that the exclusion applied to remedial action damages. This, Collision Center argued, was in error — because the Ninth Circuit's decision was made based on the federal pleading standard, requiring the pleading of facts to establish a claim for natural resource damages or other consequential damages "plausible on its face." Instead, according to Collision Center, the Ninth Circuit should have used Washington's less stringent "under any set of facts" pleading standard when determining whether the complaint in the Underlying Action sought consequential/natural resource damages. Collision Center argued that if the Ninth Circuit would have used Washington's less stringent "under any set of facts" pleading standard, it would have determined that the complaint in the Underlying Action sought consequential/natural resource damages.

Collision Center made interesting arguments but it was swimming against an incredibly strong tide in hopes of having its petition for writ of certiorari granted. The U.S. Supreme Court accepts only a fraction of cert. petitions filed (1.1 percent in 2009 — thank you Wikipedia). And even if the court granted cert., the case would no doubt be decided without the high court actually addressing the coverage issues — at least not in any detail. But given the rarity of such common CGL issues even appearing in the Supreme Court's mailroom, it seemed like something that was worth mentioning here. ■

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 more than 50-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 are wondering what the success rate is for investors involved in the Bernard Madoff Ponzi scheme in recovering some or all of their losses under commercial crime policies that they might have or have had during that period? We would think that to the extent investors had businesses with crime insurance, they would have thought of trying that route to collect their losses. Any insight you could provide would be appreciated.

A Ponzi scheme has been defined as "a fraudulent arrangement in which an entity makes payments to investors from monies obtained from later investors, rather than from any profits of the underlying business venture; the fraud consists of funneling proceeds received from new investors to previous investors in the guise of profits from the alleged business venture, thereby cultivating an illusion that a legitimate profit-making business opportunity exists which induces further investment." *United Energy Corp v. C.Rider,* et al., 944 F.2d 589 (U.S.Ct. App. 9th Cir. 1991).

Even though Ponzi schemes have adversely affected many people over the years, the investors have not been successful in making up for their losses through reliance on insurance policies.

The Ponzi scheme, by the way, is named after an Italian immigrant by the name of **Carlo Ponzi** who discovered a way to rip off wealthy people (or people who wanted to become wealthy) in 1919 while a resident of Boston, Mass.

While his is a long and interesting story, Ponzi's first, among many, schemes did not last long. In fact, it was about a year after he duped many people that he was found out and prosecuted. It has been said that he went from poverty to becoming a multimillionaire. When he died in 1949, however, he had less than $100 to cover his burial costs.

One of the latest cases brought by a former "indirect" investor with Madoff is *Methodist Health System Foundation, Inc. v. Hartford Fire Insurance Company,* No. 10-3292 (U.S. Dist. Ct. E.D. La. 20 11). This dispute was over a commercial crime policy issued to the Foundation.

Over the course of two separate purchases, the first in 2004 and the second in 2007, the Foundation invested in $6.7 million worth of shares in a mutual fund. This fund, in turn, invested a portion of its holdings into another fund, which then invested a portion of its holdings in the Madoff fund.

These shares earned substantial profits in the years between 2004 and 2007. By late 2008, however, amidst a widespread economic recession, the value of the Foundation's shares decreased substantially in value, due at least in part to the discovery of the Madoff Ponzi scheme. The domino-effect on the mutual funds adversely affected the Foundation's holdings.

Question of Coverage

There is no harm in trying, but given the litigation expense and the slight chance of winning, it can be a costly proposition. In any event, the Foundation filed a claim under its commercial crime policy in 2009, specifically under computer fraud coverage. Its rationale for this selection was that because Madoff used a computer to generate false documents that misled investors and gave the appearance of a legitimate investment operation, it should have coverage under computer fraud.

The insurer, however, denied the claim on the grounds that there was no covered computer fraud loss, that the losses were only indirectly related to the scheme, and that several policy exclusions applied. Actually, the first reason relied on by the insurer would have been sufficient to deny coverage. Crime insurance generally requires that loss be direct

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Q&A with Donald S. Malecki, CPCU

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in nature. The insuring agreement of the policy dealing with computer fraud coverage in this case, read:

> We will pay for loss of and loss from damage to 'money,' 'securities,' and 'other property' following and directly related to the use of any computer to fraudulently cause a transfer of that property from inside the 'premises' … to a person or place outside those premises.

The November 2010 issue of *Malecki on Insurance*, in an article titled, "Commercial Crime Coverage: Direct Versus Indirect Loss," discusses this subject in depth with a couple of court cases, which are not repeated here. In a number of court cases, however, courts have held that "direct means direct," as if nothing more were necessary in terms of proving the absence of coverage. Observing these opinions, one is reminded of how **Lewis Carroll** summarized what a word means in his satire *Through the Looking Glass*, particularly in the conversation between his characters, Humpty Dumpty and Alice:[1]

> "I don't know what you mean by 'glory,'" Alice said. Humpty Dumpty smiled contemptuously: "Of course, you don't — till I tell you. I meant 'there's a nice knock-down argument for you'!"
>
> "But 'glory' doesn't mean 'a nice knock-down argument,'" Alice objected. "When I use a word," said Humpty Dumpty in a rather scornful tone, "it means just what I chose it to mean — neither more nor less."
>
> "The question is," said Alice, "whether you can make words mean so many different things." "The question is," said Humpty Dumpty, "which is to be master, that's all."

The court in this case, in ruling against the Foundation, stated, like Humpty Dumpty, that the words "resulting directly from" indicate an intent to limit the coverage available and is especially significant because the language appears in a section of the policy that specifically addresses the scope of coverage … that is, the insuring agreement.

One of the cases relied on by the court to help make its point that there was no direct loss in the situation involving the Foundation was *Lynch Properties, Inc. v. Potomac Ins. Co.*, 962 F. Supp. 956 (N.D. TX 2006). The insurer here denied coverage to an insured real estate company when an employee embezzled funds from a customer's account. The real estate company reimbursed the customer and subsequently sought recovery from its insurer under a commercial crime policy that required loss resulting directly from employee dishonesty. The court found in favor of the insurer, because the losses suffered by the company, which had to refund the losses to the customer, were not a "direct result" of the employee dishonesty, since they were one step removed from the embezzlement. The Foundation was at least two steps removed, given that its money was invested by two mutual funds before getting to the Madoff fund.

Other Reasons Why Coverage Is Inapplicable

In addition to the Foundation's failure to meet the direct loss provision, the insurer established several exclusions that also barred coverage. One of these was the "trading loss" exclusion. This stated that the policy did not apply to "loss resulting directly or indirectly from trading, whether in your name or in a genuine or fictitious account." One of the cases cited by the court to make its point that this exclusion also was applicable is *Hepler v. Fireman's Fund Ins. Co.*, 239 So. 669 (La. App. 1st Cir. 1970). A bond purchaser suffered losses when the bonds lost value and sought recovery under his insurance policy, which contained a Trading Loss Exclusion nearly identical to the one in the Foundation's policy. The court denied liability under the trading loss exclusion, because the purchase and sale of bonds constituted the buying and selling of commodities and that "the very least that can be said is that the loss was one resulting indirectly from trading."

The Foundation also argued that even if its investment with one of the other mutual funds did constitute "trading," the Trading Loss Exclusion still was inapplicable, because the Foundation's losses were not caused by its investment with that mutual fund, but rather by Madoff's fraudulent misrepresentations. The court here also was not sold on that argument. It stated that even though the Foundation's investment with the mutual fund was not directly responsible for the losses sustained, the insurance provision specifically excluded losses "directly or indirectly from trading." Thus, while the court agreed that the Foundation's losses were not a direct result of its investments with one of the mutual funds, the court was satisfied that these losses were sufficiently connected to the investment in that mutual fund so as to fall under the indirect provision of the Trading Loss Exclusion of the policy.

The Entrustment Exclusion was the second and final one relied on by the insurer, even though only one proved reason is sufficient to deny coverage successfully. Under this exclusion, the insurer stated it would not pay for "[L]oss resulting from your, or anyone acting on your express or implied authority, being induced by any dishonest act to voluntarily part with title to or possession of any property." In determining whether an entrustment exclusion applies, the court here said, the question is whether the property was "delivered and entrusted" to the third party that caused the loss.

In this case involving the Foundation, the court stated that the Foundation voluntarily entrusted its funds to one of the mutual funds with the expectation that this fund would invest wisely. The court also was of the opinion that it was

insignificant that Madoff's dishonesty was twice removed from the original entrustment, because the policy in question excluded loss resulting from "any dishonest act" that induced the insured, "or anyone acting on [the insured's] express or implied authority" to voluntarily part with the property. This court was satisfied that both of the mutual funds herein involved were "acting on [Plaintiff's] implied authority", because the Plaintiff (Foundation) knowingly and voluntarily entrusted both funds with its investments.

Conclusion

Since the Foundation failed to meet the "direct loss" requirement and due to the applicability of several exclusions, this court saw no reason to address the issue of whether the losses in this case occurred as a result of computer fraud under the crime policy in question.

Over the years, there have been numerous cases involving Ponzi schemes, which usually involve millions of dollars. The direct loss requirement appears to be the Achilles' heel that can be depended on to defeat coverage, in many cases. Such was the case, in fact, in the insured's attempt at coverage for a $10 million loss in the case of *The Vons Companies v. Federal Insurance Company,* 57 F. Supp.2d 933 (U.S. Dist. Ct. C.D. CA 1998).

Insurers today not only use the ISO crime provisions but also offer their own independently filed policies. One thing about ISO's crime forms is its "double whammy" provisions that not only make coverage contingent on a direct loss, but also exclude any indirect loss.

The fact that many, if not most, insurers are successful at denying coverage for Ponzi schemes based on the failure to prove a direct loss does not necessarily mean that reason is the only one required. Much will depend on the facts of the situation. It is rather obvious that the direct loss requirement would have been the spoiler in the Foundation's case, simply because its investments went through two mutual funds before reaching Madoff's scheme. Perhaps another approach will require the insurer to rely on an applicable exclusion to deny coverage.

Whatever the case may be, coverage for Ponzi schemes are not only difficult to prove, but also costly. One has to wonder how much it cost the Foundation in the aforementioned case to litigate its arguments in what appears to have been an uphill battle. This case, in fact, may even make some people wonder why it was litigated, given the remote chances of finessing the direct loss requirement. Maybe the answer is that desperate people (or organizations) do desperate things. Whatever the reason may be, coverage for Ponzi schemes do not look too hopeful under crime coverage forms.

The author advises readers to note that this discussion is in the context of crime insurance forms, and that coverage for this kind of situation under fidelity bonds is outside the scope of this article. ■

Reference

Carroll, *Through the Looking Glass,* p. 102

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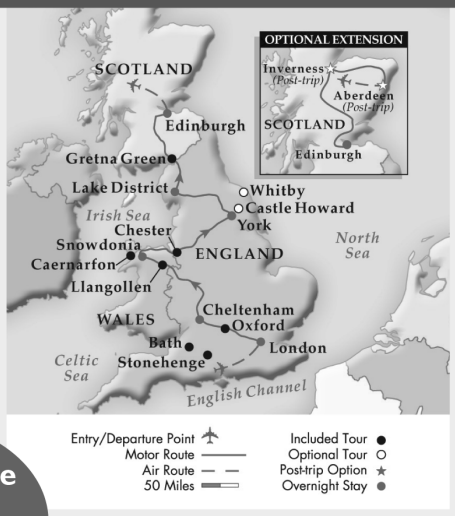

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