CLEWS

Consulting, Litigation, & Expert Witness Section Quarterly

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CPCU SOCIETY
INSURING YOUR SUCCESS

Insurance—An Industry Under Attack: Homeland and Other Security Risks

The CLEW Section Committee continues to design its first annual symposium on homeland and other security risks.

How secure are the insurers that take your business? The recent financial difficulties of Kemper, the insolvency of Reliance, Legion, and others have exacerbated the concern of risk managers, brokers, agents, and reinsurers. Standard & Poor's downgraded 648 insurers in 2002, compared to 380 in 2001.

These concerns are well founded—the reserve deficiency of property and casualty insurers more than doubled in the past year. Alice Schroeder, a property and casualty analyst at Morgan Stanley, has estimated that property and casualty companies are facing a $120 billion shortfall in claim reserves, equal to about 80 percent of the premiums that commercial insurers collect in a year.

According to Moody's Investors Service, Inc., property and casualty insurers hold $8.8 billion in corporate bonds (2.9 percent of industry's surplus) whose issuers are considered "troubled." As the result of a weak economy, insurers face potential exposure from the sale of credit derivatives and surety contracts that back up complex business transactions, such as the delivery of oil and gas by Enron.

These issues and the lingering impact of September 11 have all contributed to mounting pressure on property and casualty insurers. What is the future impact of post-9/11 risks, and liability connected to homeland security risks?

The total cost for all asbestos claims are estimated at between $200 and $265 billion. Several new bankruptcies of asbestos defendants, an ongoing rift within the plaintiff's bar over how to apportion settlement dollars, have exacerbated the problems faced by both insurers and reinsurers. Could fully reserving for asbestos and environmental losses bankrupt the insurance industry as well?

Construction defect litigation has impacted California contractors completed operations loss ratios, and perhaps, one of the largest potential exposure faced by insurers is bad-faith claims resulting from mold claims. In the *Ballard* decision in Texas, the Appellate Court affirmed the jury's award that the insurer failed to attempt in good faith to effectuate prompt, fair, and equitable settlement of claims after liability became reasonably clear.

A distinguished panel will address these questions and provide an insight for the future of our industry. CLEW Section members and guests who are involved in risk management and reinsurance consulting, attorneys, agents, brokers, and other professionals who are affected by these uncertainties will find this program especially beneficial. . . so stay tuned for more details! ■

From the Chairman

by Donn P. McVeigh, CPCU

Your committee is hard at work preparing for several upcoming events, such as the first annual CLEW symposium discussed above. The chairman of that committee, **George Gottheimer, Ph.D., CPCU,** and his two committee members, **Jim Robertson, CPCU,** and **Kevin Letcher, J.D., CPCU,** promise the program will be topical and of interest to most insurance and risk management professionals.

Progress on our mock trial for the Annual Meeting and Seminars in New Orleans will be reinvigorated soon. Our inimitable scriptwriter, **Stan Lipshultz, J.D., CPCU,** has, until recently, been hospitalized since December 27. I know we all wish Stan a speedy recovery. His unique and special skills developing these mock trials are indispensable to the success of them.

Some of you may be attending the Leadership Summit in Tampa on May 7-10. Our committee will be meeting there on May 10. If you do attend the Leadership Summit, please feel free to stay until the 10th and attend our committee meeting. ■

From the Editor

by Daniel C. Free, J.D., CPCU

"Ignorance is the curse of God; knowledge is the wing wherewith we fly to Heaven."

—William Shakespeare

In our last issue, we featured an article by two prominent Los Angeles attorneys entitled "A Case Against Reinsurance Arbitration." Our own **George M. Gottheimer Jr., Ph.D., CPCU, CLU,** took issue with some of the positions advanced by the authors in his own article entitled "The Case for Reinsurance Arbitration."

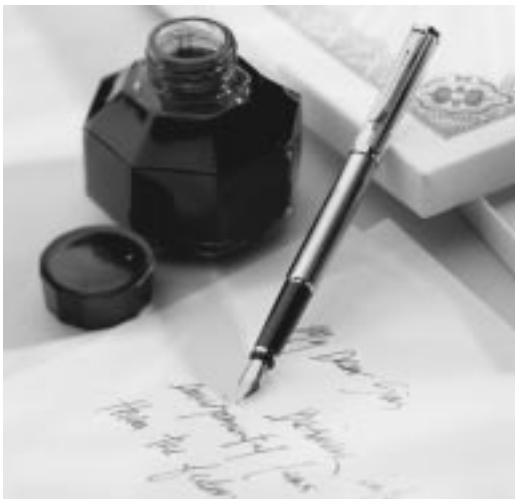
Both articles raised the issue of *ex parte* contact between the parties and their arbitrators. This generated a letter from our chairman, **Donn P. McVeigh, CPCU,** which brought about a response from Dr. Gottheimer. You may want to reread the December 2002 issue of CLEWS to follow this gentlemanly "Clash of the Titans."

Several members of the CLEW Section offer their services as expert witnesses in insurance-related litigation. The reliability of expert witnesses has been subject to greater scrutiny since the 1993 decision in *Daubert v. Merrell Dow Pharmaceuticals,* 509 U.S. 579, 125 L.Ed.2nd 46, 113 S.Ct.2786 (1993) and other decisions that follow in its wake. An article in this month's newsletter discusses the admissibility of expert opinion on the issue of an insurer's bad faith. Attorney Richard M. Davis has provided us with a good synopsis of the decisions relating to expert testimony in bad-faith cases.

Those of you who are engaged in risk management consulting may have noticed that most of the articles in previous newsletters have been geared more to those engaged in expert witness work or the practice of law. Perhaps this is because they are more prolific writers—or maybe (no surprise) it is because they are mostly lawyers who simply enjoy offering their opinions on anything, no matter what it is. Either way, we risk management consultants have thus far been underrepresented. I have taken the lead in changing this by offering the first in a series of articles about how we as consultants meet the challenges of the hard market. Market cycles are great experience builders and I encourage you to share your experiences with our colleagues.

Finally, I would like to bid farewell to **William J. Foran, J.D., CPCU,** of Wisconsin and **William Peet, CPCU,** of Minnesota, both of whom passed away since our last newsletter. Both men were independent consultants with whom I was fortunate enough to be acquainted. They each made a positive impact upon our industry and the consulting profession. Their wisdom will be remembered. ■

Letter to the Editor



From Donn P. McVeigh, CPCU

In the last issue of *CLEWS,* two articles were included discussing the merits of reinsurance arbitration. An article opposing arbitration titled "A Case Against Reinsurance Arbitration" was written by Linda Dakin-Grimm, J.D., and M. Benjamin Valerio, J.D., and a rebuttal article titled "The Case for Reinsurance Arbitration" was written by **George M. Gottheimer Jr., Ph.D., CPCU, CLU.** I have to take issue with my good friend and colleague, George Gottheimer—at least as far as *ex parte* contact is concerned.

Ex parte contact is defined as communication between counsel and its appointed arbitrator when opposing counsel (or the umpire) is not present. I've been an appointed arbitrator in only two cases, but, in both cases, *ex parte* contact was prohibited after the initial organizational meeting. This decision was rendered upon the unanimous vote of both appointed arbitrators and the umpire.

In his article, George suggests that *ex parte* contact be continued throughout the hearing process, stating that, through communications with the attorney(s) who appointed him or her, the appointed arbitrator can act as a "reality check" by smoothing the process and increasing the likelihood of a just conclusion. I totally disagree with this.

While it is likely that the appointed arbitrator may have a predisposition in favor of the side that appointed him or her, it is important for the arbitrator to strive for as much objectivity as possible in order to render a dispassionate decision. I can't conceive of any point or issue that shouldn't be brought to the attention of the full panel. Anything less is unfair to the entire process.

From George M. Gottheimer Jr., Ph.D., CPCU, CLU

My good friend, and respected colleague, **Donn McVeigh, CPCU,** takes issue with party-appointed arbitrators having *ex parte* communication with the party that appointed him or her. I have served as an arbitrator in more than 50 arbitrations over the last 16 years. In all of the arbitrations in which I have served as a party-appointed arbitrator (as opposed to the umpire), such *ex parte* communications have been permitted. There have been some instances where one of the parties has been opposed to such communication, but in the end it was permitted. In all of these arbitration proceedings, *ex parte* communication was permitted from the organizational meeting until the first brief had been filed.

For those not familiar with insurance/reinsurance arbitrations, perhaps some explanation might help. The party demanding arbitration (petitioner) selects his or her arbitrator first. The respondent usually has 30 days in which to appoint his or her arbitrator. If he or she fails to do so (I've been involved in four arbitrations where this has occurred), the petitioner gets to choose the second arbitrator. You might think that if this occurs the petitioner has it made. That's simply not the case. Arbitrators take their responsibility seriously and vote their conscience, based on the evidence produced at the hearing and the credibility of the witnesses.

Once the two arbitrators have been appointed, they select the umpire, who is neutral. If the two arbitrators cannot reach a consensus on the selection of the umpire, the governing agreement will provide a procedure for selection of the umpire. One method frequently used is for the two arbitrators to name three candidates. Each party strikes two, and the umpire is selected by drawing lots. There are several methods used to do this, depending on the geographic proximity of

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the two arbitrators. Once the umpire is selected, the panel is now in place.

The next step is an organizational meeting. At this meeting, several topics are covered, such as: a brief presentation of the issues, confidentiality, indemnity for the panel if they are sued personally, depositions, witnesses, discovery cut-off; and a schedule for filing of briefs, rebuttal briefs, and the date and site for the hearing.

During the time *ex parte* communications are permitted (from the organizational meeting to the filing of the first briefs), the party-appointed arbitrators may confer with the appointing party. While I have seen instances where the party-appointed arbitrator was selected without an interview, this is rare. In most instances, the arbitrator-candidate is given some (but not necessarily all) information concerning the issues and the position of the parties. Unless the arbitrator-candidate is in general agreement with the position proffered, he or she will not be chosen.

During the time *ex parte* communication is permitted, discovery takes place. It is during this time when the party-appointed arbitrator can be of great assistance by serving as a "reality check." Through the discovery process, considerable facts and evidence come to light of which the party-appointed arbitrator (and the client) may have been unaware. This is where the party-appointed arbitrator can be of great aid by advising his or her client of the merits or deficiencies of his or her position, given the evidence produced. Often this leads to a settlement between the parties, and the dismissal of the panel. A settlement of the dispute by the parties is always the preferred solution, rather than a decision of the panel.

Donn states the arbitrators should strive for as much objectivity as possible. I agree, and feel that *ex parte* communication does not abrogate objectivity. I have voted, on several occasions, against the party that appointed me, because the evidence and the witnesses did not support their position. The vast majority of arbitrators I have served with hold similar views. It is a rare instance where I have experienced an arbitrator being a "hired-gun." Nor have I experienced a situation where an issue was not brought to the panel's attention because of *ex parte* communication. In England, all three arbitrators are neutrals. In my experience our system is preferable. ■

Consulting in a Hard Market: Staffing to Meet Demand

by Daniel C. Free, J.D., CPCU, ARM

Daniel C. Free, J.D., CPCU, ARM, *is president and general counsel of Insurance Audit & Inspection Company, an independent insurance and risk management consulting organization founded in 1901 by his great-grandfather. He is past president of the Society of Risk Management Consultants (SRMC), an international association of independent insurance advisors.*

Free is also a founding member of the CPCU Society's CLEW Section, and currently serves as editor of CLEWS.

Risk management consultants generally agree that the demand for independent consulting services increases sharply during a hard market. We welcome the added volume and everyone puts in longer hours to handle the extra workload, but there are limits to human productivity. One of our biggest challenges in times like these is finding and adding qualified professional staff members. We spent a lot of time talking about this problem with our colleagues and discovered that we shared a lot of the same concerns and experiences. Some of the main reasons that consulting firms have a difficult time "ramping up" to meet the increased demands of the hard market are included below.

It's a Small World

Insurance and risk management consulting is a unique, rather narrow niche in the broader field of management consulting. The majority of consultants are sole practitioners or two-person operations. There are relatively few firms with more than five full-time consultants. Most of us know each other.

Among the sole practitioners, there are a number who have retired from or left positions in risk management, claims, or underwriting. These people tend to be independently minded and are quite satisfied to work as much (or as little) as they like. Some bristle at the idea of ever working for another corporate organization, especially if it means working for a colleague. Very few are interested in relocating. Thus, even though adding a practicing consultant with a few ongoing clients seems like a perfect solution, it rarely comes to pass.

The Right Combination of Education and Experience Is Rare

There are a number of undergraduate schools of insurance and risk management and several very formidable graduate programs. Students emerging from these schools, particularly the graduate schools, are hired quickly and paid very well. Unfortunately, consulting is as much, if not more, about experience than formal

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education. Without several years of experience, an emerging graduate might have little to offer a consulting firm whose clients expect to interact with those who have gained prominence.

Another hurdle is on-the-job training. Consulting tends to be a billable-hour business. Training any new person, particularly a professional, requires a substantial investment of time that could otherwise be devoted to billable services. Reputable consultants will not "double bill" a client for time spent training a new person, even if the training involves work for that client. During a hard market, a consultant's time is in even greater demand, so a new hire that can "hit the ground running" is of far greater value than a well-educated novice.

Experience Has a "Flip Side"

A lot of applicants have plenty of experience, but it is just that it is not relevant. Though consultants frequently have areas of specialization, most are industry generalists. A risk manager with 30 years of experience in one industry might be of limited value if the consulting firm has no penetration in that specific industry. An applicant with 20 years in personal lines will not have exposure to complex alternative risk financing arrangements for large commercial accounts.

One colleague touched upon a classification we called "too much experience," which includes those who: (1) are clearly "burned out"; or (2) seem unable or unwilling to learn, probably because of a lofty position they held two jobs ago. Most of us have interviewed an applicant who was absolutely convinced that he or she knew more about everything than anyone else in the room. This type of person makes a lousy consultant. Clients cannot stand them and they are no fun around the office.

Insufficient Technical Knowledge or Analytical Skill

Given that risk transfer by insurance is an important element of risk management, one would expect most legitimate candidates to have a strong grasp of insurance coverage, yet we have interviewed dozens of people with impressive résumés who were surprisingly short on product knowledge. That said, we consider analytical capability to be paramount. A person with a good head for analysis can add insurance knowledge. The reverse is not necessarily true.

We give favored candidates a "story problem" that tests analytical skills, coverage knowledge, and, to some degree, writing style. The coverage issues may require some research, which reveals the extent to which the person is willing to dig for answers—an activity that is part of our daily lives.

". . . we consider analytical capability to be paramount."

Unrealistic Compensation Requirements

Every one of our colleagues related a story about an interviewee who, despite having been "in between jobs" for a year or two, could not start for less than a six-figure salary (physician range), car, benefits, etc. These people misunderstand what consulting is all about. We wonder if they realize that no one, including their last employer, found them to be worth that much.

Most consulting organizations are smaller, billable-hour businesses. As a consultant you usually either "eat what you kill" or are compensated based upon some formula designed to measure your value to the firm. The vast majority of applicants,

whether from insurance companies, agencies, or risk management positions, have not had to substantiate productivity in terms of hourly production, much less record it as such. Generally, it takes a long time for someone unfamiliar with this discipline to learn it and live by it.

Large corporations can offer salaries and benefits that are hard for a small- to medium-sized consulting organization to match, at least with respect to a new hire. If an applicant's salary requirement is viewed as excessive, the firm will be unwilling to "carry" the novice consultant until he or she becomes profitable. In short, a novice consultant might come in with experience, but starts from scratch and works his or her way up. Too many laid-off insurance professionals think of going into consulting as a "lateral move," which is a big mistake.

Unimpressive Speaking/ Writing Skills

Consultants interact frequently with board-level management people. Superior verbal and communication skills are a "must have." Professional appearance, demeanor, and bearing are a "nice plus," although we know of some very sought-after consultants who look like they just fell out of bed.

Decisiveness is a very high priority. Nothing makes the eyes of a busy CFO glaze over faster than an advisor who rambles or who cannot make up his or her mind about what to recommend. When my grandmother was president of our company, she reputedly told an under-confident consultant "This client has sought our advice. Give it to him. Even if he chooses to ignore it, he has paid for the right to do so."

Conclusion

Of course, there are resources for finding qualified people. Headhunters have never worked for us—they are usually outrageously expensive and tend to provide candidates with minimum qualifications at the maximum allowable compensation level, thus maximizing their fees. Ads in the trade papers and on the Internet are helpful, but without a screening process, culling out the qualified candidates can take forever.

Most of our colleagues related that their best new talent came by word of mouth. The applicants who became the best consultants were those who knew they wanted to pursue a consulting career, were eager to learn, and willing to let their successes be measured by their client satisfaction rather than the price of the company stock. ■

Author's Note: *Last January, our firm subscribed to the National Job Network located in the Career Center area of the CPCU Society web site. We place a high value on the CPCU designation and this looks like it could be a very good resource. As of this writing, there are 408 posted résumés.*

The Admissibility of Expert Opinion on the Issue of an Insurer's Bad Faith

by Richard M. Davis

Richard M. Davis *is a trial lawyer with Hoeppner Wagner & Evans LLP, with offices in Merrillville and Valparaiso, Indiana. Among other types of cases, he defends insurers in bad-faith suits.*

Not long ago, most judges were lenient in permitting experts to testify. The focus of any inquiry was on the expert's qualifications. Opinions would generally be confined to the expert's area of expertise, but there was not a great deal of attention paid to the reliability of the expert's opinion. The judge would typically respond to an objection based upon the unreliable nature of the testimony by stating: "That goes to the weight of the evidence, counsel, not to its admissibility. You can fully explore those matters on cross-examination." Two United States Supreme Court cases, *Daubert v. Merrell Dow Pharmaceuticals,* 509 U.S. 579, 125 L.Ed.2d 46, 113 S. Ct. 2786 (1993) and *Kumho Tire Co., Ltd. v. Carmichael,* 526 U.S. 137, 119 S.Ct. 1167, 143 L.Ed.2d 238 (1999), changed the landscape considerably. These days, the testimony of any expert is likely to be subjected to the tests of reliability set forth in *Daubert.*

When considering whether the proposed testimony of an expert is admissible, there are several questions to consider, at least one of which should be addressed before scheduling a *Daubert* hearing.

Can the Jury Decide without Expert Opinion?

The first issue to be resolved is whether bad faith is something that jurors can recognize without the benefit of expert opinion. It has long been the law that an expert will only be allowed to provide an opinion on matters beyond the knowledge or experience of the average person. *City of Bloomington v. Holt,* 361 N.E.2d 1211 (Ind. App. 1977). In that case, the trial court ruled that jurors could determine the role of ice and the role of driver's error in the occurrence of an automobile accident as easily as could the proposed expert. Therefore, the expert's testimony was excluded.

This determination is a factually sensitive one. The Minnesota Court of Appeals reached a similar result in *Higgins v. Winter,* 474 N.W.2d 185, (Minn. App. 1991). In that case, an insurance agent had been sued for negligence in his professional duties. The plaintiff wished to offer expert testimony on the standard of care and the agent's breach thereof. The trial court did not allow it and the court, on appeal, agreed saying: "The trial court determined that under the particular circumstances, appellant's expert was in no better position than the jury to evaluate a breach of the standard of care owed by the defendant to appellants with regard to the insurance transaction."

The admissibility of an expert opinion that an insurer had acted in bad faith was considered in *Kooyman v. Farm Bureau Mutual Insurance Co.,* 315 N.W.2d 30 (Iowa 1982). The trial court did not allow the testimony, and the Iowa Supreme Court agreed saying "bad faith is the standard by which the insurer's liability must be measured; a witness may not give an opinion whether it did or did not meet that standard. It is not a proper subject of expert testimony, and the trial court properly refused it." Other courts have allowed expert testimony on bad-faith matters. See *Peiffer v. State Farm Mutual Automobile Insurance Co.,* 940 P.2d 967 (Colo. App. 1996).

Is the Expert Testimony Reliable?

Should the court determine that expert testimony on the issue of bad faith is allowable, the next step is to subject the testimony to a *Daubert* analysis. After appropriate discovery, including the

deposition of the expert, the insurer's counsel should request that the court conduct a hearing pursuant to Federal Rule of Evidence 702 (or the applicable state rule of evidence) and *Daubert,* as to the reliability of the proposed testimony. Once the issue is raised, the proponent of the testimony bears the burden of establishing that the *Daubert* criteria are met. The factors set forth in *Daubert* are: (1) whether the theory in question can be tested; (2) whether the theory has been subject to peer review and publication; (3) the potential rate of error; and (4) general acceptance within the expert's community. *Daubert* dealt specifically with scientific testimony, but *Kumho Tire* applied the same criteria to all expert testimony.

Not all of the factors set forth in *Daubert* need be considered by the court. Indeed, several of the factors may not even apply in a given case. The focus of the inquiry is on the methodology employed by the expert. If the methodology is not capable of being tested, but amounts to no more than the expert's subjective opinion (albeit informed by the expert's years of experience) then there is a powerful argument that such testimony does not satisfy the *Daubert* criteria.

Almost universally, the decision of the trial judge as to permitting or excluding expert testimony may be reviewed only for an abuse of discretion. *General Electric Co. v. Joiner*, 522 U.S. 136, 139 L.Ed.2d 508, 118 S. Ct. 512 (1977).

Is the Expert Qualified?

If the testimony passes muster under *Daubert,* it may be appropriate to test the qualifications of the expert via a motion *in limine.* In a bad-faith case, claim handling experience is a basic requisite of expert qualification. See *California Shoppers, Inc. v. Royal Globe Insurance Co.*, 175 Cal. App. 3rd 1, 221 Cal. Rppr. 171 (1985). In that case, the testimony of a lawyer, who had never adjusted claims, was excluded. Other courts, however, have reached contrary results.

Oftentimes, the plaintiff's bad-faith expert will rely upon experience he or she has gained, as a testifying expert, in cases involving other claims against the same insurer. Sometimes, the expert has no experience in the particular state where the lawsuit is pending. The law concerning bad faith varies from state to state, so it is possible to exclude expert testimony on this basis. See *City of Hobbs v. Hartford Fire Insurance Co.,* 162 F.3d 576 (10th Cir.(N.M.)1998).

Depending upon exactly what the expert is alleging, lack of qualifications may be part of the attack on the expert's methodology, at a *Daubert* hearing. One approach utilized by bad-faith experts involves documents and testimony previously gathered, in lawsuits in other jurisdictions. The expert may testify that he or she knows the claim denial in the instant case was done in bad faith because similar conduct was previously held to be in bad faith. This may be subject to challenge on the grounds that the law concerning bad faith in the state in which the present suit is pending is different from the law in the previous state. It may also be that the insurer's claims-handling procedures differ from state to state, or perhaps, region to region.

Another approach used by bad-faith experts is to take internal company documents, previous testimony of company witnesses, and the testimony of other bad-faith experts in other cases, and use those ingredients to concoct a conspiracy theory. The expert then testifies

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that the motive behind the claim denial in the instant case may be explained by reference to the conspiracy. What is typically lacking is any connection between the documents (some of which may be up to 30 years old) or the witnesses in the other cases and the case at bar. This situation may result in a successful challenge to the expert's testimony on the basis of the expert's lack of qualifications or the defective methodology employed.

Testimony as to Company Policies (Pattern and Practice)

Many jurisdictions will permit an expert to identify the industry standard and to state an opinion as to whether the insurer lived up to that standard. Such an opinion will often be couched in the context of the Unfair Claims Settlement Practices Act (see *Peiffer supra*). It may be subject to exclusion on the grounds that a jury is equally qualified to make that determination. Assume, though, that this opinion will be permitted. The expert should still be precluded from testifying as to the degree of bad faith. I am aware of three separate cases in my home state in which the same expert has tendered affidavits in opposition to one insurer's motions for summary judgment. In all three cases, the expert stated, under oath, that the claim handling in the case at bar was the most outrageous instance of bad faith he had ever encountered. Such testimony does not help the jury resolve any question before it. Bad faith, if it actually exists in a case, essentially means that there has been intentional misconduct on the part of an individual or a company. It would be cutting it extremely fine to suggest that there are degrees of such reprehensible conduct. ■

War Stories

by Donn P. McVeigh, CPCU

Last year, I was being cross-examined as an expert witness in a high-profile asbestos case when the opposing attorney flashed a liability form from the 1940s on the screen and asked me what the form numbers in the lower left-hand corner meant (they were right above the issue date). He obviously was trying to impeach my credibility.

The form number read something like this: A series of about four numbers followed by "S & H" followed by another series of four or five numbers. I had no idea what they meant, but I answered with something like the following: "I can only surmise that the insurance company was giving away green stamps with every CGL policy issued."

The judge, the older members of the jury, and my attorneys got a good laugh out of it, but not opposing counsel. My inquisitor quickly went on to another subject. ■

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