



MADOFF AND INSURANCE COVERAGE

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Reports of the Madoff fraud in December 2008 led to an influx of insurance notifications on Bankers Blanket Bond (“BBB”)/Crime; Directors’ & Officers’ (“D&O”); Errors and Omissions (“E&O”) and Professional Indemnity (“PI”) policies. Notifications were primarily made on E&O and PI policies, and mainly on behalf of lawyers, accountants and financial institutions. The litigation which ensued has led to a number of important insurance coverage issues:

BBB/Crime are first party policies whose application in this context is usually restricted to frauds undertaken by employees; forged instruments or computer misuse. Coverage issues include:

- Was Madoff an employee (as well as a director)? Policies usually exclude the acts and omissions of directors, however normally these do not apply to employee dishonesty sections of the policies.
- Was it the company’s or the employee’s fraud? While a company cannot benefit from

its own fraud, it can benefit from insurance which protects against losses arising from it’s employee’s fraud.

- Most policies require the proof of loss to be provided within six months of discovery of the fraud but such deadlines can be extended with insurers’ consent. The definition of loss can make the formulation of a proof of loss a complex issue.

Third party policies have however been the most affected:

- Many financial institutions’ E&O policies renew their insurance on a calendar year basis. The awareness of the fraud in December 2008 resulted in issues concerning the scope of notifications and prior awareness of circumstances exclusions in the renewing policies.
- Claims brought by the Trustee of Bernard L. Madoff Investment Securities LLC against the feeder funds and, in turn, feeder funds’



- claims against their investors have been largely restitution claims, normally excluded under E&O and PI policies.
- The recent decision of Justice Bannister QC in the BVI in respect of the liquidator of Fairfield Sentry Limited's restitution claims against investors provides hope to those defending those claims. For those entities defending such actions on behalf of their investor clients, substantial legal costs have been incurred. Some have taken advantage of the mitigation costs cover in their policies but they will have to show such costs have been incurred to mitigate potential claims.
 - Securities Act exclusions exclude claims arising out of breaches of the Securities Act 1933 and Securities Exchange Act of 1934. Such exclusions are usually broad and issues have arisen as a result.
 - The professional services exclusion. For D&O claims this would exclude claims arising from the professional and financial services of the insured's company.
 - Insolvency and fraud exclusions also come into play.

There have been a multitude of claims and/or defence costs paid to date by insurers on Madoff related litigation highlighting the benefits of such insurance. The litigation and insurance coverage issues arising provides a useful aide for risk managers to ensure they have the right cover in place for their organisations moving forward.

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