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PRESS RELEASE

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D&O INSURANCE **A COVERAGE RESCISSION SUCCESS STORY** **DOES THIS SUCCESS STORY ENHANCE THE BENEFITS OF SIDE A D&O COVERAGE?**

The coverage rescission success story:

SALT LAKE CITY_A federal judge has ruled that an insurance carrier does not have to help ClearOne Communications cover a \$10 million settlement with its shareholders. U.S. District Court Judge Tina Campbell said ClearOne, a maker of audio and video conferencing equipment, had provided the National Union Fire Insurance Co. of Pittsburgh the same doctored financial statements that it gave the Securities and Exchange Commission and its stockholders. Under Utah law, an insurance provider can rescind its coverage if it relied on such misrepresentations in issuing its policy. "We were reasonably confident going in that the court would ultimately grant a recession (of the policy)," said Salt Lake City attorney Phillip S. Ferguson, who represents National Union. The SEC filed a lawsuit three years ago alleging the company and two of its top executives schemed to inflate ClearOne's share price by doctoring its books. ClearOne eventually settled that dispute without receiving a fine or admitting wrongdoing. However, a class-action lawsuit by shareholders raised many of the same allegations as the SEC's action. ClearOne agreed to pay \$5 million in cash and issue an additional 1.2 million shares to settle with its stockholders. ClearOne recently received a notice from the SEC's Salt Lake City that it wants to revoke the registration of the company's stock because it failed to file current annual and quarterly reports. If SEC officials in Washington adopt the recommendation of the Salt Lake City office, ClearOne's stock will no longer trade. ClearOne filed a statement with the SEC detailing its reasons why it believes it isn't necessary for regulators to revoke its stock to protect shareholders. It has not made the statement public or revealed it to its shareholders. "That is private information," ClearOne spokeswoman DeLonie Call said. "We're not going to make it public." The company has promised its shareholders that it will complete the audit of its 2004 financial results before year end and that it will submit its 2005 documents by the end of the first quarter in 2006. In August, ClearOne finally filed its financial reports for the years questioned by the SEC in its lawsuit. The reports revealed the company had gone from a \$3.6 million profit in fiscal 2001 to a \$35.9 million loss in fiscal 2003.

Does this success story enhance the benefits of Side A D&O coverage?

Insurance carriers highlight the risk that - If the traditional D&O policy does not respond because a carrier rescinds or threatens to rescind the policy, whether due to corporate wrongdoing or because the policy was underwritten based on false or misleading corporate information, innocent insureds are left with their personal assets at risk. These same carriers promote a product called Side A coverage that provides what they term a **non – rescindable** contract – one that pays defense costs, settlements and judgments in D&O claims, when a D&O policy does not advance payments because the underlying insurer either threatens to or rescinds the policy and company does not indemnify the insureds.

The following should be noted:

- Both the traditional and Side A contracts rely on and are underwritten utilizing the same underwriting material (applications, financial statements, etc.).
- Both the traditional and Side A contracts require an application which have a warranty statement. Note: Side A contracts include an updated warranty statement, while the traditional primary or underlying contracts most often have a dated warranty.
- The ability to rescind a contract of insurance is very difficult. Most states will in fact allow a carrier to rescind its coverage if it relied on misrepresentations – Utah law is not unique. In this case AIG – National Union won.
- Side A contracts are marketed as non rescindable – but they:
 - ⇒ Are underwritten and subject to a fresh warranty statement each and every year and;
 - ⇒ Pay only non-indemnifiable claims.

So in other words, two events need to take place before the Side A contracts step in 1.) The underlying policy or policies need to have been rescinded and 2.) The insured needs to fail to indemnify the insured persons (which would require a flat refusal to reimburse or bankruptcy).

- As noted above Side A contracts, like traditional primary or underlying contracts, require the insured to complete an application which contains the following wording: (SAMPLE WORDING) “It is agreed that this application, including any material submitted therewith, shall be the basis of the insurance and shall be physically attached to and part of the policy, if issued. The company will have relied upon this application, including any material submitted therewith, in issuing the policy.” In addition to this, the Side A policies contain a “representations” sections which state: (SAMPLE WORDING) “The insured person(s) represents that the particulars and statements contained in the Application are true, accurate and complete, and agree that this Policy is issued in reliance on the truth of that representation, and that such particulars and statements, which are incorporated into and constitute a part of this Policy, are the basis of this Policy and are material to the Company’s acceptance of this risk.”

- Many insurance carriers offering Side A coverage place the following wording on their application and their respective “representations” section of the policy: (SAMPLE WORDING) “However, the knowledge of one applicant shall not be imputed to any other applicant for the purposes of this declaration.”

CONCLUSION

ANSWER TO THE QUESTION POSED ABOVE

The various **marketing materials** that are handed out by the insurance carriers providing Side A coverage do in fact make statements like the following:

“Provides protection when the primary coverage refuses to perform in a timely manner or will not respond at all.”

“The policy is non-rescindable.”

Some Side A policies do not have a provision that state the contracts are non-rescindable. They only omit the clause found in traditional policies stating that if in fact the information provided is false the coverage is void. What they fail to highlight is the fact the policy is not triggered until the insured is not indemnified and that coverage is only available for innocent insured’s and not available for guilty insureds. So in essence while the policy appears to be non-rescindable (?) on its face it is not applicable if the information provided was inaccurate. When one takes into consideration the Sarbanes Oxley Act and its compliance requirements this argument is strengthened. Note: Under Sarbanes Oxley periodic statutory financial reports are to include certifications that:

1. The signing directors and officers have reviewed the report;
2. The report does not contain any material untrue statements or material omission or be considered misleading;
3. The financial statements and related information fairly present the financial condition and the results in all material respects;
4. The signing officers are responsible for internal controls and have evaluated these internal controls within the previous ninety days and have reported on their findings;
5. A list of all deficiencies in the internal controls and information on any fraud that involves employees who are involved with internal activities;
6. Any significant changes in internal controls or related factors that could have a negative impact on the internal controls.

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