FEDERATION OF REGULATORY COUNSEL, INC.

THERE'S A NEW SHERIFF IN TOWN

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There is a buzz in the world of corporate law in North Carolina. A state with a dearth of case law in the officer and director liability realm has been given a weighty, seventy page, four appendix opinion (the "Opinion") full of detailed analysis and answers to previously unanswered questions of North Carolina corporate law. The case involves officers and directors of an insurance company, so for those of us who practice insurance regulatory law in North Carolina, it is the new guideline for advising our clients.[1]

The lawsuit was filed March 31, 2006, by the Commissioner of Insurance (the "Commissioner") as liquidator of Commercial Casualty Insurance Company of North Carolina ("CCIC" or the "Company") against defendants A. Richard Custard ("Mr. Custard"), Wendy J. Custard ("Mrs. Custard"), E. Nimocks Haigh ("Mr. Haigh")(the "Individual Defendants") and Delta Insurance Services, Inc. ("Delta")(collectively, the "Defendants"). The action was designated a mandatory complex business case by Order of the Chief Justice of the Supreme Court of North Carolina dated May 3, 2006, and assigned to Judge Ben F. Tennille, Chief Special Superior Court Judge for Complex Business Cases. The matter was before the Court on the Defendants' motion for summary judgment.

Delta was a Georgia holding company controlled by Mr. Custard. Mrs. Custard and Mr. Haigh also owned stock in Delta. Delta owned all of the stock of CCIC.

CCIC was a Georgia property and casualty insurer organized in 1988. The Company's daily operations were run by Mr. Haigh with the assistance of an experienced and qualified group of advisors, all of whom were integrally involved in the decision-making process which gave rise to the lawsuit. Mr. Haigh, however, was the only member of CCIC's management team named as a defendant.

Mr. and Mrs. Custard also owned Custard Insurance Adjusters ("CIA"). CIA is a well-known national property and casualty insurance claims adjuster. In addition to adjusting claims for other companies, CIA handled most of the claims of CCIC.

The Individual Defendants were directors and/or officers of both Delta and CCIC. Mr. Custard was the chief executive officer of CCIC and president of CIA and Delta. Mrs. Custard was secretary of CCIC and Delta. Mr. Haigh served as president and chief operating officer of CCIC from 1992 until March of 2003.

At the center of the lawsuit was the selection and volume of a particular line of business written by the Company. Initially, CCIC wrote primarily professional liability policies for environmental consultants in Florida. After a few short years, and a foray into the non-standard automobile insurance market in North Carolina, the Company shifted its focus to take advantage of the housing and construction boom on the west coast. During the late 1990s and early 2000s, CCIC experienced substantial premium growth by writing insurance policies for small tradesmen and contractors, or artisans, in California. "CCIC's growth outperformed the Company's ability to generate policyholder surplus."[2]

Company management began taking action to increase surplus as early as the spring of 2001. One of its initial steps was the filing of a Petition for Redomestication from Georgia to North Carolina in June of 2001. The Petition was approved in December of that year. Because North Carolina's premium tax rate was lower than that of Georgia, CCIC saved $1.5 million in out-of-state premium taxes the year following its

redomestication.

The month of approval of its redomestication, CCIC filed a request for a rate increase of 20% for its artisan business with the California Department of Insurance ("CADOI"). Pending approval of the rate filing, CCIC's vice president of marketing assigned a 15% bad risk surcharge on all new and renewal business. In February, the CADOI approved a rate increase of only 16.2%.

Central to the case against the Defendants were the management decisions regarding loss ratio estimate selections used in filings with the North Carolina Department of Insurance ("NCDOI"). CCIC's internal actuary completed a reserve analysis in February of 2002, based on the Company's losses for the year ending 2001. The Company's actuary utilized the loss data from both California and non-California business and found that the losses on the California artisan business outpaced those of the non-California business.

CCIC's annual statement filed with the NCDOI reported lower loss ratio estimates than those estimated by the Company's internal actuary. The differences between the reported estimates and those of the Company actuary were significant: approximately 25% for accident year 2000 and 14% for accident year 2001. Management believed that as the California artisan business matured, the losses would fall in line with the non-California business. Furthermore, the Company's outside accounting firm, Ernst & Young ("E&Y"), had provided a preliminary actuarial analysis which supported management's decision.

E&Y delivered to the Company a 2001 reserve study in April of 2002 (the "Reserve Study"). The Reserve Study was consistent with E&Y's preliminary reserve analysis and concluded that the Company's loss ratio estimates for 2001 were approximately 14% lower than the findings of CCIC's internal actuary. Again, the conclusion was rooted in the losses of the non-California business. The Company's first quarter filing showed no change in its California loss experience. An actuary for the NCDOI reviewed the Reserve Study and found no issue with its methodology, findings and conclusions.

The Company sought another rate increase in California in June, 2002. CADOI approved an increase of 8.45% in response to CCIC's requested increase of 43.3%. During the same month, AM Best downgraded the Company from A- to B++ and blamed the California risk for the downgrade. Efforts were being made by management to raise capital through various investment brokers. In fact, a purchase agreement was signed which would have resulted in a $6 million capital infusion into CCIC. The transaction was never consummated.

By the end of 2002, CCIC had drastically reduced the premium volume of its artisan business in California. It continued to pursue outside financing. E&Y issued a statement of actuarial opinion on February 29, 2003 (the "February Opinion") and concluded that CCIC had not made a "reasonable provision in the aggregate for all unpaid losses and loss adjustment expenses."[3] At the time of the filing of CCIC's 2002 annual statement, E&Y believed management's reserve estimates were "several million dollars lower" than appropriate levels. "E&Y relied on CCIC's California loss experience in calculating their reserve estimates for 2002 - a fundamental change in their approach."[4]

CCIC was placed under administrative supervision by the NCDOI on March 7, 2003. One week later, Mr. Custard invested $1 million of surplus into the Company and continued efforts to raise outside capital. In April, E&Y reissued its 2002 Reserve Study, basing it entirely upon CCIC's California losses. As a result, the loss estimates were much higher than those of the 2001 Reserve Study. CCIC was placed into rehabilitation On November 17, 2003.

Theories of Recovery

The initial theory of recovery by the Commissioner was based on allegations of improper conduct by the Individual Defendants perpetrated for the purpose of benefitting CIA. In short, the DOI alleged that those defendants breached their fiduciary duty by selling insurance through CCIC to provide a source of claims for CIA to adjust and the insurance was sold without regard to the solvency of CCIC. "Not surprisingly," Judge Tennille writes, "there does not appear to be any evidence to support what is, on its face, an irrational theory."[5]

A new theory was put forth at summary judgment. "For the first time, the NCDOI based its theory of liability on allegations that the Individual Defendants showed a lack of good faith in (1) filing CCIC's monthly reports with the NCDOI and (2) continuing to sell a high volume of artisan insurance policies in California after seeing that losses on those policies were coming in at higher than expected rates."[6]

The Decision

The Opinion begins with an explanation of the differences between the standard of conduct and the standard of review. A standard of conduct indicates how an actor should conduct a given activity while a standard of review is the test a court utilizes in reviewing an actor's conduct to determine whether it is appropriate under the circumstances. Although in many circumstances the lines between these two principles are blurred, in the world of corporate governance, they have diverged because fairness and efficiency require it. "In order to attract competent directors it is only fair that we judge their conduct according to the circumstances in which they must make decisions."[7] They often have to act without being fully informed. Efficiency is driven by the creation of corporate value. "In order for the corporation to increase in value...it must take risks."[8]

The Court's task was to determine the proper standard of review in two contexts: "(1) the operation of the business and the application of the corporate charter's exculpatory provisions and (2) the director's duty to monitor."[9] Because North Carolina case law on the subject is sparse, the Court looked to Delaware for guidance in the analysis of good faith and bad faith. The indemnity clause of CCIC's charter exculpates officer and director action taken in good faith. Duty to monitor also invokes good faith. "[W]hether there was an absence of good faith or the existence of bad faith is virtually the same."[10]

"There is no duty of good faith separate and apart from the duties of care and loyalty under either Delaware or North Carolina law."[11] When fiduciary conduct is reviewed, it must be reviewed in context. "Directors' obligations will be judged in the context in which they occur, and thus conduct by directors of an insurance company may be judged differently from conduct by directors of a textile company depending on the actions in question."[12]

The duty of loyalty and the duty of care are the two fiduciary duties of directors. Duty of loyalty is usually implicated when a conflict of interest arises. There are, however, circumstances when no such conflict exists but director action is required and a failure to act may result in a breach of that duty. An example is the director's failure to monitor corporate activities. Although there are circumstances where a director's state of mind is at issue in this context, the existence of such an issue does not bar an award of summary judgment. "The Court has a significant gatekeeper role in determining which factual circumstances warrant submission of bad faith issues to a jury."[13]

North Carolina has codified the business judgment rule in section 55-8- 30(a) of the General Statutes. A director shall discharge his duties as a director, including his duties as a member of a committee: (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation. There is a strong presumption in North Carolina that "a decision by a loyal and informed board will not be overturned by a court unless it cannot be attributed to any rational business purpose." Russell M. Robinson, II, *Robinson on North Carolina Corporation Law* §14.06 (7th ed. 2009).[14]

In order to succeed on its breach of fiduciary duty claim (and avoid the exculpatory clause of CCIC's charter), the Commissioner had to prove that the officers and directors acted in bad faith (a violation of NCGS 58-8-30(a)). The claim of breach of fiduciary duty was based upon decisions made by management concerning the volume of California artisan business written. "In order to establish a lack of good faith in business decisions in the context of an insurance company, a plaintiff...must show that the officers and/or directors displayed a conscious indifference to risks in the face of clear signals of the existence of problems likely to lead to insolvency."**15**

Judge Tennille found no evidence of conscious indifference to risk or irrational process. The Company used both in-house and outside actuaries, made efforts to increase rates, attempted to raise outside capital, reinsured risk and ceased selling unprofitable lines of business. The Custards had millions of dollars at risk. Mr. Haigh's job was at risk, as was his investment in *Delta*. "The actors were not indifferent; they made judgments."**16** Although the judgments turned out to be wrong, there was no evidence that the actors did not believe that their actions were in the Company's best interests.

The Court cites *In re Caremark Int'l Inc. Derivative Litig*., 698 A.2d 959 (Del. Ch. 1996) in addressing failure to monitor as a breach of fiduciary duty. Only a "sustained or systemic failure of the board to exercise oversight...will establish the lack of good faith that is a necessary condition of liability." *In re Caremark*, 698 A.2d. **17** A showing of bad faith is necessary to support the theory of liability.

"There is no evidence that the directors of CCIC acted in bad faith in monitoring the business risks."**18** Losses were reviewed by both in- house and outside actuaries. Even though the Company's in-house actuary assigned higher loss estimates to the artisan business than E&Y, the directors were entitled to rely on outside actuaries. In fact, the NCDOI explicitly approved of the methodology utilized by E&Y. Although there was evidence that the premium volume was too high relative to surplus, management was actively engaged in efforts to raise outside capital and implementing other measures to improve profitability. "In this context, the Commissioner has failed to establish that any director had the illicit state of mind sufficient to support a finding of bad faith in the monitoring context."**19**

The Court gives short shrift to the Commissioner's argument, based on one sentence from *State ex rel. Long v. ILA Corp*., 132 N.C. App. 587, 513 S.E.2d 812 (1999), that there exists an independent cause of action for negligent mismanagement of an insurance company. That case involved a breach of fiduciary duty that abrogated the business judgment rule because of self-dealing. Noting no showing of a conflict of interest by the Commissioner, the Court held that there is no stand-alone cause of action for negligent mismanagement. "The [*State ex rel*. Long] decision simply held that a director who is not entitled to the protection of the business judgment rule can be liable for negligent conduct which harms the corporation."**20**

Reliance on E&Y as an outside advisor was justified under the circumstances. Although CCIC's in-house actuary predicted higher losses for the artisan business, E&Y considered, and rejected, those findings. It concluded that it was more reasonable to utilize mature loss data that included non-California business. E&Y was competent to render its opinions and the NCDOI agreed with its methodology. A director is "entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented." N.C. Gen. Stat. § 55-8-30(b)(1).**21** The advice received must be followed and a director cannot rely on information she knows to be inaccurate.

Finally, the Court addressed the Commissioner's claim that the Individual Defendants breached their fiduciary duties by filing misleading financial reports with the NCDOI in 2002. "Directors of insurance companies have a fiduciary duty - under both a duty of care and a duty of loyalty - to exercise good faith in the supervision of the regulatory filings which protect policyholders as well as the owners of the company." **22** The only filings at issue were those in the latter part of 2002 estimating losses for the Company's California business.

The Commissioner alleged that the June 30, 2002, and September 20, 2002, reports were false and misleading because the loss ratios were not revised to reflect the 2002 developments prior to the filing of the 2003 annual statement. After reviewing several factors that impacted CCIC's loss reserve estimates during the period, the Court points to E&Y's methodology change as having the most dramatic impact. Its decision to forgo use of nationwide historical data in 2003 (which it had used in 2002) and use solely California data to determine ultimate losses on the California artisan business resulted in a 106.5% increase for accident year 2000 and a 119.9% increase for accident year 2001. "The decision on what data to use was a judgment call."**23** In 2003, E&Y changed its judgment because historical data on California was more mature. "The NCDOI does not fault E&Y for its methodology in 2002 or 2003. Yet it asks the Court to impose liability for breach of fiduciary duty on CCIC's officers and directors for employing the same methodologies."**24**

Summary judgment was granted in favor of Defendants. The case was not appealed by the Commissioner. "History teaches us at least three things. First, our knowledge is vulnerable. What we think we know with certainty can and probably will be proven wrong. Second, things change. Third, bad things will happen, randomly."**25**

Endnotes

1. *State ex rel. Comm'r Ins. v. Custard*, No. 06CVS4622, 2010 WL 1035809,2010 NCBC 6 (N.C. Super.Bus.Ct. March 19, 2010).

2. *Id*. at 2010 WL 1035809 at *6, 2010 NCBC at 10.

3. *Id*. at 2010 WL 1035809 at *13, 2010 NCBC at 20.

4. *Id*. at 2010 WL 1035809 at *13, 2010 NCBC at 21.

5. *Id*. at 2010 WL 1035809 at *2, 2010 NCBC at 3.

6. *Id*.

7. *Id*. at 2010 WL 1035809 at *15, 2010 NCBC at 25.

8. *Id*. at 2010 WL 1035809 at *16, 2010 NCBC at 25.

9. *Id*. at 2010 WL 1035809 at *17, 2010 NCBC at 27.

10. *Id*.

11. *Id*. at 2010 WL 1035809 at *18, 2010 NCBC at 29.

12. *Id*. at 2010 WL 1035809 at *19, 2010 NCBC at 29.

13. *Id*. at 2010 WL 1035809 at *19, 2010 NCBC at 30.

14. *Id*. at 2010 WL 1035809 at *20, 2010 NCBC at 32.

15. *Id*. at 2010 WL 1035809 at *22, 2010 NCBC at 34.

16. *Id*. at 2010 WL 1035809 at *23, 2010 NCBC at 36.

17. *Id*.

18. *Id*. at 2010 WL 1035809 at *25, 2010 NCBC at 38.

19. *Id*. at 2010 WL 1035809 at *25, 2010 NCBC at 39.

20. *Id*. at 2010 WL 1035809 at *26, 2010 NCBC at 41.

21. *Id*. at 2010 WL 1035809 at *27, 2010 NCBC at 42.

22. *Id*. at 2010 WL 1035809 at *29, 2010 NCBC at 44.

23. *Id*. at 2010 WL 1035809 at *35, 2010 NCBC at 54.

24. *Id*. at 2010 WL 1035809 at *41, 2010 NCBC at 64.

25. *Id*. at 2010 WL 1035809 at *36, 2010 NCBC at 54.