

Tip of the Month



Preservation Obligations and Insurance Policy Notification Clauses

Scenario

An accounting firm becomes aware through news reports of the collapse of an alleged Ponzi scheme. Several of its audit clients are investment funds that are victims of the scheme. The accounting firm consults with counsel about whether the accounting firm has insurance coverage if sued by the investment funds for failure to discover the fraud and is advised that it should give its insurers notice that a circumstance has arisen that may give rise to a claim. The accounting firm is unsure whether notifying its insurers also triggers its obligation to preserve evidence relevant to potential future litigation.

Duty to Preserve

The duty to preserve evidence arises when an organization has notice, either actual or implied, that evidence in its custody or control is or may be relevant to current or potential litigation involving that party. Once an organization has such notice, it must suspend its normal document retention/destruction practices and put in place a legal hold to ensure that evidence is preserved. While notice is most commonly evidenced through the filing of a lawsuit or the receiving of discovery requests, other circumstances may also trigger an organization's duty to preserve.

It is commonly stated that an organization's duty to preserve is triggered when that organization "reasonably anticipates litigation." But where there is no complaint or discovery demand, there is no bright-line test for assessing whether a legal hold must be issued. Rather, a more fact-intensive inquiry is required to determine when an organization has sufficient notice to be subject to a duty to preserve evidence.

In determining whether an organization was subject to an obligation to preserve, courts commonly consider whether that organization exhibited a "fear" of litigation. For example, courts often consider the fact that an organization made comments discussing the likelihood of litigation or designated materials as attorney work product as evidence that the organization was anticipating litigation and, therefore, had sufficient notice of its obligation to preserve materials.

Insurance Notification Clauses

The notification provisions typically included in claims-made insurance policies often raise questions similar to those an organization must consider with respect to its preservation obligations. These provisions typically state that if an insured provides notice to its insurer prior

to expiration of the policy of a circumstance that may give rise to a claim, the policy will provide coverage for a later-made claim relating to that circumstance. However, if notice of the circumstance is not provided, a later-made claim will not be covered by the expired policy and also may not be covered by a new policy, which will generally exclude claims arising from matters for which the insured had notice prior to commencement of the new policy. A commonly stated test for when notice of a circumstance should be given to an insurer is whether the known facts are "sufficiently serious to lead a person of ordinary intelligence and prudence to believe that it might give rise to a claim for damages." As with the obligation to preserve evidence, whether a circumstance is significant enough to warrant reporting to an insurer is a fact-intensive inquiry for which there is no bright-line test. Thus, the question that arises is whether an organization must issue a legal hold every time it notifies its insurer of a circumstance that may give rise to a claim.

There is little guidance provided on this issue. However, at least one court has considered whether the act of providing notice to an insurance provider constituted a triggering event for a defendant's obligation to preserve documents. In *Phoenix Four, Inc. v. Strategic Resources Corporation*, an investment company sued its investment advisor for fraud and other claims. The complaint was filed in May 2005, but on at least two prior occasions, and as early as May 2003, the defendant notified its insurers that a dispute existed.

In March 2005, the defendant vacated its office space and left behind a number of computers containing relevant ESI and documents that the landlord subsequently discarded. During discovery, the plaintiff filed a motion for sanctions and sought an adverse inference instruction against the defendant for abandoning the materials. The plaintiff argued, citing defendants' notifications to the insurance company, that the defendant had an obligation to preserve the materials because it had notice that the evidence might be relevant to future litigation. The court found that the references to future litigation included in the notifications to the insurance company, while thin, were sufficient to support a finding that defendants knew or should have known that the prospect of litigation was real.

Best Practices

When notifying an insurer of a circumstance that may lead to a claim, an organization should also consider whether it is necessary to suspend normal document destruction programs and to implement a document hold.

- **Seek Advice of Counsel.** When reporting a circumstance to an insurance company in compliance with a notification provision, an organization should consider consulting with in-house or outside counsel regarding whether there is a duty to preserve ESI and other materials relevant to potential future litigation.
- **Establish Procedures and Lines of Communication.** Courts necessarily review, with the benefit of hindsight, whether a duty to preserve evidence existed at some earlier point in time. To counter such an analysis, it is very helpful to be able to prove that the preservation issue was analyzed contemporaneously, and to be able to show the considerations that drove that analysis. Establishing policies and procedures to ensure that a contemporaneous analysis of the preservation obligation is undertaken is the best way for an organization to protect its interests. Those policies and procedures should establish lines of communication between the employees or departments responsible for compliance with notice provisions in insurance policies and those employees or departments

responsible for implementing legal holds.

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