UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

M. DIANE KOKEN, acting in her official capacity as Insurance Commissioner of the Commonwealth of Pennsylvania as Statutory Liquidator of Legion Insurance Company and Villanova Insurance Company,	)	
Plaintiff,	)	Case No. 05 C 1049
v.	)	Judge Holderman Magistrate Judge Nolan
AMERICAN PATRIOT INSURANCE AGENCY, INC., a Wisconsin corporation, and LYSA JO SARAN, an individual,	)	
Defendants.	)	

DEFENDANTS' MEMORANDUM
IN SUPPORT OF (1) THEIR OBJECTIONS TO
THE MAGISTRATE'S ORDER DATED MAY 9, 2006 AND
(2) MOTION TO AMEND CASE MANAGEMENT SCHEDULING ORDER

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Defendants, American Patriot Insurance Agency, Inc. ("Patriot") and Lysa Saran ("Saran") (collectively, "Defendants"), respectfully submit their objections to the May 9, 2006 Order (the "Order") of Magistrate Judge Nan Nolan denying as "premature" Defendants' Motion to Overrule Claim of Attorney-Client Privilege on the basis of the crime/fraud exception and under principles of waiver ("Motion to Overrule"). The privilege was asserted by Plaintiff, M. Diane Koken, Insurance Commissioner of the Commonwealth of Pennsylvania ("Liquidator"), the statutory liquidator of two insolvent Pennsylvania insurance companies, Legion Insurance Company ("Legion") and Villanova Insurance Company ("Villanova"), the former employers of the deponents.

The Liquidator asserted the privilege to terminate inquiry about a scheme to defraud Patriot which is the subject of Patriot's Seventh Affirmative Defense ("fraud affirmative

defense") and which is detailed in the affidavit of one of Legion's former senior executives, Eric Bossard and a former employee of Commonwealth Risk Services, James Agnew, who marketed the insurance program at issue. This scheme to defraud was the subject of a prior ruling of this Court which expressly sanctioned discovery on this topic. (*See* Ex. 6.) (Dkt. #51.) The attorney-client privilege was asserted in connection with the depositions of Legion's former in-house counsel, Andre Walsh, who was present "in the room" when, according to the affidavits of Messrs. Bossard and Agnew, the scheme to defraud was hatched.[1] Significantly, Walsh's presence and participation in this February, 2000 meeting has **not been denied.**

Because the issues which are the subject of their objections permeate Defendants' Affirmative Defenses and impact the depositions of multiple witnesses, amendment of the current case management schedule is necessary. Even if this Court agrees with the Magistrate that the Motion to Overrule is premature until rulings on dispositive motions, the existing Case Management Order still requires recalibration. This is necessary to permit the bifurcation of discovery which the Magistrate ordered, with a second discovery period to proceed after rulings on limited dispositive motions pertaining to a discreet contract interpretation issue.

I. INTRODUCTION

The Liquidator's assertion of privilege blocks off inquiry into: (1) whether Mr. Walsh helped to design a fraudulent scheme in February, 2000; and (2) whether the events which

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[1] The privilege was asserted during the depositions of Andrew Walsh and Richard Turner. Mr. Turner was President of Commonwealth Risk, and was the Senior Executive to whom Mr. Agnew reported. Additionally, owing to the ongoing privilege dispute, the deposition of Glen Partridge, Executive Vice President of Legion, was postponed, and documentary evidence, some of which has already been produced in redacted form, will not be provided until this privilege issue is resolved. The Mutual family of companies includes, *inter alia*, Legion, Villanova, Mutual Risk Management, Ltd. ("MRM"), Commonwealth Risk Services LP ("Commonwealth"), Mutual Holdings Bermuda Ltd. ("Holdings") and Mutual Indemnity Bermuda Ltd. ("MIB"). Acting as one entity, they collectively marketed and implemented a "rent-a-captive" insurance program to Patriot called the Roofers Advantage Program ("the Program"). (*See* Ex. 1 at Seventh Affirmative Defense, ¶¶ 1-3.)

Messrs. Bossard and Agnew have attested to in their Affidavits accurately reflect what happened. Nonetheless, the Magistrate decided that it would be "premature" for her to rule on the crime-fraud exception, and that she would instead bifurcate discovery so that the Motion to Overrule can be re-filed after rulings on summary judgment motions.

The Magistrate, relying upon an after-the-fact interpretation of an incomplete Reinsurance Treaty which Mr. Walsh himself drafted, reasoned that she could not determine whether the events of February, 2000 -- even though intended for a deceitful purpose -- were technically part of a fraud, or whether they were *fortuitously* not fraudulent. The Magistrate surmised that whether a fraud was perpetrated would be based on how this Court might interpret the Reinsurance Treaty and certain related Program documents. (*See* Exs. 2 and 3, the Magistrate's Order and Transcript of Proceedings of May 9, 2006, respectively.) The Magistrate's procedural construct will have this Court deciding the meaning of the complex Program documents and Reinsurance Treaty without any discovery into the intent of the parties or the meaning of those documents, although this Court previously decided that the fraud affirmative defense which is impacted by those documents would be subject to dispositive motions only after a factual record was created by discovery. (*See* Ex. 6.) The missing discovery, the missing facts, includes meetings wherein officers of Legion and the Mutual companies discussed and declared their carefully-considered construction of the Program documents on the precise question the Magistrate wants decided in advance of any crime-fraud ruling, namely the ultimate exposure of Patriot for Program losses.

The Magistrate's ruling creates an impossible Catch-22 for Patriot. Patriot, through the affidavits of two whistleblowers, has met its burden of showing a *prima facie* case of fraud to override the attorney-client privilege, meaning the burden then shifts to Koken (having stepped

in Legion's shoes) to explain away that fraud. As described below, the Motion to Overrule was not premature because Patriot provided uncontradicted testimony of the fraud discussions. It was Koken's/Legion's "explanation" that was inadequate in the Magistrate's eyes because it failed to meet its burden of sufficiently explaining that a fraud did not take place.

So, on the one hand, this Court should overrule the Magistrate's order and find that a *prima facie* case of fraud has already been made out and the attorney-client privilege cannot stand. On the other hand, if the Court does not do so, then we are left with the procedural framework employed by the Magistrate, which requires an amendment of the existing Case Management Order to permit dispositive motions on a limited document interpretation issues, followed by a second discovery period if the Court's interpretation of the documents upon which Koken/Legion bases its explanation is such that the fraud occurred as Patriot alleges.

II. FACTS

A. The Fraud

In this case, the Liquidator seeks to recover from Defendants over $4 million in premiums and commissions allegedly due pursuant to a Limited Agency Agreement between Legion and Patriot as one of many related Program documents.[2] Patriot has denied the contractual obligations alleged by the Liquidator, and has asserted various affirmative defenses. Patriot's fraud affirmative defense (Seventh Affirmative Defense) states, in relevant part, that the Liquidator is estopped to recover the claimed amounts, or that those amounts must be offset by damages to Patriot, by virtue of a fraud Legion and its related companies committed upon Patriot and its primary shareholders, Diane and Ken Hendricks. Virtually all the discovery Patriot needs to do in support of that fraud defense has now been short-circuited by the Liquidator's assertion

[2] The other Program documents include the Proposals for each year of the Program, the Shareholder Agreement (and amendments) and Reinsurance Treaty 103 (and amendments).

of privilege based on the fact that Walsh, in-house counsel for Legion and related companies, was merely **in the room** during the discussions where the scheme to defraud was hatched. According to the whistleblower affidavits of two individuals who were present at that meeting, Mr. Walsh was a direct participant in the scheme and was a participant in the discussions about the most efficient way in which to defraud Patriot. This is a classic crime-fraud scenario.

The crucial events pertaining to the Motion to Overrule took place in February, 2000, when the underlying Rent-a-Captive Program was coming up for the Year 4 renewal. The following recitation of those events is entirely from the pleadings in this case and the affidavits of two witnesses to the fraud (Messrs. Bossard and Agnew). At that time, Lysa Saran and Diane Hendricks met with Eric Bossard, Vice President of Legion, and James Agnew, Vice President of Commonwealth, the Mutual entity which had marketed the Program to Patriot. The Program can be summarized as follows: Legion acted as an insurance company, issuing policies on Patriot's behalf to roofing contractors. MIB acted as an offshore Bermuda reinsurer, reinsuring a portion of Legion's losses. Legion was a party to a Reinsurance Treaty with MIB. Patriot was neither a party to that Reinsurance Treaty, nor did it have possession of the Reinsurance Treaty or its various amendments (more will be said later on this point). Up to a certain point, losses on the Program (claims paid, in other words) were the responsibility of Legion. After that point, MIB would reimburse Legion subject to a cap. After that point, Patriot assumed responsibility for losses up to a subsequent amount, referred to as the Aggregate Attachment Point. Losses in excess of that amount then became the responsibility of Legion.

Prior to the February 2000 meeting, Mrs. Hendricks had been alerted that as a result of reserving deficiencies by the claims administrator Legion contracted with to handle claims, the Program actually was not performing as Mrs. Hendricks had previously believed and that serious

losses on the Program should be expected. At the meeting with Bossard and Agnew, Mrs. Hendricks was uncertain about her ultimate exposure for these losses and therefore directly inquired whether Patriot's ultimate liability extended only to the Aggregate Attachment Point or beyond. Agnew stated that he would "would check" and get back to Mrs. Hendricks and Patriot. It was apparent to him that Mrs. Hendricks actually feared that Patriot's exposure might extend beyond the Aggregate Attachment Point. (*See* Ex. 1 at Seventh Affirmative Defense, ¶¶ 6, 11-14; *see also* Ex. 4 at ¶¶ 20-21; Ex. 5 at ¶¶ 6-7.) Within a week, Messrs. Bossard and Agnew returned to Legion's offices, specifically to the office of Mr. Partridge, Executive Vice President of Legion, and took part in the discussions which are at the heart of Patriot's Motion to Overrule.

Bossard and Agnew first met with Partridge and Turner to relay the substance of the meeting with Mrs. Hendricks and Lysa Saran. (*See* Ex. 4 at ¶ 22; Ex. 5 at ¶ 8.) Mr. Partridge asked whether Mrs. Hendricks really believed Patriot was "on the hook" for all amounts above the Aggregate Attachment Point, and Mr. Bossard responded that she did indeed. (*See* Ex. 5 at ¶ 9.) Partridge, Turner, Bossard and Agnew then called in-house legal counsel for Legion[3], Mr. *Walsh*. They spoke on a speaker phone, and Walsh confirmed that in reality it was Legion which was responsible for losses in excess of the Aggregate Attachment Point. (*See* Ex. 1 at Seventh Affirmative Defense, ¶ 16; *see also* Ex. 4 at ¶ 23; Ex. 5 at ¶ 10.) According to Bossard and Agnew, Mr. *Walsh* told them that the legal obligation could be altered if certain documents pertinent to the Program were retroactively "amended" to place that obligation on Patriot rather

[3] Walsh claimed at his deposition that he also acted as legal counsel for all of the related Mutual Entities. Whether or not this is accurate (Mr. Walsh's publicly posted credentials makes no mention of this), it does support Messrs. Agnew and Bossard's conclusions that all of the Mutual Entities acted together as one.

than Legion.[4] (*See* Ex. 1 at Seventh Affirmative Defense, ¶ 16; *see also* Ex. 5 at ¶ 10.) At this point, Mr. *Walsh*, the lawyer, physically entered Mr. Partridge's office and together with Partridge, Turner, Agnew and Bossard placed a call to David Alexander, the President of MIB. After repeating for Mr. Alexander the substance of the conversations with Hendricks and Saran and their belief that Patriot was "on the hook" for amounts above the Aggregate Attachment Point, Partridge asked whether the attendees thought they could induce Patriot to pay additional amounts in order to cap these perceived (but non-existent) losses. As part and parcel of this, of course, they would have to get back to Mrs. Hendricks to "confirm" Patriot's phantom responsibility. (*See* Ex. 1 at Seventh Affirmative Defense, ¶ 17; *see also* Ex. 5 at ¶¶ 11-13.)

Walsh, Turner, Partridge, Alexander, Agnew and Bossard then discussed how much they could get Patriot to pay for what they would describe to Patriot as "reinsurance" to cap this phantom liability. They decided that $1 million was what they would charge Patriot. (*See* Ex. 1 at Seventh Affirmative Defense, ¶¶ 18-19; *see also* Ex. 4 at ¶ 24; Ex. 5 at ¶ 12.) At that point, Mr. *Walsh*, the lawyer, discussed with Partridge, Turner and Alexander the necessity to "amend" the Program documents to conclude the fraud. (*See* Ex. 5 at ¶ 12.) They instructed Bossard to inform Mrs. Hendricks that Patriot was liable beyond the Aggregate Attachment Point, but that could be remedied by payment of an additional premium of up to $1 million to purchase "reinsurance" to protect against those (non-existent) obligations. (*See* Ex. 1 at Seventh Affirmative Defense, ¶¶ 20-21; *see also* Ex. 4 at ¶ 24; Ex. 5 at ¶ 13.) In fact, at that time, the fraud participants already knew that not only would they not be purchasing such reinsurance coverage for a nonexistent liability, but that it would not even be possible to purchase that

[4] Again, we now know that document to be the Reinsurance Treaty 103 which Legion, Mutual and Walsh maintained exclusive control over and to this date, have yet to produce a complete copy.

reinsurance coverage. (*See* Ex. 1 at Seventh Affirmative Defense, ¶ 19.) Not surprisingly, this story ends with Patriot agreeing to the modifications to the Program which Legion and its related companies desired, and paying $1 million for phantom reinsurance, which was never really purchased, to cap liability which Bossard and Agnew advised they had, but which did not actually exist. (*See* Ex. 1 at Seventh Affirmative Defense, ¶¶ 26-28; *see also* Ex. 4 at ¶ 25; Ex. 5 at ¶ 14.)

B. Procedural Background And The Depositions

Based on the above fraud, supported by affidavits of two witnesses, Patriot's fraud affirmative defense seeks to deny the Liquidator a windfall benefit from this fraud. In April, 2005, the Liquidator moved to strike that affirmative defense. On August 22, 2005, this Court found that the fraud defense should proceed through discovery. (*See* Ex. 6.) This Court indicated that it could revisit the applicable law at the time of summary judgment, but that discovery should proceed on the fraud affirmative defense: "Such a determination can be made after American Patriot and Koken are given the chance to explore the facts." (Ex. 6.) So American Patriot set out to "explore the facts." But Patriot's discovery was cut off by overbroad assertions of privilege.

1. Walsh Deposition

Mr. Walsh's deposition was taken on March 1, 2006. Mr. Walsh was requested by Patriot's counsel to review the affidavit of Mr. Bossard, which particularizes the alleged fraud and the conversations pertinent thereto. (*See* Ex. 7 at 107-108.) As a preliminary matter, the Liquidator's counsel objected to *any* use of the affidavit at all. (*Id.*) Counsel for Patriot then inquired into the limited issue of whether Mr. Walsh even remembered the conference call with Partridge and Turner referred to above. (*See* Ex. 7 at 110-111.) Again, counsel for the Liquidator objected on the basis of attorney-client privilege. (*Id.*) Follow-up attempts to inquire

about Mr. Bossard's affidavit or the fraud discussions were met with the same objections. (*See* Ex. 7 at 113-120, 123-125, 166-168.) For example, Patriot's counsel asked Walsh to answer "yes" or "no," did he review any documents prior to responding to the inquiries at the February 2000 meeting. Again, this line of inquiry was met with instructions not to answer based upon the attorney-client privilege. (*See* Ex. 7 at 116-118.)

2. Turner Deposition

Mr. Turner's deposition was taken on March 2, 2006. As with Mr. Walsh's deposition, when Patriot's counsel attempted to question Mr. Turner about an amendment to the Program documents designed to shift additional liability for Program losses to Patriot, Mr. Turner was permitted to say only that it related to "an offer made to the Hendrickses regarding their liabilities." (Ex. 8 at 110.) When he was asked for his recollections about that offer (recollections which presumably would have included the fraud discussion where, according to Bossard and Agnew, amending the Program documents was discussed), counsel for the Liquidator objected based on attorney-client privilege. (*See* Ex. 8 at 110-113.) Further questions to Mr. Turner about efforts to purchase additional reinsurance ("phantom" reinsurance which was never purchased) were met with the objection that "my sense is that that question could or could not involve an answer that would reveal the communications of counsel." (Ex. 8 at 135, 153-154.) Ultimately, it was stipulated that the position of the parties would not change with respect to any inquiries into the fraud discussions, Mr. Bossard's Affidavit, or related discussions and that Court intervention would be necessary. (*See* Ex. 8 at 138-139.)

The Liquidator also made it plain at both depositions that the dispute about the underlying propriety of the attorney-client privilege is a dispute between Patriot and the Liquidator. First, at Walsh's deposition:

> I'm going to object to questions about paragraph 23 [of Bossard's affidavit] and object to your use of paragraph 23 in this deposition. This is my privilege. This is not a privilege for Mr. Bossard or anyone else to waive. And I object to its use and I object to any answers and response to any questions relating to paragraph 23.

(Ex. 7 at 113.)

> I can't instruct him not [to] answer, he's not my client. I can advise people who are potentially revealing attorney-client privileged information that there may be repercussions as a result of that waiver by somebody who does not own the privilege.

(Ex. 7 at 114.) This script was recited from again the next day at Mr. Turner's deposition:

> With respect to any kind of advice or discussions you may have had with Mr. Walsh, I'm cautioning the witness, I believe they're covered by the attorney-client privilege, and though I cannot direct you not to answer, I would caution you that this is the Liquidator's privilege to hold and it is not yours to waive.

(Ex. 8 at 106.) Counsel for the Liquidator then further tightened the noose on Mr. Turner by adding: "I said watch out." (Ex. 8 at 107.)

Although the resulting instructions not to answer came from counsel for the deponents, they were based solely on the assertion of privilege by the Liquidator -- clearly a coercive assertion alluding ominously to "repercussions" and "watch out." Indeed, correspondence from deponents' counsel, copied to counsel for the Liquidator, made it explicit that the third deponent, Mr. Partridge, was prepared to testify but, like the other deponents, was awaiting resolution of "the privilege issues outstanding between the parties in this action." (*See* Ex. 9.)[5]

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[5] We agree that the privilege once held by Legion now belongs to Legion's Liquidator. *See Maleski v. Corporate Life Ins. Co.*, 641 A.2d 1, 4 (Pa. Commw. Ct. 1994); *see also Foster v. Monsour Medical Foundation*, 667 A.2d 18, 20 (Pa. Commw. Ct. 1995). Indeed, the fact that the Liquidator "steps into the shoes" of Legion, as referenced in *Foster*, sustains Patriot's reliance on Legion's misconduct as an affirmative defense against the Liquidator. As in *Platypus Wear, Inc. v. K.D. Company, Inc.*, 905 F. Supp. 808, 810 (S.D. Cal. 1995), this motion is brought in the litigation forum because its essence is to overrule a party's claim of privilege, not to compel testimony of a deponent who will appear to testify if the claim of privilege which Legion owns is overruled.

C. Proceedings On Defendants' Motion To Overrule Claim Of Privilege

Patriot thereafter filed with Magistrate Nolan a Motion to Overrule the Liquidator's claim of privilege based on the crime-fraud exception.[6] The thrust of Patriot's argument was that it should be permitted unfettered inquiry into the fraud discussions because of Mr. Walsh's direct involvement. In response to the Motion to Overrule, it might have been expected that the Liquidator would deny that the fraud discussions ever occurred. Not so. In fact, the Liquidator did not even deny that Mr. Walsh was explicitly asked, as the opening gambit of the fraud, what Patriot's liability was. Remarkably, the Liquidator also did not deny that the participants heard Mr. Walsh say that based on the original Program documents marketed and sold to Patriot, it did not have liability beyond the Aggregate Attachment Point, and that losses above those reinsured by MIB were Legion's responsibility. (*See* Ex. 4 at ¶ 23; Ex. 5 at ¶ 10.) The Liquidator also did not deny that the fraud participants (including Walsh) then brainstormed about misrepresenting to Patriot that it had unlimited liability, and inducing Patriot into executing documents which would conveniently create just such liability. Nor did the Liquidator deny that one goal of the fraud was to trick Patriot into paying $1 million for reinsurance to protect against a non-existent liability (reinsurance which would never really be purchased).

Instead, relying upon Reinsurance Treaty 103 which Mr. Walsh drafted and later retroactively amended (in many cases years after the fact), the Liquidator suggested that all this was not part of a fraud because, according to the Liquidator, even if all the participating

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[6] Patriot also argued a subject matter waiver of any assertion of the attorney-client privilege because the Liquidator's counsel inquired of Mr. Walsh in areas intended to further the Liquidator's case, but which inevitably seeped into the subject matter of the very fraud which was being walled-off from Patriot's inquiries. The Magistrate did not rule on the subject matter waiver. If this Court neither upholds Patriot's assertion of the crime-fraud exception nor carves out an additional period to return to the Magistrate after dispositive motions, then the Motion to Overrule should be sent back to the Magistrate to rule on the subject matter waiver issue.

gentlemen **thought** that Patriot's liability was capped, and that Program documents needed to be surreptitiously altered to uncap it, that does not matter because something they have since discovered in an amendment to Reinsurance Treaty 103, *sans* any changes, **fortuitously** did place additional liability on Patriot all along. (*See* Ex. 10 at 10-12.) The Liquidator's position on this score was summarized at the very end of its response to the Motion to Overrule: "Legion's unwittingly truthful representation the exposure existed (even with a fraudulent intent) bars any fraud claim." (Ex. 10 at 19 n. 9.)

Consequently, the fraud discussions occurred exactly as Messrs. Agnew and Bossard averred. Mr. Walsh and his compatriots set out to defraud Patriot. They did so because their interpretation of their own documents was that Patriot did **not** have unlimited liability, and they saw an opportunity to change that and charge Patriot and the Hendricks an additional $1 million in the process. But, the Liquidator now says, that interpretation was wrong. That additional exposure existed all along under Reinsurance Treaty 103. According to the Liquidator, the fact that Walsh, Partridge, Turner, Alexander, Bossard and Agnew all believed to the contrary, and took steps to change the exposure, is of no consequence. Of course, this is not so, as explained immediately below, but the Magistrate felt that a decision of that nature should be made by this Court on dispositive motions.

First, the Program documents do not in fact support the Liquidator's argument. To understand why this is so, one need only realize that Patriot's exposure depends upon an obligation to reimburse MIB for losses reinsured by MIB. (*See* Ex. 4 at ¶¶ 13-14.) Where MIB is not involved, Patriot is not exposed. The Liquidator's new-found explanation depends upon the notion that the exposure for what the Liquidator calls a "fourth layer" of reinsurance coverage under Reinsurance Treaty 103 -- a $5 million/$10 million layer which the Liquidator

referred to liberally in its response to the Motion to Overrule -- was always with Patriot because MIB was responsible to reinsure that layer. The problem with this is that according to Bossard and Agnew and the face of the Program documents, MIB was not so responsible, and so neither was Patriot.

The Liquidator, relying on self-serving testimony by Mr. Walsh given at his deposition in response to friendly questions by counsel for the Liquidator (these are the questions that form the bases of Patriot's subject matter waiver agreement), argued that a 1993 Amendment to Reinsurance Treaty 103 covering the Mutual entities added the supposed "fourth layer" of liability to the Program. But, that Amendment on its face reveals that it was entered into between Legion and other Mutual entities, **not MIB**. (*See* Ex. 11 at AMPAT 019656-657.) Moreover, the Liquidator knows this. During Legion's liquidation proceedings in Pennsylvania instituted by **the Liquidator**, on April 25, 2002, Mutual Risk Management, Legion's ultimate parent, by its CEO, Robert Mulderig, sent **the Liquidator** a commutation proposal in the hope of inducing **the Liquidator** to commute certain reinsurance agreements. (*See* Ex. 12.) That proposal, at page 3, paragraph 2 (ii), described the same level of reinsurance which the Liquidator now calls the "fourth layer." (*Id.* at 3.) The proposal explains that this layer pertains to "certain Mutual Indemnity Reinsurers." (*Id.*) Then, it clarifies that "this additional excess of loss reinsurance coverage was added to the GC Treaty (Reinsurance Treaty 103) for Mutual Indemnity Ltd., Mutual Indemnity (U.S.) Ltd. and Mutual Indemnity (Barbados) Ltd * * * such additional coverage **does not apply to Mutual Indemnity (Bermuda) Ltd.**" (*See* Ex. 12 at 3 n. 2.) (Emphasis added.)[7]

[7] This was both confirmed and, in one sense, contradicted, in May, 2003, by MIB's president, David Alexander. In an affidavit in the related Bermuda litigation spawned by the fraud of the Mutual entities, Mr. Alexander confirmed that MIB was **not a party to** and not obliged to pay any amounts under the 1993 Amendment. (*See* Ex. 13 at ¶ 15.) But whereas Mutual Risk Management's

Then, in October 2002, in proceedings by certain Mutual reinsurers in the Commonwealth Court of Pennsylvania to enforce an agreement executed by one of the Liquidator's subordinates, **the Liquidator** offered the April 25, 2002 Commutation Proposal letter, and other documents the parties and their attorneys prepared. (*See* Ex. 14 at 32-57.) **The Liquidator** cross-examined a witness for the Mutual reinsurers regarding a document that **the Liquidator** introduced into evidence as Rehabilitator's\Respondent's Exhibit 7, the final (or nearly final) version of Schedule 12 to the Commutation Agreement. (*See* Ex.14 at 57-71.) Schedule 12 was a catalogue of which of the Mutual reinsurers would pay what amounts as part of a total commutation payment of more than $120 million. (*See* Ex. 14 at 52 – 57; *see also* Ex. 15.) One of the categories identified on Schedule 12 is "Amounts owed under Amendment 3 to Reins[.] Agreements 101 and 103." (Ex. 15.) Mutual Indemnity (U.S.) Ltd., Mutual Indemnity Ltd. and Mutual Indemnity (Barbados) Ltd. each have specific dollar figures attributed to them. But MIB and Mutual Indemnity (Dublin) Ltd. -- who are not signatories to Amendment 3 -- have no dollar figures attributed to them. (*Id.*)

To repeat the obvious, MIB was not responsible for the additional excess of loss reinsurance, neither was Patriot, and the Liquidator knows it. So the Program documents did ***not*** all along impose on Patriot the kind of additional liability beyond the aggregate attachment point falsely represented to Mrs. Hendricks. Patriot's exposure was in fact capped at the aggregate attachment point just as Messrs. Bossard and Agnew have so testified by affidavit.

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commutation proposal (from its CEO, Mr. Mulderig) recognizes that MIB was excluded from that exposure by its absence from the 1993 Amendment, Mr. Alexander instead falsely suggests that MIB's insulation from the Amendment was as a result of a Partial Settlement and Commutation Agreement between the Liquidator and MIB in April, 2003. (*Id.*)

Mrs. Hendricks asked a direct question and what was represented to her in response was intended as a fraud, and was in fact a fraud.

The Liquidator's explanation to the prima facie case of fraud made out by Patriot is no explanation at all. Instead, the document which is at the center of that explanation – Reinsurance Treaty 103 -- a document which has been routinely retroactively "amended" years after the fact and which is in Legion's possession and control, has not yet been produced by Legion or the Liquidator. Moreover, the "explanation" that a particular interpretation of documents would render the fraud discussions superfluous is laughable. Why have the February, 2000 parley and then change the Program documents? Because the statements made to Mrs. Hendricks were a fraud, and most certainly a *prima facie* fraud. This Court should find that the Liquidator's dubious "explanation" is not satisfactory, and that the crime-fraud exception invalidates the privilege.

D. The Ruling Of The Magistrate

The Magistrate's minute order states the Motion to Overrule is denied without prejudice, "for the reasons stated in open court." (Ex. 2.) The rationale for the ruling therefore rests in the transcript of the proceedings of May 9, 2006. The Magistrate stated: "[I]t is premature to be able to decide this Motion until the district court decides your summary judgment." (Ex. 3 at 15.) The Magistrate explained that her plan was to "reserve this part of discovery" to be raised again by Defendants after summary judgment. (*See* Ex. 3 at 17.) Indeed, the Magistrate stated that she was **bifurcating** discovery into pre-summary judgment and post-summary judgment on the contract interpretation issue:

> "So, I think the best and fair thing to do is to deny it as premature. Basically I am bifurcating discovery. If you really want to know what I am really doing I am saying that any discovery on your crime fraud issue I think would be – that has to wait until a ruling

> on what I am calling the issue of the case which is the parties' differing interpretations of the liability distribution."

(Ex. 3 at 22.)

The Magistrate went on to say that the summary judgment point she had in mind was the parties' differing interpretations of the liability distribution under Reinsurance Treaty 103 and the Program documents. (*See* Ex. 3 at 15, 22.) Her explication of what she envisions this Court deciding was not detailed, which is understandable since it could not have been her intent to dictate the parameters of this Court's contract interpretation. But the reference to interpreting the liability distribution can only mean deciding what Reinsurance Treaty 103 means and whether the Program documents in February, 2000 already placed on Patriot the same uncapped exposure which the fraud strategy was calculated to create. Inherent in this reasoning is the assumption that this Court will interpret Reinsurance Treaty 103 and the original Program documents to determine Patriot's exposure -- capped or uncapped -- **without** all of the evidence on what the contracting parties themselves thought these documents meant.

Counsel for Patriot pointed out to the Magistrate that there is a logical disconnect in delaying decision on the crime-fraud question to await an interpretation of documents which includes Reinsurance Treaty (and its attachments) which Patriot was not a party to, nor had access to, nor which has been produced or certified as complete by the party that possessed it. (*See* Ex. 3 at 19.) As counsel for Patriot pointed out, those documents -- which are the lynchpin of the Liquidator's explanation -- have been in the sole control of the Mutual entities and could be retroactively amended at their sole discretion at any time. (*Id.*) In fact, even now the Liquidator must concede that it has not provided Patriot (or the Court) with a complete version of the Reinsurance Treaty. (*See* Ex. 3 at 5-6, 19.)

Nonetheless, the Magistrate set up a procedure which leads to this Court interpreting those Program documents (including manifestly the Reinsurance Treaty) without any extrinsic evidence of why the documents might have been amended -- was it because the original documents did not relieve Legion of exposure so that changes had to be made? The Magistrate confirmed that this was her intention by stating that it seemed like **right now,** without any discovery, all the work was already done for summary judgment. "Here is your 56(f) here, here is your whole thing right here. You have done it all for your summary judgment." (Ex. 3 at 23.)[8]

It is not clear which party the Magistrate had in mind when she assumed the filing of a summary judgment motion addressed to the meaning of the Reinsurance Treaty and other Program documents based on their four corners. Certainly Patriot would not be the moving party, since Patriot believes that it is important for this Court to know what the core group of Legion and officers of its sister companies believed the related marketing and risk-bearing Program documents meant before they embarked on a project which could only make sense if they had already concluded that the documents placed uncapped liability onto Legion, not Patriot.

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[8] The Magistrate also questioned whether Defendants had already established the crime-fraud exception, based on Judge Kennelly's treatment of the exception. It appears that the Magistrate had in mind *Motorola, Inc. v. Vosi Technologies, Inc.*, No. 01 C 4182, 2002 WL 1917256 (N.D. Ill. Aug. 19, 2002). In *Motorola*, the Court decided it could not rule on the crime-fraud exception with respect to privilege claims over the files of litigation counsel until it had a better sense of what patents were allegedly infringed, so that the Court could determine whether the infringement claim was knowingly baseless (which could invoke the exception). *Motorola*, 2002 WL 1917256, at *6. The *Motorola* Court did not state that the motion would be subject to reassertion after dispositive motions, as the Magistrate did here, but that it would be subject to reassertion after further discovery of the particulars of the infringement claims. *Id.* The Court then actually directed a response to certain discovery so that the Court could better understand what patents were implicated. *Id.* That ruling has no logical nexus to what the Magistrate determined to do here, except that it shows that in some cases ruling on a motion to compel discovery can be premature. We maintain that this Court's decisions in *BDO Seidman*, *supra*, amply set out the burden-shifting analysis in this context and, under *BDO Seidman*, Koken failed to meet her burden to explain through evidence in her control that a fraud did not take place necessary to sustain application of the privilege.

Perhaps the Liquidator does not concur that such evidence would be necessary for the Court to have. At any event, the Magistrate must have assumed the Liquidator does not concur; *i.e.*, the Magistrate must have assumed that the Liquidator intends to move for summary judgment on the interpretation of the four corners of the Reinsurance Treaty and other documents, claiming there is no dispute of material fact about their meaning. Otherwise, the Liquidator has created a procedural roadmap which is entirely theoretical in that no practical vehicle exists to get the issue considered by partially dispositive motion. In the real world, evidence pertaining to the interpretation of the Reinsurance Treaty and other documents at the time should certainly be before this Court when it decides what the relevant documents mean.[9] Accordingly, the crime-fraud exception should apply to open up discovery on the fraud affirmative defense as initially envisioned by this Court.

III. THE CRIME-FRAUD EXCEPTION DEFEATS THE LIQUIDATOR'S ASSERTION OF PRIVILEGE TO THE EXTENT IT SEEKS TO PROTECT TESTIMONY AND DOCUMENTS THAT PERTAIN TO THE FRAUD

The Magistrate's bifurcation decision is inconsistent with the law and the rationale for the crime-fraud exception. "Under the crime-fraud exception, communications that would otherwise be protected by the attorney-client privilege, * * * lose their protected status if they were made for the purpose of getting advice for the commission of a fraud or crime." *United States of America v. BDO Seidman*, No. 02 C 4822, 2005 WL 742642, at *8 (N.D. Ill. March 30, 2005), *aff'd United States of America v. BDO Seidman*, No. 02 C 4822, 2005 WL 2171173, at *2 (N.D.

[9] It seems impossible that anyone could conclude that the question of capped or uncapped exposure can be determined on the four corners of the Program documents. The documents were not complete in a way that would permit that analysis to be done, and even Mr. Walsh conceded that. Walsh admitted that even under his own newly-constructed explanation, "[y]ou would need to know the loss experience of other programs" *(i.e.*, all the programs impacted by the Reinsurance Treaty, not only Patriot's) to know if Patriot had exposure beyond the Aggregate Attachment Point in any year. (*See* Ex. 7 at 87-89.) Nonetheless, that information was never available to Patriot. As Mr. Walsh conceded,

Ill. Aug. 30, 2005) (later Rule 60 ruling). It was therefore clearly erroneous, based upon the affidavits of Bossard and Agnew alone, for the Magistrate to suggest that Patriot has not already met its burden to establish that the communications in issue were for the purpose of advancing a fraud, so that the crime-fraud exception defeats the Liquidator's assertion of privilege.

To fulfill the requirements of the crime-fraud exception, Patriot must make out a *prima facie* showing of the fraud, and that the communications in question are in furtherance of the fraud. BDO Seidman, 2005 WL 742642, at *8; see also Brennan v. Brennan, 422 A.2d 510, 515 (Pa. Super. Ct. 1980). As this Court stated in BDO Seidman: " * * * *prima facie* evidence [does] not mean enough to support a verdict in favor of the person making the claim. Instead, * * * a party has established a *prima facie* case whenever it presents evidence sufficient to require the adverse party, the one with superior access to the evidence and the best position to explain things, to come forward with that explanation." BDO Seidman, 2005 WL 742642, at *8.

Patriot met this burden. The point at which there is sufficient *prima facie* evidence to eclipse the privilege was reached. Patriot has submitted whistleblowers attesting to activities whose purpose was to conclude a fraud. In fact, other courts which have addressed this precise set of facts in granting injunctive relief against draws on letters of credit which were posted by Mr. and Mrs. Hendricks to secure liabilities on this Program, found a "likelihood" under FED. R. CIV. P. 65 that Patriot would be able to prove fraud on the merits, a higher hurdle than *prima facie*. See Hendricks v. Bank of America, 408 F.3d 1127 (9th Cir. 2005) (see also Ex. 16 at 27 (Transcript of Injunction Hearing in United States District Court for Central District of California); Ex. 17 at 6-7 (Transcript of Injunction Hearing in Eastern District of Michigan),

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"[c]ertainly while I was there we were not in the habit of identifying the information in one program to participants in another program." (Id.)

rev'd on other grounds, *Hendricks v. Comerica Bank*, 122 Fed. Appx. 820, 823-825 (6th Cir. 2004) (not recommended for full-text publication)).

In short, the allegations of the affirmative defense and affidavits in this case fulfill any reasonable formulation of the *prima facie* requirement. The information provided by Messrs. Bossard and Agnew supplies threshold evidence of fraud beyond the supporting allegations of almost any other case. This is orders of magnitude beyond the kind of "speculation and innuendo" in the supporting declarations in *BDO Seidman*. There, based on "evidence" not nearly as distinct in detail as in this case, this Court applied the crime-fraud exception and ordered disclosure of a subject document just as soon as it learned that a BDO employee stated that "the sole purpose of the activity is to obtain a loss" so as to evade income tax. *United States of America v. BDO Seidman,* No. 02 C 4822, 2005 WL 1625002, at *5 (N.D. Ill. May 7, 2005). That holding translates easily to this case, where Patriot has already provided testimony from officers of Legion and Commonwealth Risk Services, a sister marketing company, about a well-considered and explicit series of discussions with the sole purpose of perpetrating a fraud on Patriot.

In a statement from the Queen's Bench often cited, the logic and justice in limiting the privilege by application of the crime-fraud exception was explained as follows:

> In order that the rule may apply there must be both professional confidence and professional employment, but if the client has a criminal object in view in his communications with his solicitor one of these elements must necessarily be absent. The client must either conspire with his solicitor or deceive him. If his criminal object is avowed, the client does not consult his adviser professionally, because it cannot be the solicitor's business to further any criminal object. If the client does not avow his object he reposes no confidence, for the state of facts, which is the foundation of the supposed confidence, does not exist. The solicitor's advice is obtained by a fraud.

In Re Marriage of Decker, 606 N.E.2d 1094, 1101 (Ill. 1992) (quoting *Queen v. Cox*, 14 Q.B. 153, 168 (1884)); *see also In re Investigating Grand Jury of Philadelphia County*, 593 A.2d 402, 407 (Pa. 1991) (also quoting *Cox*, 14 Q.B. at 168).

Here, it is patent that Mr. Walsh's clients "conspired with him." The fraudulent object of what his clients were doing was explicitly "avowed." They questioned him about whether the present state of the documents imposed certain liabilities on Patriot. He said they did not. They then proceeded, with him present, to discuss changing certain documents, and making misrepresentations to Patriot, to accomplish their fraudulent purpose. Plainly, they did not consult their legal adviser professionally, because it could not have been Mr. Walsh's "business to further any [fraudulent] object." But Mr. Walsh was there. He took part. He played a role. He knows what was said and why. He even knows how Legion and the other Mutual entities construed the "Patriot exposure" question which the Magistrate wants this Court to answer. In this circumstance, the crime-fraud exception bars imposition of the attorney-client privilege.

The Liquidator's position that she has now "explained" what might otherwise look like a fraud has in reality instead just embroiled the Liquidator and Mr. Walsh in further elements of that fraud. The documentary evidence *directly contradicts* the interpretation now advanced by the Liquidator and Mr. Walsh, and *directly contradicts* the interpretation the Liquidator afforded these same documents in her own litigation with Legion and its reinsurers in Pennsylvania. Were the expositions of the 1993 Amendment to Reinsurance Treaty 103 provided by Messrs. Mulderig and Alexander truthful? Not if Mr. Walsh's present construction is correct. Or is Mr. Walsh just trying desperately to continue the fraud, which was after all based in part on a set of vaguely incomprehensible documents? All-in-all, the notion that Mr. Walsh, who participated in the fraud -- but who now provides an interpretation of Program documents contrary to the clear

language of the 1993 Amendment, the reading of that language by Legion's parent, the affidavit testimony about that language by MIB's President, and the interpretation of the documents Mr. Walsh himself previously gave -- can be used as a shield against inquiry into the fraud is absurd. This is precisely what the crime-fraud exception was intended to guard against.

IV. CASE MANAGEMENT

A. Bifurcation Of Discovery

Although Patriot believes that this Court should grant its Objections, overrule the Magistrate and determine that the crime-fraud exception defeats the Liquidator's claim of privilege, if this Court agrees that the issue is not yet ripe, the Magistrate's intention to bifurcate discovery makes sense. But, the original plan of case management did not anticipate or allow for that bifurcation.

The Case Management Order entered by the Court on September 13, 2005 closes discovery by June 30, 2006, with dispositive motions due by July 31, 2006 and fully briefed by September 6, 2006. Pre-trial order and motions in limine are due October 10, 2006, with the motions fully briefed by October 16. Trial is set for October 23, 2006. (*See* Ex. 18.) Obviously, the one month or so between final briefing of dispositive motions (which the Magistrate expects to rely on for the crime-fraud determination) and the remaining case activities is not sufficient to permit the Magistrate to consider the crime-fraud motion and then permit a second, bifurcated period of discovery.

Therefore, Patriot requests that this Court enter a new Case Management Order, which confirms this procedure:

1) After the close of the original discovery period, the Court will decide partly dispositive motions limited to the issues of whether, from the four corners of the Reinsurance Treaty 103 and the original Program documents, the Court can

determine Patriot's level of exposure, and, if so, what was that exposure?

2) If the Court cannot determine from the four corners of the Program documents that Patriot's exposure was originally uncapped, then the fraudulent intention and acts of Legion and its sister companies in connection with the Year 4 renewal discussions come into play. At that point, the Magistrate will be called on to rule on the pending Motion to Overrule Objections Based on the Crime-Fraud Exception.

3) If the Magistrate grants Defendants' Motion to Overrule, then a period for discovery pertaining to Patriot's fraud affirmative defense will ensue.

4) An additional period of summary judgment briefing for all remaining dispositive motions, followed by pre-trial particulars and then trial.

B. Extension Of Time For Discovery

Subsequent to the May 9, 2006 hearing, at the Magistrate's request, the parties engaged in a meet-and-confer discussion. The purpose was to determine whether they could agree on what other discovery, including even additional questions for Messrs. Walsh, Turner and Partridge, might be undertaken notwithstanding the crime-fraud issue now submitted to this Court. At that meet-and-confer, the parties agreed that the issues which are impacted by the crime-fraud exception in this case are so pervasive that all other discovery should await this Court's ruling on the above Objections. The Magistrate herself recognized the wisdom of this course, agreed with it, endorsed it, and urged the parties to so advise this Court. (*See* Ex. 19 at 2-4.)

Accordingly, the Liquidator joins with Defendants in this one portion of this Memorandum. The parties request that regardless what the Court rules on the issues briefed above, whether or not the attorney-client privilege is overruled here, and whether or not the Court decides to provide for the bifurcation of discovery envisioned by the Magistrate, that this

Court extend all the dates in the existing Case Management Order. That extension should be for a period long enough to permit the Court's ruling on the crime-fraud issue to be received and analyzed by the parties, and then to provide for the conclusion of discovery which may or may not (depending on the Court's ruling) include discovery of the facts related to the crime-fraud and attorney-client privilege.

V. CONCLUSION

For all of the above reasons, American Patriot Insurance Agency, Inc. and Lysa Saran respectfully request that this Court sustain their Objections and vacate the May 9, 2006 Order in its entirety, and overrule the Liquidator's assertion of attorney-client privilege, along with the entry of a modified Case Management Order to allow for this discovery to be completed. In the alternative, they respectfully request that this Court enter a new Case Management Order consistent with the Magistrate's Order.

Dated: May 23, 2006

Respectfully submitted,

American Patriot Insurance Agency, Inc. and Lysa Saran

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