FIFTH CIRCUIT RULES THAT UNDERWRITERS MUST, FOR NOW, CONTINUE TO PAY DEFENSE COSTS FOR DEFENDANTS IN THE STANFORD PONZI SCHEME

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Pendergest-Holt v. Certain Underwriters at Lloyd's of London, __ F.3d ___, 2010 WL 90909 (5th Cir. March 15, 2010)

The legal wrangling in the Stanford Ponzi Scheme began in early 2009 when the SEC sued R. Allen Stanford, three of his companies, and eventually four of his fellow executives. A couple of months later, the government began prosecuting a parallel criminal case. One of the criminal defendants pled guilty.

On the insurance side, Certain Underwriters at Lloyd's of London ("Lloyd's") and Arch Specialty Insurance Co. ("Arch") issued a $10 million primary Directors and Officers ("D&O") policy and a following form $90 million excess policy. These policies insure losses resulting from any claim first made during the Policy Period for a "Wrongful Act." The term "Loss" includes defense costs incurred in connection with legal proceedings against an officer or director, but the D&O policies did not impose a duty to defend. At First, Lloyd's and Arch agreed to advance defense costs to the Stanford executives under a reservation of rights to deny coverage on a variety of grounds, which specifically included the fraud and money laundering exclusions. In November 2009, Lloyd's and Arch notified the Stanford executives that they intended to stop advancing defense costs on account of the money laundering exclusion. The executives almost immediately brought this action, seeking a determination that coverage exists under the policies.

This coverage action proceeded on an expedited basis. A month after the suit was filed, Houston federal judge David Hittner presided over a preliminary injunction hearing. On the one hand, Lloyd's and Arch presented evidence and argued that as of the date of the guilty plea entered by one of the executives, these underwriters had determined that money laundering, as defined in the policy, had in fact taken place. On the other hand, the executives pled the Fifth Amendment and did not testify. A critical issue was whether the executives were likely to succeed on the merits. In this regard, Judge Hittner found that the "'money laundering' exclusion most likely would not preclude coverage." Accordingly, Judge Hittner "prohibited the underwriters from 'withholding payment' for all costs 'already incurred' by the executives and to be 'incurred' by them in the future . . . until a trial on the merits in this case or such other time as this Court orders." *Pendergest-Holt v. Certain Underwriters at Lloyd's of London*, ____ F. Supp. 2d ____, 2010 WL 317684 at *14 (S.D. Tex. Jan 26, 2010).

The Fifth Circuit reviewed the District Court ruling *de novo* because the preliminary injunction turned on a mixed question of law. Initially, the Fifth Circuit acknowledged that Texas law governs the dispute. Then, the Fifth Circuit noted that Lloyd's and Arch "must . . . pay legal costs incurred by the executives in defending against those allegations 'until such time that it is determined that the alleged act or alleged acts did in fact occur.'"

In order to make that determination, the Fifth Circuit analyzed the money laundering exclusion and also compared that exclusion to the distinct fraud exclusion. While Lloyd's and Arch reserved their rights to deny coverage based on the fraud exclusion, they conceded it was premature to enforce that exclusion at this time. This is because the fraud exclusion "does not apply until there is a 'final adjudication' that the insured engaged in fraudulent conduct," requiring a court to so rule in connection with the "underlying D&O proceeding, rather than in a parallel coverage action or other lawsuit."

The money laundering exclusion, however, does not include the "final adjudication" requirement. Instead, it applies if there is an occurrence of money laundering, as defined in the policy, which is broader than the violation of a money laundering statute. As noted by the Fifth Circuit:

> [t]he money laundering exclusion is different. It bars coverage for loss (including defense costs) resulting from any claim "arising directly or indirectly as a result of or in connection with any act or acts (or alleged act or acts) of money laundering," but then provides for qualified reimbursement of defense costs, coupled with the ability to claw back reimbursed funds from the insureds in certain instances:
>
> Notwithstanding the foregoing Exclusion, Underwriters shall pay Costs, Charges and Expenses in the event of an alleged act or alleged acts *until such time that it is determined that the alleged act or alleged acts did in fact occur*. In such event the Directors and Officers and the Company will reimburse Underwriters for such Costs, Charges and Expenses paid on their behalf.

Pendergest-Holt, 2010 WL 909090 at *3 (emphasis added).

Accordingly, the critical issue was whether the exception to the exclusion applies, i.e., whether it is "determined that the alleged acts did in fact occur." In other words, just because allegations of money laundering are asserted, that does not allow Lloyd's and Arch to immediately deny coverage. Rather, Lloyd's and Arch "must instead pay legal costs incurred by the executives in defending against those allegations until such time that it is determined that the alleged act or alleged facts did in fact occur." *Id* at *4.

On the one hand, Lloyd's and Arch contend that this language allows them unilaterally to "determine that the alleged [money laundering] did in fact occur," however, that "determination" is subject to judicial review and would be reconsidered if the executives are eventually cleared of the charges. On the other hand, the Stanford executives argued that there needs to be a judicial determination that the money laundering occurred, perhaps in a parallel coverage action. The Fifth Circuit observed that the policies were silent as to "who" gets to make this "in fact" determination. The significance in this case is whether Lloyd's and Arch can immediately cease

funding the executives' defenses; or must they wait to see if a court decrees that money laundering "in fact" occurred. In light of the intensity of the SEC and criminal proceedings, it is easy to see that millions of dollars are at stake with regard to this issue.

Since the terms "determined" and "in fact" are not defined in the policies, the Fifth Circuit reviewed various dictionary definitions of those terms and noted that "[n]one of these definitions provides a conclusive answer, though taken together they favor a judicial decision maker over any other." *Id.* at *6. The resulting complexity of the issue was noted by the Fifth Circuit:

> Without clearer direction from the policy itself, the parties both offer plausible interpretations. Neither is unreasonable: "From the point of view of [the underwriters], to wait for a judicial determination of the elements listed in the [exclusion] means that [they] may have to pay substantial sums for defense costs even though it is later determined" the alleged acts did in fact occur, while "[f]rom the point of view of [the executives], it is unfair to give an insurer the ability to escape its duty to advance payment merely because it asserts the [exclusion], without any judicial decision."

Id.

Lloyd's and Arch then compared the money laundering exclusion to the fraud exclusion and argued that the fraud exclusion specifically required a "final adjudication" of fraud, whereas that language is missing from the money laundering exclusion. This difference, Lloyd's and Arch posit, means that it is not necessary to have a judicial determination of money laundering before they can deny coverage on that basis. The Fifth Circuit analyzed the differences between the money laundering and fraud exclusions and held that they both require a judicial determination of either fraud or money laundering. They are different, however, in that the determination of fraud to invoke the fraud exclusion must take place in the underlying action, here the SEC or criminal proceeding. The absence of "final adjudication" and the use of the terms "determined" and "in fact" in the money laundering exclusion "implies that the coverage decision is to be made -- not in the criminal or SEC actions -- but in a parallel and independent proceeding." *Id.* at *8.

Accordingly, the Fifth Circuit "concluded that the 'in fact' determination must be made by a court in a separate, parallel coverage action, in which all admissible evidence is welcome." In so doing the court noted "the awkwardness -- readily recognized by Judge Hittner -- in putting the civil 'car' before the criminal 'horse.'" As a result, its remand order requires a different judge from Judge Hittner (who is presiding over the criminal trial) to take over the coverage action. The new judge will preside over the remand of this case, which "will be the collateral vehicle for the 'determin[ation] . . . in fact' that the D&O Policy contemplates. . . . The district court will consider the underwriters' future obligation to advance the costs of defense, but its grant of relief from this obligation – if any – remains subject to reconsider should the executive be exonerated in either the criminal or SEC proceedings." *Id.* at *10.

The Fifth Circuit noted that Lloyd's and Arch, if successful in proving the validity of the fraud and/or money laundering exclusion, can pursue the executives for reimbursement of the

expanded defense costs. The court also noted, however, the very unlikely probability that such a recovery effort would be successful (afterall, if the exclusions apply, then the executives will be broke and in prison). Accordingly, the Fifth Circuit affirmed the district court ruling that "[t]he underwriters are enjoined from refusing to advance defense costs as provided for in the D&O Policy unless and until a court 'determine[s] in fact' by clear and convincing evidence that the alleged act or alleged acts [of money laundering] did in fact occur."

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