

Refco Bankruptcy Court Orders Advancement of Defense Costs Despite Guilty Pleas in Criminal Proceedings

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The United States Bankruptcy Court for the Southern District of New York has granted another preliminary injunction ordering an excess directors and officers liability insurer to advance defense costs, despite the fact that the insurer had denied coverage on the basis of a prior knowledge exclusion and three of the insured entity's principals have pled guilty to various offenses, including violations of the securities laws. *Murphy v. Allied World Assurance Co. (U.S.), Inc. (In re Refco, Inc.)*, No. 08-01133 (Bankr. S.D.N.Y. Apr. 21, 2008). The bankruptcy court applied New York law and relied heavily on the case *In re WorldCom, Inc. Securities Litigation*, 354 F. Supp. 2d 455 (S.D.N.Y. 2005), as well as its prior decisions with respect to a lower level excess carrier.

The insurer issued an excess directors and officers liability insurance policy to Refco, Inc. The policy excluded "Loss in connection with any claim or claims made against the Insureds: alleging, arising out of, based upon, in consequence of, or attributable to facts or circumstances of which any Insured had knowledge as of inception and (i) which a reasonable person would suppose might afford valid grounds for a claim which would fall within the scope of the coverage hereunder, or (ii) which indicate the probability of any such claim."

The policy incepted on the date of Refco's initial public offering. Two months after the IPO, Refco announced that its financial statements had failed to disclose the existence of a large related-party receivable and therefore were unreliable. Specifically, the company disclosed that an entity controlled by Refco's then-CEO Phillip Bennett owed Refco approximately \$430 million, and that this amount may have represented the Bennett-controlled entity's assumption of uncollectible debt owed to Refco. The company entered bankruptcy shortly thereafter. Numerous lawsuits followed, including securities fraud litigation against certain former directors and officers. In addition, Refco's former CEO, CFO and President were indicted on federal securities fraud and other charges. The former CEO and two others have entered guilty pleas in those criminal proceedings.

The insurer denied coverage based upon the prior knowledge exclusion, and the directors and officers brought the instant adversary proceeding. In prior phases of the bankruptcy proceedings, the court ordered a

lower-level excess carrier to advance defense costs without adjudicating similar coverage defenses. In ruling on the instant motion, the court again ordered the insurer to advance defense costs despite the entry of the guilty pleas in separate criminal proceedings.

The court offered three grounds for its holding. First, the court concluded that the statements by the former CEO and two other criminal defendants in connection with their guilty pleas constituted inadmissible hearsay and could not provide a basis for the insurer to establish that any insured had prior knowledge of the facts and circumstances underlying any claim such that the prior knowledge exclusion would be triggered.

Second, the court held that the obligation to pay defense costs exists until there is "a final determination by an objective fact finder" of no coverage. The court opined that since no final judgments had been entered in the criminal case nor had the defendants been sentenced, there had not been a final adjudication of the conduct underlying application of the exclusion. The court rejected the insurer's arguments that the prior knowledge exclusion itself did not contain any "final adjudication" requirement. Instead, the court relied on a provision regarding advancement of defense costs in the primary policy that provided that "[i]f it is finally determined that any Defense Costs paid by the Insurer are not covered under this Policy, the Insureds agree to repay such non-covered Defense Costs to the Insurer."

Third, the court found that in order to prevail with respect to the exclusion's application, the insurer must show that "the prior knowledge exclusion would apply in every instance unambiguously." The court found that the insurer was reading the prefatory language "arising out, based upon, or attributable to" too broadly and observed that "[g]iven [that] the guilty pleas . . . do not identify by name any of the moving insureds or refer to any of such insureds' individual fiduciary or other duties or allege any facts as to why those particular insureds were unjustly enriched, I cannot conclude that the exclusion as a matter of law applies to all of the [underlying claims]."

Finally, without reaching any further conclusions, the court questioned (1) whether the guilty pleas constituted extrinsic evidence upon which he could rely for purposes of determining the insurer's obligation to advance defense costs, and (2) "whether coverage for all insureds is meant to be excluded by one insured's knowledge." As to the latter, the court suggested that the exclusion was ambiguous and would require "an interpretation against the insurer."