

Refco Court: Prior Knowledge Exclusion Bars Coverage

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Applying New York law, a federal district court has held that an insured's admitted knowledge of criminal wrongdoing prior to the inception of directors and officers liability policies issued to Refco, Inc., served to exclude coverage for litigation arising from such wrongdoing. *XL Specialty Ins. Co. v. Agoglia, et al.*, No. 08 Civ. 3821 (S.D.N.Y. Mar. 2, 2009). Wiley Rein LLP represented one of the insurers in the case.

In February 2008, Refco's former CEO pleaded guilty to criminal charges relating to his active participation in a scheme to conceal from investors and others, including the Securities and Exchange Commission, hundreds of millions of dollars in uncollectible debts. The scheme, which the CEO admitted began in the late 1990s, involved packaging the debts into a receivable from an entity controlled by the CEO and then disguising the nature of that receivable through a series of transactions that took place at the end of each financial reporting quarter. The truth about the receivable was revealed by the company on October 10, 2005, about two months after its initial public offering. Immediately following the revelation, Refco's stock price plummeted, and the company, along with many of its subsidiaries, filed for bankruptcy a week later. These events led to numerous lawsuits against the company's directors and officers for which they sought insurance coverage.

Three excess insurers denied coverage for the lawsuits on several grounds. In the coverage litigation that followed, the insurers moved for summary judgment based on the applicability of the prior knowledge exclusions in their respective policies. Addressing the arguments presented, the court first found that because each count in the indictment to which the CEO pleaded guilty was predicated on his knowledge of and/or participation in the receivable scheme before August 11, 2005 (the date the policies inception), the judgment of conviction against the CEO established that an insured had the requisite knowledge of facts and circumstances. Next, the court held that whether there was "reason to suppose" that such facts and circumstances "might afford grounds" for a claim was to be determined by an objective standard as to what a reasonable person would believe, and concluded that this standard was met here, given the scope and nature of the receivable scheme devised and executed by the CEO.

The court also found that all of the underlying litigation arose out of facts and circumstances to which the CEO admitted knowledge. In making this finding, the court rejected the insureds' argument that each and every claim or cause of action asserted in each lawsuit had to be evaluated to determine whether it arose from the

facts and circumstances concerning the receivable scheme. The court pointed out that the policies defined "Claim" to mean, in relevant part, a civil or criminal proceeding in a court of law. This definition, according to the court, combined with the fact that phrases such as "arising out of" are to be interpreted broadly under New York law, meant that it was sufficient for purposes of applying the knowledge exclusions that the lawsuits, "taken as a whole," arise out of the receivable scheme and its fraudulent concealment.

Concluding that the exclusions at issue were triggered by the CEO's prior knowledge, the court turned to the question of whether that knowledge was a basis to bar coverage for all of the insureds. In this regard, the insureds had argued that the severability provisions in the policies precluded the imputation of the CEO's knowledge to them for purposes of applying the exclusions. As to two of the excess policies that followed the form of the primary policy, the court disagreed. According to the court, reading the "Full Severability" provision as a whole and in the context of the entire primary policy, it was clear that the non-imputation clause in that provision applied only to information stated in the application for coverage and concerned only grounds for rescission. The court further pointed out that the primary policy included a separate severability provision for exclusions and that this provision itself identified the particular exclusions set forth in the primary policy to which the provision applied—*i.e.*, the "above EXCLUSIONS." As the court recognized, the knowledge exclusions in the follow form excess policies were not one of those identified exclusions.

The court also recognized that coverage under the two follow form excess policies applied, in conformance with the terms and conditions of the primary policy, only to the extent that the excess policies themselves did not provide otherwise. In this regard, the court pointed out that the prior knowledge exclusions in the excess policies were predicated on the knowledge of "any insured." Therefore, according to the court, even if the primary policy included a general non-imputation clause that applied to exclusions, this would represent a difference in conditions that would control for purposes of determining the availability of coverage under the excess policies. As to the third excess policy, the court concluded that there were disputed issues of material fact precluding summary judgment.