

Insurer Enjoined from Ceasing Advancement of Defense Expenses on Ground that Money Laundering Exclusion Barred Coverage

March 2010

The United States District Court for the Southern District of Texas, applying Texas law, has granted a request for a preliminary injunction prohibiting a D&O insurer from ceasing the advancement of defense expenses. *Pendergest-Holt v. Certain Underwriters at Lloyd's of London*, 2010 WL 317684 (S.D. Tex. Jan. 26, 2010). The court concluded that the "eight corners rule" applied to determine the insurer's obligation to advance defense expenses and that allegations of dishonesty were insufficient grounds for the insurer to deny coverage based on a money laundering exclusion that required an "in fact" determination. The order was stayed, pending an expedited appeal of the decision, for which the United States Court of the Appeals for the Fifth Circuit heard oral argument on February 25, 2010.

Several insured individuals and entities faced a civil action instituted by the U.S. Securities and Exchange Commission (SEC) as well as a criminal action. The SEC alleged that the insureds ran a multi-billion dollar Ponzi scheme, and the criminal action involved charges of, among other things, mail fraud, wire fraud and conspiracy to commit securities fraud and money laundering. One individual reached a plea agreement in a related criminal proceeding and subsequently made statements implicating the insureds in alleged illegal activity.

A federal district court appointed a receiver and seized the assets of the insureds named in the SEC action. The court, however, issued an order stating the payment of defense expenses under the D&O policy was permissible, even if the proceeds were considered the assets of the receivership estate, because the potential harm to the insureds was "real and immediate." The insurer issued reservation of rights letters to several insureds and agreed to advanced defense costs, subject to its rights under the policy. The insurer later issued denial letters in which it stated that it would pay defense expenses until the date of the other individual's plea agreement but denied coverage for defense expenses incurred after that date.

The insurer based its denial on a "Money Laundering Exclusion," which barred coverage for Loss "arising directly or indirectly as a result of or in connection with any acts (or alleged act or acts) of Money Laundering" The Money Laundering Exclusion also provided that the insurer "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." The insurer contended that it had "sufficient information to establish the claims against [the insureds] . . . constitute[d] Money Laundering as defined" in the policy and that the insureds had "in fact" engaged in those activities. The insurer explained that evidence that had developed after the initiation of the SEC and criminal actions provided the basis for its conclusion that "Money Laundering" had "in fact" occurred.

The insureds filed a declaratory judgment seeking an order directing the insurer to pay defense costs and sought a preliminary injunction prohibiting the insurer from retroactively denying coverage. The court concluded that the insureds met the burden for a prohibitory preliminary injunction.

First, the court concluded that the insureds had a substantial likelihood of prevailing on the merits of the coverage issue. The court noted that, for purposes of a preliminary injunction, it was not required to decide what "level of factual determination must be made to satisfy the language of the Money Laundering Exclusion." However, the court agreed with the insureds that the exclusion required more than the insurer's own determination. The court determined that, although the policy did not provide a duty to defend, the insurer's duty to advance defense costs was governed by the "eight corners" rule and that the insurer could not rely on extrinsic evidence to support its claim that the Money Laundering Exclusion "in fact" applied. Otherwise, the court stated, the insurer would have the ability to act "as judge and jury and convict its own insureds" to avoid further financial responsibility. The court also rejected that insurer's argument that the insureds had the burden of proving that there had been no determination that the alleged money laundering had in fact occurred, noting that the insurer had the burden of proving the applicability of an exclusion. In addition, the court declined to infer that the insureds' refusal to testify in support of the preliminary injunction was proof that the allegations against the insureds were true.

Next, the court determined that the insureds had demonstrated a substantial threat of irreparable injury if the injunction were not granted. The court pointed out that judge presiding over the SEC action had noted "real and immediate" harm with respect to both actions if the insurer did not advance defense expenses, especially in light of the complexity of the cases and potential punishment. Furthermore, the court described as "absurd" the insurer's position that the insureds needed to prove themselves innocent before being entitled to funds for the expenses necessary for their defense in the underlying actions. The court also determined that the potential harm to the insureds outweighed the purely economic consequences to the insurer. Finally, the court concluded that public interest weighed heavily in favor of the preliminary injunction because the public interest favored the protection of criminal defendants' rights and because the taxpayers would ultimately bear the costs of the defense of the criminal proceeding if injunctive relief were not granted.

The court therefore ordered that the insurer was enjoined from withholding payments of defense expenses incurred on behalf of the insureds. In addition, the court, after concluding that the issue was within its discretion, ordered that the insureds were not required to post a bond.