

Insurer Required To Advance Pending Judicial "In Fact" Determination Subject To Modification after Conclusion of Underlying Proceedings

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Applying Texas law, the United States Court of Appeals for the Fifth Circuit has affirmed, in part, an order granting a preliminary injunction that prohibited a D&O insurer from ceasing the advancement of defense expenses, and remanded to the district court for further proceedings. *Pendergest-Holt v. Certain Underwriters at Lloyd's of London*, 2009 WL 909090 (5th Cir. Mar. 15, 2010). The court concluded that "determined . . . in fact" language in a money laundering exclusion requires a judicial finding of money laundering, either in the underlying civil or criminal proceedings or in coverage litigation. Such finding, though, is subject to modification depending on the outcome of the underlying actions. The court also held that the "determined . . . in fact" language constitutes an unambiguous decision by the parties to circumvent Texas's "eight corners rule," thus permitting the trier of fact to consider extrinsic evidence beyond the policy and complaint.

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, 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.

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 relied on evidence that had developed after the initiation of the SEC and criminal actions as the basis for its conclusion that "Money Laundering" had "in fact" occurred.

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

On expedited appeal to the Fifth Circuit, the court first considered the question of what type of determination triggers the Money Laundering Exclusion. The insurer argued that it has the right to determine when money laundering has "in fact" occurred, noting that the policy's fraud exclusion contains language requiring a determination "by final adjudication" that is absent from the Money Laundering Exclusion. The court rejected this argument, noting that the insurer could have explicitly given itself the right to determine whether money laundering has "in fact" occurred, but chose not to do so. The court concluded that the "determined . . . in fact" language required a judicial determination.

The court, however, also rejected the insureds' argument that the determination can only occur in the underlying civil or criminal proceedings, rather than in separate coverage litigation. The court observed that similar exclusions often contain a "final adjudication" requirement, and courts routinely conclude that policies with such language require a determination in the underlying litigation rather than in the coverage litigation. When "in fact" language replaces a "final adjudication" requirement, however, the court noted that courts typically conclude that the insurer can seek a determination either in the underlying litigation or in separate coverage litigation. Accordingly, the court held that the insurer could attempt to prove that the insureds committed money laundering in the coverage litigation. The court held, however, that any determination in the coverage litigation would be subject to modification after the conclusion of the underlying civil and criminal proceedings "should the executives be cleared of all charges." In addition, the court held that any repayment obligations the insureds might face in the event of an adverse ruling from the district court in the coverage action would not be triggered until after the conclusion of the underlying proceedings and any "reconsideration" of the court's initial coverage determination occasioned by the insureds' exoneration.

The court next considered what evidence the district court could consider in making the "in fact" determination required under the Money Laundering Exclusion. The court noted that the policy provides that the insurer shall advance defense costs "until it is determined that the alleged act or alleged acts did in fact occur." By choosing such language, the court held, the parties had effectively contracted around the limits of Texas's "eight corners rule," which limits determinations regarding an insurer's duty to pay defense costs to an

analysis of the policy and underlying complaint. Accordingly, the court held that, on remand, the district court could consider extrinsic evidence beyond the policy and complaint in determining whether the Money Laundering Exclusion applies to bar coverage. Observing that the underlying and coverage actions were both pending before the same district court judge, the court directed that "any subsequent coverage proceedings must be before another judge" in order to "extricate the . . . judge from an awkwardness that was not of his choosing." The court declined to address whether a "preponderance" or "clear and convincing" evidence standard should apply to the "in fact" determination on the ground that the district court "may find that the answer is not outcome determinative."