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NEWSLETTER

Insurer Not Obligated To Continue Advancing Defense Expenses Where Money Laundering Exclusion Most Likely Bars Coverage

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The United States District Court for the Southern District of Texas, applying Texas law, has ruled that a D&O insurer is not obligated to continue advancing defense expenses where the insurer had shown a substantial likelihood that a money laundering exclusion in the policy applied to bar coverage. *Pendergest-Holt v. Certain Underwriters at Lloyd's of London,* 2010 WL 4026068 (S.D. Tex. Oct. 13, 2010).

Several insured individuals and entities faced a civil action instituted by the Securities and Exchange Commission (SEC) as well as a criminal action. The SEC alleged that the insureds ran a multi-billion dollar Ponzi scheme. 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.

After initially reserving its rights and agreeing to advance defense expenses for several of the insureds, the insurer later denied coverage based on a "Money Laundering Exclusion" in the policy. The Money Laundering Exclusion barred coverage for loss in connection with the concealment, transfer, acquisition or control of Criminal Property, which was defined to include property obtained in connection with criminal conduct. The Money Laundering Exclusion also provided that the insurer must advance defense expenses "until such time that it is determined that the alleged act or alleged acts did in fact occur."

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. After an initial ruling for the insureds and an appeal, which were summarized in the March 2010 and April 2010 issues of *Executive Summary*, respectively, the district court determined that the "in fact" determination required the insurer to show a substantial likelihood that it could demonstrate by a preponderance of the evidence that each of the insureds "in fact" committed Money Laundering as defined in the policy.

As an initial matter, the court determined that the other individual's guilty plea, in which he admitted that he intentionally and knowingly participated in a scheme to defraud purchasers of the insured's CDs, demonstrated that the funds obtained by the insured company from the CD sales were "Criminal Property" as defined in the policy. The court then ruled that the insurer had shown a substantial likelihood that each insured in the coverage action had engaged in Money Laundering with respect to the CD sale proceeds and that its coverage denial based on the Money Laundering Exclusion was proper with respect to these insureds.

The court concluded that the insurer had met its burden of demonstrating a substantial likelihood that the Money Laundering Exclusion applied to the chief accounting officer and controller of the insured company as well as its owner. Based upon testimony and exhibits in the record, the court found that the chief accounting officer and controller were responsible for producing financial reports through a procedure referred to internally as "reverse engineering" of investment revenue results, which the court found was "illogical and without accounting business justification" because they appeared to be based primarily on "aspirational goals." The court further found that these insureds "were denied all actual investment performance information" and that "[t]he absence of *any* documentary backup from [the individual who later pled guilty] was a red-flag that something was seriously amiss."

The court further found that the company's owner personally was aware that the CDs at issue "were being marketed on the basis of important material misrepresentations about the Bank's investment portfolio and investment performance." The court found that the owner knew since at least 2006 that representations in the company's financial reports and other promotional materials contained materially false information about the company's assets and the performance of its investments. In particular, the court noted that these materials represented that the bank's only form of lending was done on a cash-secured basis to existing clients, while in fact the owner himself and entities he controlled received hundreds of millions of dollars in undisclosed loans and other fund transfers, which ultimately totaled about $1.8 billion by the end of 2008 and which were not repaid.

Accordingly, the court concluded that the insurer had established a substantial likelihood that these insureds "in fact" engaged in Money Laundering and that the insurer therefore had no further obligation to advance defense costs on their behalf.