

Policy Voided Where Insured Concealed Operation of Ponzi Scheme and Misrepresented Financial Status

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Applying Georgia law, the United States Bankruptcy Court for the Northern District of Georgia has voided a surplus lines policy on the grounds that the insured, a purported hedge fund management firm, concealed that it was operating a Ponzi scheme, submitted an inaccurate financial statement, and misrepresented that its investment funds were “stable.” *Perkins v. Am. Int’l Spec. Lines Ins. Co.*, 2012 WL 2105908 (Bankr. N.D. Ga. Apr. 3, 2012). However, the court, considering alternative arguments to provide a complete record for the district court’s *de novo* review, rejected the insurer’s contention that it was entitled to deny coverage based on, among other things, (i) the policy’s definition of “wrongful act” and (ii) the lack of any legal obligation to pay damages.

An insurer issued successive investment management policies to a purported hedge fund management firm. The firm founder, however, used a portion of the investors’ money to run a Ponzi scheme. The remaining monies were invested in risky index options, even though the firm offering materials promised to invest in common stocks of U.S. companies. Ultimately, the firm investors filed two lawsuits against the firm and, shortly thereafter, the firm filed for Chapter 11 bankruptcy. The Chapter 11 trustee commenced this action seeking coverage for the investors’ claims arising out of the firm’s investment in risky index options. The insurer filed motions for summary judgment, arguing that the policy was void based on material misrepresentations made by the firm during renewal discussions and, alternatively, that coverage would be barred based on, among other things, (i) the policy’s definition of “wrongful act” and (ii) the lack of any legal obligation to pay damages.

The court granted the insurer’s motion with respect to rescission, holding that the policy was void on the grounds that the firm concealed that it was operating a Ponzi scheme, submitted an inaccurate financial statement, and misrepresented that its investment funds were “stable.” In so ruling, the court rejected the trustee’s argument that some of the firm owners were not aware of the misrepresentations, noting that an insured’s knowledge of the falsity of a misrepresentation is immaterial for purposes of rescission under Georgia law. The court also declined to hold that the insurer was required to expressly ask whether the firm was conducting a Ponzi scheme, reasoning that an insurer covering investment management risks has the right to assume that its prospective insured is a legitimate company.

In the alternative, however, the court denied the insurer's motion with respect to coverage. First, the court held that the investors' claims did in fact allege a "wrongful act" under the policy, namely, the firm's investment in risky index options instead of the common stock of U.S. companies. The court explained that the trustee was entitled to establish that the investors lost a portion of their money through such improper investments and not through the Ponzi scheme. Second, the court rejected the insurer's argument that the firm's obligation to pay investors constituted restitution, not damages, because the firm stole the money through the Ponzi scheme. The court reiterated that the trustee only sought coverage for the firm's liability to investors based on its improper investments, not the operation of the Ponzi scheme, and noted that the firm could not steal what it had already lost through investments.