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Insurance 101: Insights for Young Lawyers: Ponzi Schemes, and Money Laundering, and Defense Costs! Oh My!

D&O Insurance Implications from the Stanford Coverage Litigation

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Eighteen months ago, the Securities and Exchange Commission sued Texas financier R. Allen Stanford and his fellow executives, alleging a Ponzi scheme of mammoth proportions arising from the alleged sale of sham certificates of deposit at Antigua-based Stanford International Bank Ltd. According to prosecuting authorities, the scheme resulted in a reported $7 billion in investment losses. The day the SEC action was filed, the court appointed a receiver and seized all assets in the possession of the defendants.

Several months later, in June 2009, the government instituted a parallel criminal proceeding through a 21 count indictment, charging the Stanford executives with conspiracy to commit mail, wire and securities fraud; wire fraud; mail fraud; conspiracy to obstruct an SEC investigation; obstruction of an SEC investigation; and conspiracy to commit money laundering.

In August 2009, James Davis (the former CFO of two Stanford companies) pled guilty to separate charges for mail fraud, conspiracy to violate the mail, wire, and securities fraud laws, and conspiracy to obstruct a proceeding before the SEC. In connection with his plea agreement, Davis testified that, together with the other named defendants, he had engaged in various acts in furtherance of a Ponzi scheme.[1] "These

acts included the creation of falsified financial statements, bribery, the concealment of billions of dollars of fraudulent personal loans to Allen Stanford, and the execution of bogus real estate transactions designed to artificially inflate the value of company assets."[2] The other defendants pled not guilty.

The legal shenanigans that ensued have created a circus-like atmosphere for the proceedings. Stanford has cycled through numerous criminal defense counsel, running up more than $6 million in costs for his defense alone. Total defense costs for all defendants have exceeded $15 million. Despite limited precedent, Stanford's co-defendants in the criminal action persuaded the presiding judge that their cases should be severed, allowing them to be tried independently of the top executive. Jury selection in Stanford's criminal trial is scheduled for January 2011. Meanwhile, the SEC regulatory action is stayed pending the outcome of the criminal cases.

These parallel civil and criminal proceedings provide the context for the insurance coverage dispute that is the focus of this article. With directors and officers liability policies totaling $100 million, the coverage litigation that ensued was a virtual certainty. At the center of the coverage dispute are the astronomical defense costs incurred by Stanford and his co-defendants. In *Pendergest-Holt v. Certain Underwriters at Lloyd's of London*,[3] the Fifth Circuit Court of Appeals concluded in March 2010 that the insurers must continue advancing defense costs—but only until a court determines in a collateral proceeding whether the defendants have engaged in conduct excluded from coverage by the policies. This article examines the court's analysis and its implications for xboth insurers and policyholders, as well as practical insights gleaned from the dispute and its partial resolution.

THE INSURANCE POLICIES

Directors and officers of the Stanford Financial entities were insured under D&O policies issued by Certain Underwriters at Lloyd's of London (''Lloyd's'') and Arch Specialty Insurance Co. (''Arch''). The primary policy issued by Lloyd's provided $10 million in coverage, and Arch issued a follow-form excess policy with an additional $90 million in limits. The policies cover ''[l]oss resulting from any Claim first made during the Policy Period for a Wrongful Act.''[4] ''Loss'' expressly includes necessary legal fees and expenses incurred in defending any judicial or administrative proceeding against a director or officer.[5]

The policies did not impose on the insurers a duty to defend potentially covered claims, providing instead that the executives must defend themselves. The insurers were, however, responsible for paying covered defense costs provided the executives notified the underwriters before the costs were incurred.[6] If the insurers consented to defense costs, they were required to pay them no more than once every sixty (60) days.

THE COVERAGE DISPUTE

The insurers initially agreed to advance defense costs for the executives, including Stanford, pending a ''final coverage determination,'' but reserved the right to deny coverage at any time based on the terms of the policies, including exclusions for fraud and money laundering. After Davis pled guilty to the charges against him in August 2009, however, the insurers stopped paying defense costs for all of the executives.

On November 16, 2009, the insurers advised the individual insureds that they would no longer advance defense costs "because they had determined, based on evidence available to them up to that point, that Money Laundering, as defined by the policy had occurred."[7] Although the letter came in November 2009, the withdrawal of defense payments was effective as of August 27, 2009—the date Davis entered his guilty plea. Only one of the 21 counts charged in the indictment alleges money laundering as defined by law and Davis did not plead guilty to any charge of money laundering. Nevertheless, the insurers ***unilaterally determined*** that all of the allegations levied against the executives in both proceedings "[arose] directly or indirectly as a result of or in connection with" acts of money laundering, as broadly defined in the policies.[8]

The insureds filed suit the next day, seeking damages, a declaration that their defense costs must be reimbursed under the policies, and a preliminary injunction ordering the insurers to continue paying defense costs until a final judgment on the merits of the coverage dispute. The insureds argued that the insurers' retroactive denial of coverage was contrary to the terms of the policies and Texas law and, as such, was a breach of the policies.[9] Originally assigned to another federal judge, the coverage lawsuit was transferred to Judge David Hittner in the Southern District of Texas, before whom the criminal case is pending.

The coverage lawsuit centers on the policies' money laundering exclusion, which bars coverage for loss—including defense costs—resulting from claims "arising directly or indirectly as a result of or in connection with any act or acts (or alleged act or acts) of Money Laundering,"[10] defined to include more than just a violation of a money laundering statute. As broadly defined, Money Laundering includes:

(i) the concealment, or disguise, or conversion, or transfer, or removal of Criminal Property, (including concealing or disguising its nature, source, location, disposition, movement or ownership or any rights relating thereto); or

(ii) the entering into or becoming in any way concerned in an arrangement which is known or suspected to facilitate (by whatever means) the acquisition, retention, use or control of Criminal Property by or on behalf of another person; or

(iii) the acquisition, use or possession of Criminal Property; or

(iv) any act which constitutes an attempt, conspiracy or incitement to commit any act or acts mentioned in the foregoing paragraphs (i), (ii) or (iii); or

(v) any act which constitutes aiding, abetting, counselling or procuring the commission of any act or acts mentioned in the foregoing paragraphs (i), (ii) or (iii).[11]

Notwithstanding its breadth, the money laundering exclusion provides for qualified reimbursement of defense costs, coupled with the ability to claw back reimbursed funds from the insureds in certain instances:

> Notwithstanding the foregoing Exclusion, Underwriters 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.[12]

Relying on this exclusion, the broad definition of Money Laundering, a single count in the criminal indictment for money laundering or conspiracy to commit money laundering,[13] and other allegations contained in the indictment, the insurers made their own determination that Money Laundering (as defined) had in fact occurred and stopped paying all defense costs as of August 2009. Although the indictment contained only a single count for money laundering, the insurers maintained that all of the allegations against the executives in the criminal and SEC proceedings arose, directly or indirectly, as a result of or in connection with an act of Money Laundering.[14]

Although the policies also exclude coverage for criminal acts and fraud, that exclusion contains the common provision requiring a ''final adjudication.''[15] The parties agreed that the crime/fraud exclusion could not be a valid basis for the refusal to pay defense costs because the final adjudication requirement required an adjudication of guilt or liability in the underlying case.[16] With respect to alleged acts of Money Laundering, in contrast, the policies provide that defense costs shall be covered ''until such time that it is determined that the alleged act or alleged acts did in fact occur.''[17] The policies' broad definition of Money Laundering is not at issue in the coverage lawsuit; rather, the parties disagree on the meaning of ''determined in fact''—who makes the ''determination'' and when may it be made.

On December 17, 2009, Judge Hittner conducted a hearing on the executives' request for a preliminary injunction. The insurers presented evidence upon which they relied in determining that the money laundering exclusion applied. Counsel for the insureds objected that this evidence was irrelevant under applicable Texas law, as discussed more fully below.[18] The executives invoked their Fifth Amendment right not to testify. The court concluded that the money laundering exclusion would most likely not preclude coverage and granted the preliminary injunction prohibiting the insurers from withholding payment for defense costs pending a trial on the merits. The insurers appealed, obtaining a stay of the district court's preliminary injunction.

THE FIFTH CIRCUIT'S RULING

On appeal, the Fifth Circuit focused its analysis on two issues:

(1) whether the underwriters' duties end when they make an ''in fact'' determination . . . or whether that determination can only be made in the first instance by a court; and

(2) whether a court may examine evidence in making its determination or whether it is instead confined to the underlying complaint's allegations and the D&O Policy's terms.[19]

With respect to construction of the ''determination in fact'' language in the Money Laundering exclusion, the Fifth Circuit held that a court must make the determination (not the insurers!), but that the determination may be made by another court in a separate coverage proceeding and does not have to be in the underlying action.[20] The court declined to decide whether the eight-corners rule applies to an insurer's obligation to advance or reimburse defense costs, deciding that the policies contemplated the consideration of extrinsic evidence. The Fifth Circuit recognized the well-established right of the parties to contract around the eight-corners rule, concluded that they had so contracted and held that the parties' freedom to contract must control.

The Fifth Circuit's opinion continued an injunction against the carriers requiring them to advance defense fees until a separate judicial determination

could be made as to whether the defendants "in fact" committed money laundering. A hearing on the remanded injunction is set for September 1, 2010.[21] The SEC case has been stayed pending the outcome of the criminal proceeding, with jury selection set for January 2011.[22]

LESSONS LEARNED

Analyzing the Opinion

As a practical matter, the Fifth Circuit decision creates no victors in this coverage fight. While the insureds obtained a short-term win, securing advancement of defense costs until the coverage issues are tried this month, the requirement that they defend that victory in an ancillary civil proceeding before the criminal trial jeopardizes their defense in both cases. While the carriers have won the right to exit the runaway train before it finally crashes, defense costs are mounting by the hour. And, quite possibly, the insurers narrowly escaped the common situation in which the insurer loses the coverage battle because it failed to state its agreement in plain and unequivocal terms. Because repayment obligations by the executives would not be triggered until after final adjudication of the underlying matter, moreover, the likelihood of ever recovering from the insureds previously-advanced fees seems most unlikely.

Although the scope of the exclusion and the definition of Money Laundering were not the focus of the Fifth Circuit's analysis, the breadth of the exclusion, coupled with the use of such imprecise terms as "determined," creates ambiguity against which insurers and insureds alike should be cautioned. In most jurisdictions, including Texas, uncertain language that is susceptible of more than one reasonable interpretation is dangerous ground for an insurer, who is likely to lose any contest over the meaning of the ambiguous text. In this case, the insureds may unexpectedly lose funding for their defense in an extraordinarily complex case because the policies did not employ standard "final adjudication" language, instead creating an opportunity for the insurers to claim a unilateral right to make the "determination in fact" and giving courts room to supply an unfavorable meaning for the imprecise terms.

As analyzed below, however, insurers, insureds and their counsel can draw some valuable lessons from the judicial analysis spawned by the dispute.

"Determination in Fact" v. "Final Adjudication"

Who Decides, and When

The court's analysis rests largely on a comparison of the language of the fraud exclusion with the text of the money laundering exclusion. Commonly found in D&O policies, the fraud exclusion disclaims coverage for loss: "[R]esulting from any Claim . . . brought about or contributed to in fact by . . . any dishonest, fraudulent or criminal act or omission by the Directors or Officers of the Company . . . *as determined by a final adjudication*.[23]"

In the coverage litigation, the insurers conceded there was no "final adjudication" that the insureds had engaged in fraudulent conduct and, as such, the fraud exclusion did not afford a basis for withdrawal of defense costs.

Because the money laundering exclusion is worded differently, however, the insurers argued that the exclusion permitted them to determine unilaterally its applicability as a defense to coverage. The money laundering exclusion precludes coverage for loss (including defense costs) resulting from any Claim "arising directly or indirectly as a result of or in connection with any act or acts (or alleged act or acts) of Money Laundering," but provides for reimbursement of defense costs ("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*."[24] The primary issue in the coverage litigation was who determines "in fact" that acts of money laundering occurred and how that determination is made.

> ***"While there is nothing remarkable about an insuring reserving the right to make a unilateral coverage decision, it is similarly unremarkable to require an insurer to be explicit when doing so."***

Having concluded the policy permitted them to determine whether the alleged acts occurred, and having determined that Money Laundering did, in fact, occur, Underwriters elected to cease funding the defense. Both the district court and the Fifth Circuit easily rejected this argument: "While there is nothing remarkable about an insurer reserving the right to make a unilateral coverage decision, it is similarly unremarkable to require an insurer to be explicit when doing so[.]"[25]

Evidentiary Issues

The Eight-Corners Rule and Extrinsic Evidence

In determining the insurers' duty to pay the defense costs incurred by Stanford and the other executives,

the district court applied what is commonly known in Texas as the "eight-corners" rule. Texas courts analyze an insurer's duty to defend under an insurance policy pursuant to the eight-corners—or "complaint-allegation"—rule,[26] which mandates a comparison solely of the factual allegations in the underlying petition (the first "four corners") with the language of the insurance policy (the second "four corners").[27] As expressed by the Texas Supreme Court:

> The eight-corners rule provides that when an insured is sued by a third party, the liability insurer is to determine its duty to defend solely from terms of the policy and the pleadings of the third-party claimant. Resort to evidence outside the four corners of these two documents is generally prohibited.[28]

Facts outside the pleadings (even easily ascertained facts) ordinarily are not material to the determination of whether the insurer has a duty to defend.[29]

Although the parties agreed that the policies did not impose on the insurers the duty to defend, the district court found persuasive the reasoning applied by other courts who determined that the duty to advance defense costs is closely analogous to the duty to defend.[30] Reasoning from the purpose of the eight-corners rule in the duty-to-defend context, the district court explained:

> If a contemporaneous duty to advance or reimburse defense costs were judged on an "actual facts" basis, an insurer's contractual obligation to pay defense costs could change on a daily basis as additional "facts" are developed. Essentially, coverage that directors and officers relied upon and expected when the Policies were purchased on their behalf could be withdrawn at the insurer's whim. If, as Underwriters suggest, the Policies afford Underwriters absolute discretion to withhold payments whenever charges of intentional dishonesty are leveled against directors and officers, then insurers will be able to withhold payment in virtually every case at their sole discretion. That would leave directors and officers in an extremely vulnerable position, as any allegations of dishonesty, no matter how groundless, could bring financial ruin on a director or officer. Essentially, an insurer could act as judge and jury and convict its own insureds, thus avoiding any further financial responsibility for the insureds' defenses. This simply can not be the case.[31]

Agreeing with the insureds that the eight-corners rule applies to the insurers' obligation to advance or reimburse defense costs in the absence of a contractual duty to defend, the district court concluded that the insurers were not entitled to rely on evidence developed in the SEC and criminal actions as a basis for declining coverage.

On appeal, the Fifth Circuit acknowledged the issue of whether the eight-corners rule applies where the insurer has a duty ***not*** to defend, but to advance, pay or reimburse defense costs. The court observed that the Texas Supreme Court has applied the eight-corners rule only in the context of duty-to-defend cases and noted that no Texas state court has applied the rule to cases involving a duty to advance defense costs.[32] The court declined to address the issue, however, finding that the policies' terms "plainly state that the underwriters must advance defense costs 'until it is determined that the alleged act or alleged acts did in fact occur[.]'"[33] This language, the court concluded, requires recourse to something other than mere allegations contained in the pleading and contemplates the consideration of extrinsic evidence in making the determination. Where the parties have elected to "override judge-made doctrines—like the eight-corners rule—by contracting around them," the contract should be enforced as written in honor of the freedom of contract.[34]

Burdens and Standards of Proof

On remand, the district court must determine whether, with respect to each insured, "Money Laundering" (as defined in the policies) in fact occurred.[35] In May, the district court announced that this "in fact" determination would be made in the context of a preliminary injunction hearing and requested briefing from the parties on the applicable standards and burdens of proof.[36] Based on the briefing, the district court confirmed that the insurers would bear the burden of proving that Money Laundering in fact occurred.[37]

Because the Fifth Circuit expressly reserved "the question of whether a decision on the Money Laundering exclusion should be made by a preponderance standard or only by clear and convincing evidence,"[38] the district court also tackled this issue. The Texas Insurance Code is silent, providing that the insurer bears the burden of proving applicability of an exclusion without specifying the applicable evidentiary standard of proof.[39] In support of a lower standard, the insurers cited several Texas cases in which a preponderance of the evidence standard governed the applicability of particular exclusions, rather than the higher clear and convincing evidence standard.[40] Admittedly citing no Texas directly case on point, the insureds referred the court to *Couch on Insurance*: "While the degree of proof required for both coverage and exclusions is generally described as being a preponderance of the evidence, there may be a slightly heavier weight required for proof of exclusions.[41]"

In the absence of a case or statute on point, the court was not persuaded that a higher standard of proof applied.

The practical complications that stem from ''determining'' whether money laundering ''in fact'' occurred under a preponderance standard are readily apparent in this scenario. The particular issue currently before the court is the insurers' obligation to continue paying defense costs in *criminal* proceedings against the insureds. The standard of proof in those criminal proceedings is the exacting beyond-a-reasonable-doubt standard. Insurers can be expected to argue that the standard set forth in the policies is, by its terms, different from the standards for a criminal conviction. However, this may be inconsistent with the insured's expectations. For purposes of the crime/fraud exclusion, the policies' final adjudication language has been construed to require an adjudication in the underlying proceeding. When that proceeding is a criminal case, the standard of proof is beyond a reasonable doubt, so applicability of the exclusion based on a final adjudication in the underlying case will be determined pursuant to the criminal standard of proof. Similarly, fraud typically must be established by clear and convincing evidence in any underlying action to determine an insured's liability. If the insured's conduct is determined in a separate proceeding, a lower preponderance standard of proof could very well yield a different result in the coverage litigation. It is not entirely clear that this inconsistency effectuates the parties' intentions. Where a policy does not specify the requisite standard of proof to avoid coverage based on a ''determination in fact'' that money laundering occurred, it may be reasonable to interpret the exclusion to require a determination under the standard of proof applied in the underlying proceeding that would establish the insured's guilt or liability.

Determination in an Earlier, Ancillary Proceeding

One of the most significant issues raised by the court's interpretation of the policy is, as the court put it, the ''awkwardness . . . in putting the civil 'cart' before the criminal 'horse.'''[42] As analyzed below, litigating the coverage dispute before the underlying lawsuit is resolved creates significant risks for the insured. These dangers are most pronounced when coverage issues overlap with the defense of the underlying action. First, the insured's strategy in the coverage case may conflict with his defense in the underlying matter—a heightened risk if the underlying proceeding is a criminal prosecution as opposed to a civil suit. Second, forcing an insured to battle overlapping coverage and liability issues simultaneously on two fronts jeopardizes his ability to prevail in either contest due to divided attention and depleting resources (the very rationale that underlies the eight-corners rule in Texas).

a. Conflicting Strategies on Overlapping Issues

By requiring the parties to engage in a separate coverage proceeding to determine the same underlying fact questions that are present in the pending criminal proceedings by the DOJ and civil proceedings by the SEC, the court has placed the insured individuals in an impossible position. If they defend themselves in the civil proceeding, they give prosecutors a preview of their defense strategy and create judicial admissions that may be used against them in the criminal proceeding. If they invoke the Fifth Amendment in the coverage proceeding, they arm the insurers with an ability to claim that the testimony would have been unfavorable.

Putting the individual insureds to trial on the issue of money laundering to address the coverage question, however, imposes upon them a Hobson's choice with substantial penalties.

If the Stanford defendants continue to invoke their Fifth Amendment privilege, as they have previously done with regard to the coverage issues in this case,[43] their silence may be used by the carriers to help prove that they did in fact engage in money laundering. It is well settled that a civil litigant's decision to invoke his Fifth Amendment right not to testify may be used against him in a civil proceeding. Indeed, an ''adverse inference'' may be drawn from a party's decision to invoke the Fifth Amendment in a civil proceeding.[44] While the refusal to testify is not *proof* of underlying facts in the civil matter and the litigant's silence must be accompanied by independent facts to support liability, a fact-finder may nevertheless draw an inference that had the defendant answered the question, the answer would have been adverse to his position in the litigation.[45] The civil defendant's silence may be ''weighed in the balance'' of the evidence against him.[46] That said, both the Fifth Circuit and the United States Supreme Court have expressly recognized that ''a party claiming the Fifth Amendment privilege should suffer no penalty for his silence.''[47] Putting the individual insureds to trial on the issue of money laundering to address the coverage question, however, imposes upon them a Hobson's choice with substantial penalties. Without testifying, the defendants may be unable to negate the insurers' allegations of money laundering. Indeed, as one of the carriers' attorneys said, ''The best evidence they have is their own testimony. If they can point to where the

$7 billion went, they have a pretty good defense for money laundering."[48]

On the other hand, if the parties choose to testify in the coverage dispute, they may create evidence that can later be used against them in the criminal proceedings. As the Supreme Court has said, "truthful responses of an innocent witness, as well as those of a wrongdoer, may provide the government with incriminating evidence from the speaker's own mouth."[49] In most scenarios, parties are able to seek a stay of civil proceedings to avoid this impossible choice.[50] For example, the Alabama Supreme Court ordered a stay of the government's civil case against former WorldCom CEO Bernie Ebbers for these very reasons:

> A civil party's Fifth Amendment right against self-incrimination cannot be adequately protected by requiring him simply to assert his right to remain silent when asked specific questions during a civil deposition; such an approach construes the Fifth Amendment too narrowly. The dangers in such an approach have been identified as including the possibility of a criminal investigator's being "planted" at the deposition, the revealing by the deponent of his weak points by his selection of which questions he refuses to answer, and the opportunity presented to a prosecutor of deriving, by a point-by-point review of the civil case, a "link in the chain of evidence" that would unconstitutionally contribute to the defendant's conviction in the criminal case.[51]

In view of these serious concerns, discovery in the Stanford Financial SEC action has been stayed pending a resolution of the criminal case.[52] While the same *degree* of danger to defendants present in parallel civil and criminal proceedings by the government is not implicated with a coverage decision, the evidentiary issues persist. The fact that a different district judge is presiding over the collateral coverage issues provides the defendants no relief from the impossible choice they face.

b. Litigation on Dual Fronts

Moreover, any defense the parties present in the coverage proceeding could create a roadmap for prosecutors in the criminal case of both defense strategy and evidence. Even if the individual defendants plead the Fifth Amendment as they are expected to do, their counsel most likely will question other witnesses—such as former executive James Davis, who already pled guilty and thereby forfeited his own insurance coverage—as well as put on documentary evidence obtained from the SEC and DOJ investigations. Either scenario gives the prosecution a four-month advance preview of the criminal trial defense. Finally, the fact that a coverage lawsuit would be allowed to proceed is especially problematic here, where Allen Stanford is now representing himself in the coverage litigation since the withdrawal of his counsel due to a conflict of interest.[53]

c. Without Resources to Defend Effectively

Finally, the adjudication of coverage for defense costs through an ancillary proceeding that occurs ***before*** the underlying lawsuit is resolved creates another set of complications with regard to the defendants' ability to mount an effective defense. First, the insureds are effectively forced to establish their innocence in order to secure payment of defense costs. Judge Hittner recognized this legal conundrum in the context of evaluating the irreparable harm to the insureds if they were required to prove their innocence in the SEC and criminal proceedings in order to establish their entitlement to defense costs under the policies:

> If convicted on all charges against them in the Criminal Action, [the insureds] each face potential punishment of up to approximately 375 years incarceration in addition to financial and reputational ruin. Without the ability to fund an adequate defense in such a complex case, [the insureds] no doubt face irreparable harm.[54]

Finding that the insureds "unmistakably" would suffer real, immediate, and irreparable harm if injunctive relief were denied, Judge Hittner characterized the insurers' contrary position as "absurd," explaining that "these circumstances are precisely why corporations procure D&O insurance on behalf of their directors and officers."[55]

> "Indeed, it would contravene the very purpose of the Policies—as well as the policy language itself—to require [the accused] to prove their innocence before being entitled to funds for their defense.[56]"

Judge David Godbey, presiding over the SEC action in the Northern District of Texas, likewise recognized the "real and immediate" harm that the insureds would suffer if they were unable to obtain injunctive relief securing the payment of their defense costs.[57] Notably, Judge Godbey stayed the SEC action pending resolution of the criminal cases against the insureds.

> ***"Still, a determination at this juncture cannot be final in the sense that, as the underwriters concede, a determination of the facts on remand unfavorable to the executives would have to be reconsidered should the executives be cleared of all charges."***

d. Both Parties Face Uncertainty

Adjudicating (or "determining") the coverage issues before the underlying lawsuit is resolved raises another practical problem. Even the Fifth Circuit recognized that the outcome in the coverage lawsuit would need to be revisited if the insureds are unable to establish their innocence without compromising their defense in the criminal action, but are then acquitted in the underlying matter. "[Any determination in a separate coverage proceeding] cannot be final in the sense that, as the underwriters concede, a determination of the facts on remand unfavorable to the executives would have to be reconsidered should the executives be cleared of all charges.[58]"

Conversely, any repayment obligations by the executives, should they ultimately be convicted, "are triggered only by the coverage determination after any reconsideration."[59] "Any other reading," the court wrote, "ignores the realities of the underlying litigation and the purposes of the policy."[60]

With the benefit of hindsight gained from these opinions, insurers might be cautioned to use clear and unambiguous language stating plainly that they reserve a unilateral right to make a determination in fact that defeats coverage for defense costs, assuming that is their intent at the outset. Perhaps more importantly, insureds and their brokers should carefully consider any policy exclusion that does not require final adjudication[61] before it applies to bar coverage for defense costs. Doing so will allow insureds to avoid scenarios requiring them to fight a coverage battle at the expense of the underlying litigation or run the risk of losing coverage for their defense before the underlying matter is finally resolved.

Black Hat v. White Hat Coverage

Although not directly addressed by the Fifth Circuit, the Stanford case also raises issues regarding coverage of so-called "black hats" under a D&O policy and whether individual defendants, particularly those accused of criminal conduct, should be allowed to bleed a D&O policy of its limits. Here, there is only $100 million in D&O coverage for an alleged $7 billion in investor losses. Without even addressing the insurance issues related to legal fees for the SEC's action against the company or the defendants, the mounting fees by the receiver's counsel, or the legal fees for the dozens of former Stanford investment advisors sued as relief defendants, it is readily apparent that many parties are vying for a limited amount of insurance proceeds. Allen Stanford alone has already racked up more than $6 million in legal fees in defending the criminal and SEC suits against him.[62] His legal fees, along with those of other defendants, had reached $15 million by the end of May, while others covered under the policies had just received notice they will sued by the SEC.[63]

The Stanford cases serve as a reminder that when purchasing D&O policies, officers and directors need not only to consider adequately protecting themselves from the litigation risks inherent in their duties, but also the extent to which they want to protect any wrongdoers among them. This is particularly true for non-employee directors, as evidenced by *Enron*, *WorldCom*, and *HealthSouth*, where "black hats" were able to deplete substantial amounts of insurance proceeds available for other "innocent" directors and executives. When coverage exclusions are not applied until after final adjudication, wrongdoers have the same right as innocent individuals to deplete policy limits—a nonrenewable asset.

Policies that contemplate separate and earlier coverage proceedings may provide greater protection for innocent directors and officers by insulating the policy proceeds against depreciation by their "guilty" counterparts. On the other hand, setting a trigger somewhere below final adjudication offers less protection for all directors and officers. It is important for companies and their officers and directors to consider fully these implications when negotiating their D&O coverage. Regardless of whether the policy provides an opportunity for early adjudication of conduct exclusions, insureds will want to preserve the directors' and officers' ability to manage this part of the insurance themselves, rather than vesting the insurer with the right to make unilateral "in fact" determinations.

Another important consideration relating to the issue of black hats versus white hats is the method by which a company addresses its indemnification obligations. Assuming black hats are *former* officers and directors by the time coverage issues arise, companies may have the option to cut off indemnification for directors and officers who do not have individual indemnification agreements.[64] While most D&O policies include former officers and directors within the definition of insured, boards are not precluded from cancelling D&O coverage, entering into new coverage that alters that definition, or changing the corporate charter or bylaws so that former officers and directors are not included in indemnification obligations.[65] Officers and directors should carefully consider whether indemnification should be provided through personal indemnification agreements, which preclude later boards from reneging on indemnification obligations even for bad actors, or whether it should be part of the company's bylaws or charter, allowing black hats to be cut off from coverage by later boards.

PRACTICAL CONSIDERATIONS FOR POLICY NEGOTIATIONS

The challenges created by the Fifth Circuit's decision—complicated for insureds and insurers alike—might have been avoided entirely by more careful policy drafting.

- **Final Adjudication Language**. Insureds may seek to include final adjudication language in all conduct exclusions. Final adjudication language in exclusions may help avoid scenarios like the one presented here where the carriers potentially stood in the stead of a court as fact-finder. Had the money laundering exclusion included the same final adjudication language as the fraud exclusion, the parties would not be fighting against the underlying factual allegations simultaneously on two fronts. In using less common language, insurers should be cautioned to articulate their intent clearly. As a result of the uncertainty surrounding the use of "determination in fact" language, a number of D&O insurers now include more precise language in exclusions that do not contain a final adjudication clause. For example, some insurers may state that a written admission constitutes an in-fact determination.
- **Advancement of Costs**. Ensure that the policy clearly articulates the circumstances, if any, under which the carrier may decide unilaterally to stop advancing defense costs. If the insurer can make this determination on its own, an insured's early decisions about the quality (and quantity) of legal representation may be based on false assumptions. Knowing from the outset that it may be responsible for its own expenses, an insured may select different counsel and employ a different defense strategy based on funding considerations.
- **Inconsistent Language**. Make sure language is consistent throughout the policy, as well as excess policies, for similar provisions. Much of the problem arose here because the language in one conduct exclusion was different from another. This left the court in the position of assuming the parties wanted the exclusions treated differently and resulted in the ruling permitting a separate coverage to proceed.
- **Conduct Exclusions**. Avoid any broad conduct exclusions. The money laundering exclusion here, which included the "determination in fact" language was remarkably broad, covering a wide range of activity well beyond the statutory definition of money laundering. Carefully consider all exclusionary language and the scenarios that could trigger it in light of the insured's activities and potential liability. Consider also whether the description of excluded conduct is consistent with the law applicable to potential underlying litigation.
- **Indemnification / Former Officer & Director Coverage**. Carefully consider whether the company wants the greatest breadth of coverage for its officers and directors or whether it wants to retain the right to manage the exhaustion of limits as between black hat and white hat directors. This can be addressed both with the definition of "insured person" within a D&O policy, as well as by how the company guarantees indemnity.
- **Severability**. Although severability was not directly addressed in the court's decision, the case nonetheless raises important considerations about severability clauses contained in D&O insurance policies, particularly with regard to whose knowledge and/or acts may be imputed to others. Here, the trigger for discontinuing the advancement of defense costs was the guilty plea of former Stanford companies CFO James Davis in a separate criminal proceeding. He testified, in connection with his guilty plea, that he and the other defendants had engaged in acts in furtherance of a Ponzi scheme. From the insured's standpoint, policy language should be drafted as narrowly as possible to provide for imputation between fewer individuals and for the conduct of fewer individuals to be imputed to the organization if entity coverage is provided.

[1] Pendergest-Holt v. Certain Underwriters at Lloyd's of London, 600 F.3d 562, 565–66 (5th Cir. 2010).

[2] *Pendergest-Holt*, 600 F.3d at 566.

[3] *Pendergest-Holt*, 600 F.3d 562.

[4] *Pendergest-Holt*, 600 F.3d at 566.

[5] *Pendergest-Holt*, 600 F.3d at 566.

[6] *Pendergest-Holt*, 600 F.3d at 566.

[7] *Pendergest-Holt*, 600 F.3d at 567–68.

[8] *Pendergest-Holt*, 600 F.3d at 568.

[9] Pendergest-Holt v. Certain Underwriters at Lloyd's of London, 681 F. Supp. 2d 816, 820 (S.D. Tex. 2010).

[10] *Pendergest-Holt*, 600 F.3d at 567.

[11] *Pendergest-Holt*, 600 F.3d at 567.

[12] *Pendergest-Holt*, 600 F.3d at 567 (emphasis in opinion).

[13] *Pendergest-Holt*, 600 F.3d at 568.

[14] *Pendergest-Holt*, 600 F.3d at 568.

[15] *Pendergest-Holt*, 600 F.3d at 566–67.

[16] *Pendergest-Holt*, 681 F.Supp.2d at 824 (citing *In re Enron Corp. Sec., Derivative & "ERISA" Litig.*, 391 F. Supp. 2d 541, 572–72 (S.D. Tex. 2005) and Nat'l Union Fire Ins. Co. v. Brown, 787 F. Supp. 1424, 1429 (S.D. Fla. 1991), *aff'd*, 963 F.2d 385 (11th Cir. 1992) ("[T]here must be a 'final adjudication' by a judge finding the insureds committed or attempted acts of dishonesty and fraud to preclude coverage.")).

[17] *Pendergest-Holt*, 600 F.3d at 567.

[18] *Pendergest-Holt*, 681 F. Supp. 2d at 825 n. 9.

[19] *Pendergest-Holt*, 600 F.3d at 570.

[20] *Pendergest-Holt*, 600 F.3d at 573–74.

[21] *Hearing to determine who pays Stanford legal fees*, Associated Press (Apr. 20, 2010).

[22] *Pendergest-Holt*, 600 F.3d at 566.

[23] *Pendergest-Holt*, 600 F.3d at 566–67 (emphasis added).

[24] *Pendergest-Holt*, 600 F.3d at 567 (emphasis in opinion).

[25] *Pendergest-Holt*, 600 F.3d at 571.

[26] GuideOne Elite Ins. Co. v. Fielder Rd. Baptist Church, 197 S.W.3d 305, 308 (Tex. 2006).

[27] *GuideOne*, 197 S.W.3d at 308. *See* Nat'l Union Fire Ins. Co. v. Merchs. Fast Motor Lines, Inc., 939 S.W.2d 139, 141 (Tex. 1997); Liberty Mut. Ins. Co. v. Graham, 473 F.3d 596, 599–600 (5th Cir. 2006) (applying Texas law). *See also* King v. Dallas Fire Ins. Co., 85 S.W.3d 185, 187 (Tex. 2002) (duty to defend is determined "solely by the allegations in the pleadings and the language of the insurance policy").

[28] *GuideOne*, 197 S.W.3d at 307.

[29] *GuideOne*, 197 S.W.3d at 308.

[30] *Pendergest-Holt*, 681 F. Supp. 2d at 827.

[31] *Pendergest-Holt*, 681 F. Supp. 2d at 828–29 (internal citations omitted). *See Julio & Sons*, 591 F. Supp. 2d at 659; *Basic Energy*, 655 F. Supp. 2d at 673 ("The Court agrees with Plaintiff that this reimbursement of defense costs obligation is most analogous to a duty to defend even when the duty to defend is explicitly disclaimed.").

[32] *Pendergest-Holt*, 600 F.3d at 574.

[33] *Pendergest-Holt*, 600 F.3d at 574.

[34] *Pendergest-Holt*, 600 F.3d at 574.

[35] Pendergest-Holt v. Certain Underwriters at Lloyd's of London, 2010 U.S. Dist. LEXIS 45262 *3 (S.D. Tex., May 10, 2010).

[36] *Pendergest-Holt*, 2010 U.S. Dist. LEXIS 45262 at *3.

[37] *Pendergest-Holt*, 2010 U.S. Dist. LEXIS 45262 at *5 (citing Gore Design Completions, Ltd. v. Hartford Fire Ins. Co., 538 F.3d 365, 370 (5th Cir. 2008) ("Texas law places the burden of proving that an exclusion applies on the insurance company."); Tex. Ins. Code §554.002; and Texas Farmers Ins. Co. v. Murphy, 996 S.W.2d 873, 879 (Tex. 1999) ("If there are any contractual provisions that could limit or bar recovery, it is incumbent on the insurer to plead and prove them.")).

[38] *Pendergest-Holt*, 600 F.3d at 575.

[39] Tex. Ins. Code §554.002. *See Pendergest-Holt*, 2010 U.S. Dist. LEXIS 45262 at *7 n. 6.

[40] *Pendergest-Holt*, 2010 U.S. Dist. LEXIS 45262 at *6–7 (citing Routis v. Clarendon Am. Ins. Co., 2007 Tex. App. LEXIS 3704 at *8 (Tex.App.—Houston [1st Dist.] 2007, no pet.) (to establish arson by an insured, the insurer bears the burden of proving that the insured set the fire; "[h]owever, the insurer's burden of proof is not to show by an absolute certainty, but rather, by a preponderance of the evidence that the insured set the fire"); Murphy v. Texas Farmers Ins. Co., 982 S.W.2d 79, 84 (Tex.App.—Houston [1st Dist.] 1998) ("To establish arson as a defense to a civil suit for insurance proceeds, the insurance company must show by a preponderance of the evidence that the insured set the fire or caused the fire to be set."), *aff'd on other grounds*, 996 S.W.2d 873 (Tex.1999); Nobles v. Employees Retirement Sys. of Texas, 53 S.W.3d 483, 486 (Tex.App.—Austin 2001, no pet.) (an insurer has the burden to plead, and prove, by a preponderance of the evidence, a policy exclusion and present some evidence of its applicability).

[41] *Pendergest-Holt*, 2010 U.S. Dist. LEXIS 45262 at *7.

[42] *Pendergest-Holt*, 600 F.3d at 575.

[43] *Pendergest-Holt*, 600 F.3d at 568.

[44] Baxter v. Palmalgiano, 425 U.S. 308, 318 (U.S. 1976).

[45] *Baxter*, 425 U.S. at 318 ("Our conclusion is consistent with the prevailing rule that the Fifth Amendment does not forbid adverse inferences against parties to civil actions when they refuse to testify in response to probative evidence offered against them: the Amendment 'does not preclude the inference where the privilege is claimed by a party to a civil cause.'").

[46] *Baxter*, 425 U.S. at 318.

[47] Wehling v. Columbia Broad Sys., 608 F.2d 1084, 1089 (5th Cir.), reh'g denied, 611 F.2d 1026 (5th Cir. 1980 (citing *Spivak v. Klein*, 385 U.S. 511, 515 (1967)).

[48] Juan A. Lozano, *Waiting Game Continues in Stanford Legal Dispute*, Associated Press (April 22, 2010).

[49] Ohio v. Reiner, 532 U.S. 17, 21 (2001).

[50] SEC v. Dresser Indus., Inc., 628 F.2d 1368 (D.C. Cir. 1980) ("[A] court may decide in its discretion to stay civil proceedings, postpone civil discovery, or impose protective orders and conditions 'when the interests of justice seem to require such action.'") (quoting United States v. Kordel, 397 U.S. 1 (1970)).

[51] *Ex Parte Ebbers*, 871 So.2d 776, 788 (Ala. 2003) (citations omitted).

[52] *Pendergest-Holt*, 600 F.3d at 566.

[53] Brenda Sapiro Jeffreys, *Insurers Paid More Than $6 million in Stanford Legal Fees So Far*, Tex. Law. Lawyer (May 31, 2010).

[54] *Pendergest-Holt*, 681 F. Supp. 2d at 831 (citing *WorldCom*, 354 F.Supp.2d at 469).

[55] *Pendergest-Holt*, 681 F. Supp. 2d at 831.

[56] *Pendergest-Holt*, 681 F. Supp. 2d at 831–32.

[57] SEC v. Stanford Int'l Bank Ltd., et al., Cause No. 3:09-CV-00298, at 8, 2009 U.S. Dist. LEXIS 124377 (N.D. Tex. Oct. 9, 2009) (order clarifying status of insurance proceeds).

[58] *Pendergest-Holt*, 600 F.3d at 575.

[59] *Pendergest-Holt*, 600 F.3d at 576.

[60] *Pendergest-Holt*, 600 F.3d at 576.

[61] Dan A. Bailey, D&O Policy Commentary, 702 PLI/Lit 205, 215 (Feb. 17–18, 2004) ("For those forms which require a final adjudication, courts have consistently held that the adjudication must occur in the underlying D&O proceeding (not in the coverage litigation) and therefore the exclusion is inapplicable if the claim against the D&Os is settled. "); *see also Pendergest-Holt*, 600 F.3d 573 and n.28.

[62] Brenda Sapiro Jeffreys, *Insurers Paid More Than $6 million in Stanford Legal Fees So Far*, Tex. Law. Lawyer (May 31, 2010).

[63] Brenda Sapiro Jeffreys, *Insurers Paid More Than $6 million in Stanford Legal Fees So Far*, Tex. Law. Lawyer (May 31, 2010).

[64] Schoon v. Troy, C.A. No. 2362-VCL (Del. Ch. 2008).

[65] Schoon v. Troy, C.A. No. 2362-VCL (Del. Ch. 2008).