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FIFTH CIRCUIT REQUIRES D&O INSURERS TO ADVANCE DEFENSE COSTS TO STANFORD EXECUTIVES SUBJECT TO JUDICIAL DETERMINATION IN PARALLEL COVERAGE ACTION

Executives of the Stanford Group alleged to have engaged in a massive Ponzi scheme won a preliminary—and perhaps temporary—victory in litigation against D&O insurers when the United States Court of Appeals for the Fifth Circuit affirmed a lower court decision and ruled that insurers must continue to advance defense costs until a judicial determination is made that the policy exclusion for money laundering applies. *Pendergast-Holt v. Certain Underwriters at Lloyd's*, No. 10-20069 (5th Cir. March 16, 2010). The D&O insurers had argued that they should be allowed to stop advancing defense costs based on their own determination that money laundering, as broadly defined in the policy, had "in fact" occurred. In a complex ruling, the Court:

- Interpreted the D&O policy to require a judicial determination on the merits that the money laundering exclusion in the policy applied;
- Required the judicial determination to be made in a separate, parallel coverage action by a different judge than the one assigned to the criminal action against the executives; and
- Ruled that any judicial determination denying coverage would be subject to reconsideration if the executives were exonerated in the criminal or SEC proceedings.

The Fifth Circuit's ruling is a victory for the Stanford defendants since it requires the insurers to continue advancing defense costs, but it may be short lived because it allows the insurers to seek a judicial determination in a separate proceeding from the existing criminal case that is scheduled for trial in January 2011. If the D&O insurers present evidence that the money laundering exclusion applies, it is unclear what evidence, if any, the Stanford executives

will be able to present without waiving their Fifth Amendment right to self-incrimination and giving the prosecution an early look at the defense strategy. As the Fifth Circuit noted in its opinion, whether the judicial determination requires proof by a preponderance of evidence or by clear and convincing evidence is a "substantial issue" that may be outcome determinative.

Although the Fifth Circuit's ruling in the Stanford case involves unique facts, it is a helpful reminder that companies and their directors and officers should be vigilant when reviewing the terms of D&O policies, including definitions, exclusions, and endorsements. In most cases, policies should provide that defense costs will be advanced until the alleged wrongful conduct is "determined by a final adjudication" in the underlying action. The Stanford policy did not use this language in its broadly worded exclusion for money laundering, so the insurers stopped advancing defense costs after the SEC froze the company's assets, the receiver's accounting expert found that investment proceeds were improperly used, and the former Stanford CFO admitted that he and others engaged in a massive Ponzi scheme. In addition, where the policy permits or does not preclude recovery of defense costs from insureds who violate personal conduct exclusions, the policy should expressly require restoration of policy limits by the net amount of the recovery.

As the SEC continues to focus on individuals responsible for corporate misconduct and insurers are asked to pay substantial amounts in cases of corporate misconduct, companies should not be surprised when insurers argue that "[b]y the bargain, they are not compelled to remain aboard an aircraft that has lost its wings."[1] While the policy exclusion for money laundering at issue in the Stanford case may not apply in many securities fraud cases,[2] careful attention to the terms of D&O policies when they are purchased or renewed will ensure that coverage is available when it is needed most.

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1 *Pendergast-Holt*, slip op. at 21.

2 The Fifth Circuit (paraphrasing the D&O insurers' appellate brief) specifically noted: "One example of a fraud claim safe from the Money Laundering exclusion would be an alleged reckless failure to disclose material information—e.g., where the company operates an otherwise legitimate business but is alleged to have overstated earnings in public filings." *Pendergast-Holt*, slip op. at 11 n. 17.