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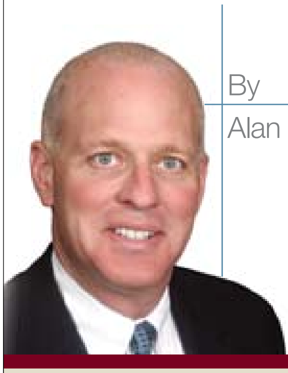

By
Alan Rutkin

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Ring Around the Collar

A financial fraud case evolves into a notable directors-and-officers court ruling.

Just as Darwin theorized that new species evolve, I believe that new insurance coverage issues evolve. My theory is simple: New liability issues evolve into new insurance coverage issues. It always happens.

The latest evidence of coverage evolution is the issues arising from various financial frauds, such as the Stanford Financial Group's case concerning the money laundering exclusion.

Stanford claimed large and steady returns on "conservative" investments. In fact, Stanford was a Ponzi scheme. The bank and its officers were sued, and insurers defended under directors and officers coverage. But in October a court found in *Pendergest-Holt v. Certain Underwriters at Lloyd's of London* that the money laundering exclusion relieved insurers of any obligation to pay defense costs.

Pendergest-Holt recounted the machinations of the policyholders' financial shenanigans. The officers—individuals who were CPAs—were shown to have reverse-engineered their financial reports based upon the returns that were promised, as opposed to the returns actually achieved. Their bookkeeping included increasing the value of a real estate investment by a factor of 50 only three months after acquiring it.

The judge finds criminal behavior that voids a key portion of the policy.

The court then applied the money laundering exclusion. The policy set its own definition of money laundering that included not only statutory "money laundering," but a variety of acts concerning "criminal property," defined as "property which constitutes a benefit obtained from…or in connection with criminal conduct…[which a director or officer] knows or suspects or reasonably should have known or suspected that it constitutes" such property.

First, the court took careful note of the policy language that I quoted. If the policyholders should have known of the criminal property, coverage was barred. With this standard, the court was able to reach its findings by a simple conclusion that the policyholders' denial of knowledge is "unpersuasive" and "strains credulity." The court did not need to find that the policyholders actually knew of the criminal property.

Second, the court enforced this exclusion as written. If the transactions were related to criminal property, and the policyholders should have known so, coverage was barred. The court's analysis was an intensely factual consideration of whether the policyholders were tied to the fraud. Given these findings—group chairman Allen Stanford being involved personally and the officers engaging in reverse-engineering the returns—the individuals were found to have the required tie to the activities.

Third, this exclusion and the court's findings were different from the analyses common to other exclusions relating to frauds, such as the "personal profit" exclusion or the "fraud" exclusion.

There, the exclusions often require determinations "in fact" or judicial determinations. Here, the court saw no such hurdle; this money laundering exclusion contained neither requirement.

The court denied the policyholders' request to stay the decision pending appeal, finding that the appeal had "little likelihood of success" and ultimately, "there is no serious legal question regarding the policy's money laundering exclusion."

In the judge's view, the issues here were completely evolved. BR

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