Court Ends Defense Costs Coverage for Allen Stanford Under D&O Policies Prior to a Final Adjudication of Civil and Criminal Liability

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Upon remand after a decision by the U.S. Court of Appeals for the Fifth Circuit (previously discussed in a Jenner & Block practice advisory available at http://www.jenner.com/files/tbl_s20Publications/RelatedDocumentsPDFs1252/2868/Stanford_Financial_D-O_Insurers_03.17.10.pdf), the United States District Court for the Southern District of Texas recently issued a decision ending directors and officers liability ("D&O") insurance coverage for R. Allen Stanford and other Stanford Financial executives prior to a final adjudication of such executives' criminal and civil liability.

In Pendergest-Holt v. Certain Underwriters at Lloyd's of London, No. H-09-3712, 2010 U.S. Dist. LEXIS 108920 (S.D. Tex. Oct. 13, 2010), the court ruled on the application of a money laundering exclusion in D&O insurance policies. Prior to the court’s decision, Mr. Stanford and other Stanford Financial executives had sought advancement of defense costs from such D&O insurers for defense of criminal and SEC actions regarding alleged misconduct at Stanford Financial, including participation in a massive Ponzi scheme. The insurers initially advanced defense costs but – after a Stanford Financial CFO entered a guilty plea – retroactively denied coverage and sought reimbursement for all advanced amounts. The insurers based their denial on the money laundering exclusion, which required the insurers to pay defense costs until such time that it was determined that the alleged act or acts did “in fact” occur. Mr. Stanford and other executives then sued for coverage, and, in an earlier decision, the court entered a preliminary injunction prohibiting the insurers from withholding defense costs and from making the “in fact” determination unilaterally under the money laundering exclusion; the Fifth Circuit affirmed the preliminary injunction in-part but remanded for the district court to determine whether the “in fact” requirement of the money laundering exclusion had been met.

On remand, the court held an evidentiary hearing, after which it issued the above decision and made the “in fact” determination required by the money laundering exclusion. The court held that the insurers had proven – by a preponderance of the evidence – a substantial likelihood of success in demonstrating that Mr. Stanford and the other executives seeking coverage had “in fact” committed money laundering as defined.
in the money laundering exclusion. In making a determination that the “in fact” standard had been met, the court examined the policy language, the underlying complaints, and outside evidence presented at the evidentiary hearing, including the testimony of witnesses. Notably, Mr. Stanford and the other executives seeking coverage neither testified nor were deposed, and the court stated its findings and conclusions were narrow and not intended to be used in the criminal and SEC actions those individuals were facing.

The court also denied a stay pending appeal, meaning the insurers – as of the court’s judgment – no longer had an obligation to pay or advance defense costs. The court justified this by the fact that there was a “dwindling insurance pot” for the use of some thirty other Stanford Financial executives. The court did leave open the possibility that should Mr. Stanford and the other executives prevail in the criminal and SEC actions, they could seek a final determination on the merits from the court as to the applicability of the money laundering exclusion. But in the interim, they are on their own in funding their defense.

This decision demonstrates the importance of negotiating for the narrowest exclusionary wording in D&O insurance policies. While the specific money laundering exclusion at issue in this decision does not frequently appear in D&O policies, the language permitting application of the exclusion “in fact” frequently does appear in so-called “conduct” exclusions in D&O policies – exclusions precluding coverage for personal profit, criminal, or fraudulent acts. Instead of an “in fact” standard, policyholders strongly should negotiate for policy language that requires a “final adjudication in an underlying action” before application of the conduct exclusions. Importantly, as the court noted in its decision, the fraud exclusion in the D&O policies was not at issue as to Mr. Stanford and other executives because, unlike the money laundering exclusion, it applied only after a final judgment had been entered against a policyholder. Here, a simple change of language of the money laundering exclusion during placement of the policy to a “final adjudication in an underlying action” standard would have preserved coverage for Mr. Stanford’s and other executives’ millions of dollars of ongoing defense costs.

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