The Lingering $65 Billion Question

Bernie Madoff may be last year's news but the financial consequences of his $65 billion scam will not soon be forgotten. As Madoff victims seek to recoup their losses through any of a number of means - from tax refunds and SIPC claim payments to auctions of Madoff's pricey yachts, opulent homes and personal effects - many victims are facing the grim prospect of recovering only a fraction of their losses. Not unexpectedly, a number of Madoff's former clients have turned to the courts, casting blame on, among others, alleged co-conspirators, the Securities Exchange Commission and even other victims. It could be years before the merits of these lawsuits are fully tested, and the viability of litigation as a method for recouping losses is, no doubt, case specific. Nonetheless, as interested onlookers watch to see whether these lawsuits yield any financial returns, plaintiffs' lawyers continue to look for other potential avenues of liability.

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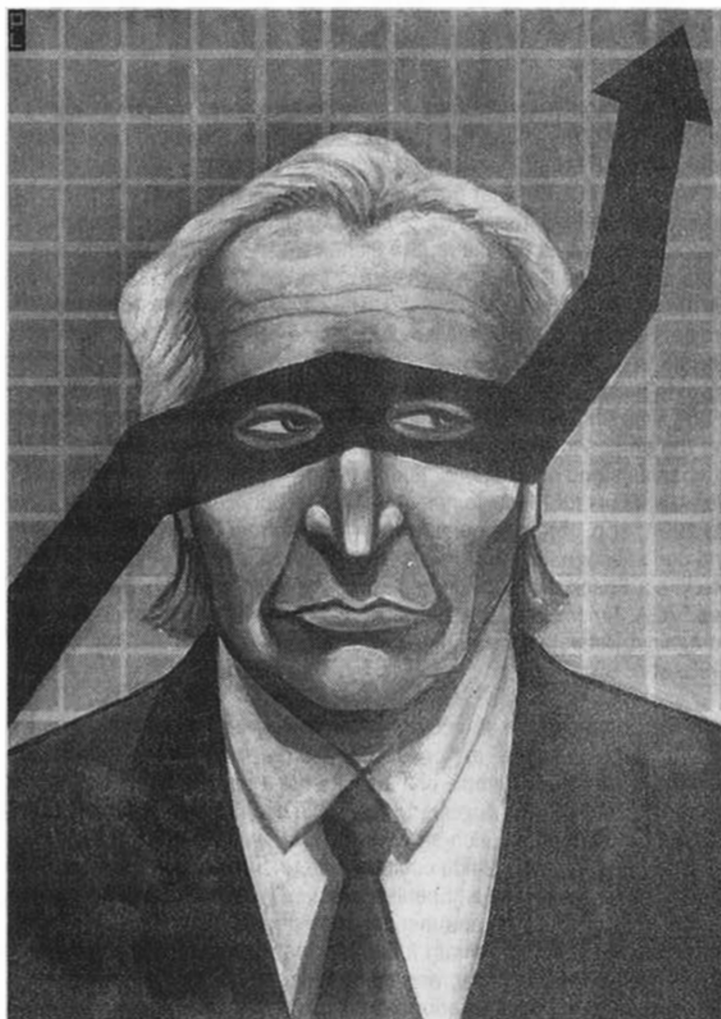
Is there a way for Madoff victims to recover their losses? Some have set their sights on insurance companies as holding the answer to that question. Advancing claims for coverage under a range of policies not clearly designed to cover losses resulting from a Ponzi scheme, at least half a dozen complaints have been filed against various insurers demanding either first-party coverage for the insured's own losses or third-party coverage with respect to claims, suits or government investigations initiated against the insured. The types of insurance policies at issue vary from case to case, ranging from homeowner's policies, *see, e.g., Horowitz v. AIG International Group, Inc.*, No. 1:09-cv-7312 (S.D.N.Y. filed Aug. 19, 2009), to fidelity bonds, *see, e.g., Massachusetts Mutual Life Insurance Co. v. Certain Underwriters at Lloyd's of London*, No. 4791-VCP (Del. Ch. filed Aug. 10, 2009).

The *Horowitz* purported class action pending in the United States District Court for the Southern District of New York alleges that the defendant insurers improperly denied coverage for plaintiffs' Madoff-related losses under homeowner's insurance policies providing certain fraud coverage. According to the first amended complaint filed on Sept. 22, 2009, even though defendants paid the claims of "hundreds of eligible policyholders who suffered Madoff-related losses pursuant to this coverage," defendants denied plaintiffs' insurance claims because plaintiffs "received more money from Madoff through withdrawals in their account than they had deposited." Thus, a key issue in *Horowitz* portends to be whether appreciation in an investment account constitutes a covered loss.

This issue could likewise arise in *Bleznak Black, LLC v. Allied World National Assurance Co.*, No. L-3663-09 (N.J. Super. Ct. filed July 20, 2009), a case involving "all risk" insurance policies, in which plaintiff seems to be seeking recovery not only of the $13.4 million deposited with Madoff but also the gains that had purportedly been posted to plaintiff's account. More fundamentally, though, the case presents the question whether funds held in an account constitute "intangible property" under the terms of the policies at issue or instead "money and securities." According to Bleznak Black, its loss was not a "theft of money" for which there is no coverage but rather a theft of "intangible property," allegedly defined as property that "has no intrinsic and marketable value, but is merely the representative or the equivalent of value."



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Notably, plaintiffs in other cases may need to demonstrate the reverse in order to establish coverage under their policies. In *Upsher-Smith Laboratories, Inc. v. St. Paul Fire & Marine Insurance Co.*, No. 27-CV-09-18818 (Minn. Dist. Ct. filed July 14, 2009), one of the policies at issue apparently provides that the insurer "will pay you for your direct loss of, or your direct loss from damage to, Money, Securities and Other Property directly caused by Computer Fraud." Thus, were the court to find in favor of Upsher-Smith, there would need to be at least an implicit finding that Upsher-Smith's losses were of money, securities or tangible property given that "Other Property" means "any tangible property other than Money and Securities that has intrinsic value." Likely to be more significant in *Upsher-Smith*, however, is whether plaintiff's losses resulted from "Computer Fraud," as that term is defined in the crime policy, or whether any of a host of other policy exclusions apply to bar coverage. The court in *Ann & Hope, Inc. v. Federal Insurance Co.*, No. 1:09-cv-6324 (S.D.N.Y. filed July 15, 2009), may be called upon to address similar questions.

While the complaints in *Horowitz, Bleznak Black, Upsher-Smith* and *Ann & Hope* seem to turn on the nuances of the loss incurred, other cases focus more on the role of Madoff himself. For example, in *Massachusetts Mutual*, the plaintiffs seek coverage under a fidelity bond that allegedly protects against loss resulting directly from dishonest or fraudulent acts committed by certain individuals-which, according to plaintiffs, includes Madoff. Fidelity bonds, which are generally designed to protect against employee dishonesty or fraud, do not typically apply to the acts of an independent person over whom the insured does not have supervision and control. Thus, certain defendants in *Massachusetts Mutual* have moved to dismiss the complaint on the grounds that plaintiffs failed to allege facts that would bring Madoff with the bond's definition of "employee" or establish that the bond's exclusion of coverage for "independent brokers" is not applicable.

Finally, some institutional account custodians are seeking professional liability coverage in connection with lawsuits initiated against them by investors who lost money in Madoff's Ponzi scheme. In *Associated Community Bancorp, Inc. v. Travelers Cos.*, No. 3:09-cv-1357 (D. Conn. filed Aug. 27, 2009), plaintiffs have alleged entitlement to defense and indemnity with respect to such lawsuits, and the insurers have moved to dismiss the complaint on the grounds that various exclusions apply to bar coverage. For instance, defendants have advanced the argument that the policy's insolvency exclusion precludes coverage. That exclusion purportedly states that there is no coverage for losses "based upon, arising out of or attributable to" the insolvency, receivership, bankruptcy or liquidation of, or financial ability to pay by, any investment company or any broker dealer in securities or commodities. According to defendants, the underlying investor plaintiffs would not have suffered a loss and would not be pressing a claim against the insureds "but for" Madoff's inability to pay the investors.

As is often the case in insurance coverage litigation, the outcome of these lawsuits will likely depend on how the courts apply the terms of the applicable insurance policies to the facts of the individual cases. Accordingly, whether any given judicial coverage determination will have far-reaching implications remains an open question. Policyholder and insurer counsel alike are closely watching these lawsuits unfold to see if the coverage arguments advanced have the potential to gain traction in the courts.

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