IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF GEORGIA

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. ANGELO A. ALLECA, SUMMIT WEALTH MANAGEMENT, INC., SUMMIT INVESTMENT FUND, LP, ASSET DIVERSIFICATION FUND, LP, and PRIVATE CREDIT OPPORTUNITIES FUND, LLC Defendants.	:	Civil Action No. 1:12-CV-3261-WSD

MEMORANDUM OF LAW IN SUPPORT OF RECEIVER'S MOTION FOR APPROVAL OF SETTLEMENT OF DISPUTED CLAIM AND SETTLEMENT AGREEMENT, AND FOR ENTRY OF BAR ORDER

I. Introduction

Movant Robert D. Terry, the Receiver appointed by Order dated September 21, 2012, respectfully submits this his Memorandum of Law in Support of Motion to Approve Settlement of a Disputed Claim. The Motion seeks the entry of an Order approving a proposed settlement of a disputed claim for payment under an errors and omissions insurance policy issued by Federal Insurance Company ("Federal") insuring, among others, Summit

Wealth Management, Inc., (“Summit”) and all of its former employees. If approved, the proposed settlement will bring $1,487,500 into the Receivership Estate, and allow the Receiver to file a proposed plan of interim distribution to claimants of the Receivership Estate.

If approved, this settlement will also extinguish the insurance policies that are the subject of the settlement and will result in the entry of a Bar Order against all insureds, potential insureds, or any other claimants in and to any proceeds of those policies, as more fully described in the proposed Compromise Settlement and Policy Release Agreement (“Settlement Agreement”) attached as Exhibit A to the Motion filed concurrently herewith. The Receiver has notified all known insureds and potential insureds known to the Receiver at their last known addresses by mailing a copy of the Notice of Receiver’s Motion for Approval of Settlement of Disputed Claims and Settlement Agreement, and for Entry of a Bar Order (“Bar Notice”) attached as Exhibit B to the Motion.

II. Undisputed Facts

A. The E&O Policy.

The policy at issue, Asset Management Protector Policy 8210-5886 (the "Policy"), was originally issued to Summit for a **Policy Period**[1] of August 17, 2008 through August 17, 2009.[2] The Policy has two coverage parts: (a) Directors and Officers Liability Coverage Part ("D&O Part") and (b) Professional Liability Coverage Part ("E&O Part"). The proposed settlement concerns only the E&O Part, as the Receiver has not made any claim and will not make any claim under the D&O Part. A true and correct copy of the 2012 Policy, the form of the policy in force at the time of the first reported claim is attached hereto as Exhibit 1.

Under the 2012 Policy ("Policy"), National Advisory Services, Inc. is the named insured. The E&O Part, however, defines "**Insured**" as, among other things, any "**Investment Adviser**." Ex. 1, E&O Pt. § II (G). "**Investment Adviser**," in turn, is defined as:

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[1] Terms appearing in bold text in this memorandum are defined terms under the Policy.

[2] The policy subsequently was renewed annually, up to and including the August 17, 2012 to August 17, 2013 **Policy Period**. As detailed in the Compromise Settlement and Policy Release Agreement, attached as Exhibit A to the Motion_, at the time of each of the last two renewals, Summit and National Advisory Services specifically applied for increases in the policy limits, and submitted an additional Limits Increase Letter or "Warranty Letter" on each occasion, as described in greater detail below.

> (1) any **Organization** that is registered as an adviser under the Investment Advisers Act of 1940, solely in its capacity as such; and
>
> (2) any **Insured Person** of any **Organization** identified in (l)(1) above, but solely in his or her capacity as an **Executive** or **Employee** of such **Organization**.

Ex. 1, E&O Pt. § II (l). "**Organization"** means:

> the **Named Organization** [National Advisory Services] and any **Subsidiary . . . .** *Id.*, General Terms & Conditions ("GTC") § V (P).

"Insured Person" means:

> any **Executive** of an **Investment Adviser** … or any **Employee** of an **Investment Adviser**..., solely in his or her capacity as such.

Ex. 1, E&O Pt. § II (H). Because Summit is a subsidiary of National Advisory Services and is registered under the Investment Advisers Act of 1940, it is an **Insured**. Summit's investment adviser representatives, the advisers who maintained client relationships and provided investment recommendations to clients, were employees of Summit. Therefore, they are **Insured Persons**. *Id.*; § (II)(H).

The Policy provides for reimbursement of defense costs and indemnification of liability for certain defined Claims arising from covered errors in the rendering of professional advisory services by **Insureds** and **Insured Persons**. It is an eroding policy, which means the amount available

to indemnify **Insureds** and **Insured Persons** for liability resulting from covered losses decreases by each dollar that is paid in defense costs. Ex. 1, GTC § V(c). The Policy is a "claims made" policy, meaning that it covers only claims of which Federal is notified during the **Policy Period**.

In connection with the original application for insurance, Summit submitted an application containing an acknowledgement in Section II, ¶ 13, that:

> 13.b ___ no person(s) or entity(ies) proposed for this insurance has any knowledge or information of any fact, circumstance or situation that might reasonably be expected to give rise to any claim that would fall within the scope of the proposed insurance, except as follows: (If none, check here __ "None").

Neither the check box at the beginning of the quoted paragraph nor the check box at the end of the paragraph was checked. The following, however, appeared immediately below question 13:

> **Without prejudice to any other rights and remedies of the Underwriter, any claim arising from any claims, facts, circumstances or situations required to be disclosed in response to . . . . 13.b above is excluded from the proposed insurance.**

"Knowledge Exclusion" (bold in original). A true and correct copy of the Application is attached here to as Exhibit 2. The Application was signed by Alleca, Summit's CEO on August 20, 2008.

During the **Policy Periods for the 2009 Policy and the 2010 Policy,** the limit of liability was $1,000,000. Prior to renewal of the 2010 Policy, Summit requested an increase in the limits by $1,000,000, increasing the Maximum Aggregate Limit of Liability to $2,000,000 for the upcoming **Policy Period** of August 17, 2011 to August 17, 2012. As part of approving that requested limit increase, Federal requested and obtained from Summit a letter on Summit letterhead that said:

> It is agreed that with respect to the One Million ($1,000,000) increased Limit of Liability in excess of the current One Million ($1,000,000) Limit of Liability, no person proposed for coverage under this Policy is aware of any facts or circumstances which he or she has reason to suppose might give rise to a future claim.
>
> It is further agreed that if such facts or circumstances exist, whether or not disclosed, any claim or action arising from them is excluded from this proposed coverage.

("First Limits Increase Letter" or "First Warranty Letter") (Ex. 3). The First Warranty Letter was signed by Alleca as "Chairman or Chief Executive Officer."

Similarly, prior to the expiration of the 2011 Policy, Summit requested an additional $1,000,000 increase in the Limit of Liability, from $2,000,000 to $3,000,000, for the upcoming **Policy Period** of August 17, 2012 to August 17, 2013. Once again Federal requested and obtained a letter on Summit letterhead that said:

> It is agreed that with respect to the One Million ($1,000,000) increased Limit of Liability in excess of the current Two Million ($2,000,000) Limit of Liability for a total of Three Million ($3,000,000) Limit of Liability, no person proposed for coverage under this Policy is aware of any facts or circumstances which he or she has reason to suppose might give rise to a future claim.
>
> It is further agreed that if such facts or circumstances exist, whether or not disclosed, any claim or action arising from them is excluded from this proposed coverage.

("Second Limits Increase Letter" or "Second Warranty Letter") (Ex. 4). The Second Warranty Letter was signed by Carrie Mistina, Chief Financial Officer of Summit.

The Policy contains a number of exclusions from coverage, the most relevant of which, for purposes of the present motion, is the exclusion of any **Claim**:

> (P) based upon, arising from, or in consequence of:
>
> > (1) any criminal or deliberately fraudulent act or omission or any willful violation of any statute or regulation by an

> **Insured**, if a final, non-appealable adjudication in any underlying proceeding establishes such criminal or deliberately fraudulent act or omission or willful violation; or
>
> (2) an **Insured** having gained any profit, remuneration or advantage to which such **Insured** was not legally entitled, if a final, non-appealable adjudication in any underlying proceeding establishes the gaining of such profit, remuneration or advantage.

Policy § III (P) ("Fraud Exclusion"). The Fraud Exclusion is further qualified, in relevant part:

> For purposes of these Exclusions III.(P)(1) and III.(P)(2) above:
>
> * * *
>
> (b) No criminal or deliberately fraudulent act or omission or any willful violation of any statute or regulation by an **Insured** shall be imputed to any **Insured Person**, and only criminal or deliberately fraudulent acts or omissions or willful violations of any statute or regulation by any Chief Executive Officer or equivalent, Chief Compliance Officer or equivalent, or General Counsel or equivalent of an **Organization** shall be imputed to such **Organization**. . . .

Id. For purposes of the present Motion, the qualifications contained in III (P)(2)(b) above is referred to as the "Fraud Exclusion Severability Clause."

B. The Litigation Stay

This Court's Modified Order Appointing Receiver dated November 11, 2012 ("Modified Receivership Order") contained a litigation stay provision in Paragraph XVI:

As set forth in detail below, the following proceedings, excluding the instant proceeding and all police or regulatory actions and actions of the Commission related to the above-captioned enforcement action, are stayed until further Order of this Court:

> All civil legal proceedings of any nature, including, but not limited to, bankruptcy proceedings, arbitration proceedings, foreclosure actions, default proceedings, or other actions of any nature involving: (a) the Receiver, in his capacity as Receiver; (b) any Receivership Property, wherever located; (c) any of the Receivership Defendants, including subsidiaries and partnerships; or, (d) any of the Receivership Defendants' past or present officers, directors, managers, agents, or general or limited partners sued for, or in connection with, any action taken by them while acting in such capacity of any nature, whether as plaintiff, defendant, third-party plaintiff, third-party defendant, or otherwise (such proceedings are hereinafter referred to as "Ancillary Proceedings").

The parties to any and all Ancillary Proceedings are enjoined from commencing or continuing any such legal proceeding, or from taking any action, in connection with any such proceeding, including, but not limited to, the issuance or employment of process.

All Ancillary Proceedings are stayed in their entirety, and all Courts having any jurisdiction thereof are enjoined from taking or permitting any action until further Order of this Court. Further, as to a cause of action accrued or accruing in favor of one or more of the Receivership Defendants against a third person or party, any applicable statute of limitation is tolled during the period in which this injunction against commencement of legal proceedings is in effect as to that cause of action. This provision shall not prevent the Receiver from

pursuing any claim or cause of action on behalf of the Receivership Estate or Receivership Defendants.

C. Litigation and Claims Asserted to Date.

The following claims have been asserted against Summit and/or certain **Individual Insureds**. The Receiver does not contend that any of these claims were asserted with knowledge of, or in violation of, either the Modified Receivership Order or the original order dated September 21, 2012.

1. Toll/Topkis Claim. On or about September 21, 2012, a civil complaint was filed in the U.S. District Court for the District of Delaware by Plaintiffs Bruce E. Toll and Douglas Topkis against Summit and other defendants, Civil Action No. 7889-VCP ("Toll/Topkis Litigation"). A true and correct copy of the complaint filed in the Toll/Topkis Litigation is attached hereto as Exhibit 5. The complaint alleged, among other things, aiding and abetting breach of fiduciary duty, breach of contract, and fraud. It sought an award of damages in an unspecified amount. The transactions at issue, however, totaled $2,000,000. The Receiver submitted the claim for coverage to Federal during October 2012.

On November 1, 2012, Federal wrote a letter to Summit's agent, Noble P. Powell, Jr. of the Willis Group, expressing Federal's "preliminary views on coverage with respect to the allegations contained in the complaint

filed in the Toll/Topkis litigation." A true and correct copy of the letter is attached hereto as Exhibit 6. In the letter, Federal contended that the First Warranty Letter and the Second Warranty Letter limited coverage to, at most, $1 million because at the time they were executed a "person proposed for coverage," namely Alleca, was "aware of facts or circumstances which he [had] reason to suppose might give rise to a future claim." Ex. 6, pp 2-3. Furthermore, Federal reserved all rights to contend that the coverage was completely precluded as to the first $1 million based on the Exclusion Acknowledgement because "Alleca may have known prior to the inception date of the 2008-09 Policy Period of facts that could give rise to this claim." *Id.*, p. 3, n. 2.

2. <u>Byers Complaint</u>. On February 22, 2013, Summit clients Paula F. Byers, Randall T. Larson, and Timothy K. Walkoe filed a civil action in the Circuit Court for Du Page County Illinois against Summit, Summit employee Farokh Bill Billimoria and other named defendants. Civil Action File No. 2013L000183 ("Byers Complaint"). A true and correct copy of the Byers Complaint is attached hereto as Exhibit 7. Billimoria is an **Individual Insured** under the Policy. In the Byers' Complaint, the plaintiffs assert various claim relating to losses they incurred as a result of investments made by and through Summit and Billimoria. The plaintiffs seek damages in the

cumulative amount of $450,000, comprised of $150,000 in losses for plaintiff Larson, $250,000 for plaintiff Walkoe, and $50,000 for plaintiff Byers.

The Receiver gave notice to Federal of the Byers Complaint. In response, Federal's counsel informed the Receiver's counsel that the same preliminary analysis of coverage it had submitted in connection with the Toll/Topkis Litigation also applied to the Byers Complaint (as expanded or modified by Federal based on further investigation and as discussed during negotiations, as summarized in Section V of this motion). Defendants, through counsel, sought and obtained a stay of the litigation based upon the Modified Receivership Order.

3. Pflaster Arbitration. On or about May 21, 2013, Summit customers Stephanie C. Pflaster and related entities filed a Statement of Claim and Demand for Arbitration before the Financial Industry Regulatory Authority ("FINRA") against several named Respondents, including Jon Courtney, Jr. ("Courtney"), an **Individual Insured** under the Policy. A true and correct copy of the Pflaster Statement of Claim (excluding exhibits) is attached hereto as Exhibit 8. The claim alleges that Courtney "had a part in the creation and sale" of the private placement investment purchased by Pflaster that "provided funding to a nationwide Ponzi scheme . . . ." Exhibit

8, p.1. The Statement of Claim sought compensatory damages in the amount of $75,000.00 plus the disgorgement of commissions, fees and other compensation, damages for lost opportunities, interest, punitive damages, and other damages. *Id.* pp. 21-22.

Upon receipt of the Pflaster Statement of Claim, the Receiver gave notice of the claim to Federal. Federal's counsel has indicated to counsel for Receiver that the same preliminary analysis of coverage it had submitted in connection with the Toll/Topkis Litigation was applicable to the Pflaster arbitration (as expanded or modified by Federal based on further investigation and as discussed during negotiations, as summarized in Section V of this motion). Respondent Courtney, through counsel, sought and obtained a stay of the Pflaster arbitration based upon the Modified Receivership Order.

4. Elliott Arbitration. On or about April 13, 2013, Summit customer Charles Elliott and related entities filed a Statement of Claim and Demand for Arbitration before FINRA against Courtney and others. A true and correct copy of that Statement of Claim (excluding exhibits) is attached hereto as Exhibit 9. Elliott's Statement of Claim seeks an award of $350,000 in compensatory damages, disgorgement of commissions, fees and other compensation, damages for lost opportunity, interest, punitive

damages, and other relief. Exhibit 9, pp. 20-21. Upon receipt of the Elliott Statement of Claim, the Receiver caused notice to be given to Federal. Once again, Federal's counsel indicated that its view of coverage was consistent with the letter it had written in response to the Toll/Topkis Litigation (as expanded or modified by Federal based on further investigation and as discussed during negotiations, as summarized in Section V of this motion). Through counsel, Courtney once again sought and obtained a stay of the Elliott arbitration.

5. Claims Filed With The Receiver. In 2013, the Receiver instituted a claims process as provided for in the Modified Order, undertaking to identify all losses or claims against Summit itself and/or its employees, as **Individual Insureds** that might be covered under the Policy. The Receiver's counsel wrote to Federal on March 22, 2013 identifying claims of former Summit customers totaling $17,511,193. Since the date of that letter, the Receiver has identified over $48 million of claims, the vast majority of which are Losses submitted by former Summit clients, including Byers, Elliott and Pflaster. The Receiver notified Federal of said claims and Losses by letter dated on June 25, 2013.[3]

[3] There are additional claims from trade and other creditors which would not be covered under the Policy.

III. Nature of the Dispute.

In the Receiver's view practically all of the $44 million in claims are, or but for the stay would be, **Claims** involving **Losses** covered under the Coverage Provision of the E&O Part of the Policy, and the Receiver has so advised Federal. Through counsel, Federal has continuously indicated that the Claims identified above will be disputed as either not covered or excluded on several bases which generally can be described as fraud in connection with the Application for insurance, the operation of the Knowledge Exclusion, or the submission of false Warranty Letters in connection with the increases in policy limits. Federal has also stated that, if necessary, it would institute an action for declaratory judgment seeking to have the Policy declared void or, in the alternative, to reduce the limits or exclude claims. Federal has delayed in filing such an action pending the settlement discussions with the Receiver.

Because of the existence of the Fraud Exclusion Severability Clause, the Fraud Exclusion is not available to Federal as against claims of the **Individual Insureds** to Policy proceeds. Therefore, the Receiver requested that Federal evaluate claims that might be asserted by the **Individual Insureds** separately. Federal complied with that request. Federal's position as the Receiver understands it is discussed in Section V A below.

IV. Terms of Proposed Settlement

The Receiver and Federal have agreed, subject to Court approval, to a compromise of Summit's claims under the Policy on the terms and conditions reflected on the proposed Compromise Settlement and Policy Release Agreement ("Settlement Agreement") attached as Exhibit A to the Motion filed concurrently herewith. The principal features of the Settlement Agreement are (1) payment by Federal of the total sum of $1,487,500.00 ("Settlement Consideration") to the Receivership Estate, and (2) the entry of a Bar Order foreclosing future claims under the Policy. The settlement is expressly contingent on the development of a bar order mechanism in a form acceptable to Federal (and Court approval of that mechanism) to protect Federal from further claims by those claiming rights under the Policy. The Bar Order is necessary to give effect to the Settlement Agreement, since Federal contends that in the absence of a settlement it could obtain a declaratory judgment of no coverage or limited coverage in an amount less than the Settlement Consideration.

V. Basis for Approval By the Court

The proposed Settlement Agreement was obtained in good faith and is a compromise of matters within the duties of the Receiver as set forth in the Modified Receivership Order. The Settlement Agreement was reached after

protracted negotiations between the Receiver and Federal, and was agreed to without misconduct, gross negligence, or criminal intent. As such, it should be approved by the Court.

In deciding to agree to the proposed settlement, the Receiver considered various factors including the limits of the policy, the claim already made or likely to be made against the policy, the position of Federal regarding the absence of coverage or exclusion from coverage, the expenses of litigation and the likelihood of success.

Under the terms of the Settlement Agreement, the Receivership Estate would receive a significant recovery. The Receiver believes the proposed Settlement is in the best interests of the Estate and provides a favorable recovery without the burden and large expense of protracted litigation against Federal. As explained in further detail below, the Settlement would also maximize the amount of coverage to be used to pay claims and, significantly, would avoid the wasting of insurance dollars potentially available to claimants to be used instead for payment of defense costs.

"The standard for determining whether a proposed settlement should be approved is whether the settlement is 'fair, reasonable and adequate.'" *In re Mid-Atlantic Toyota Antitrust Litigation*, 605 F. Supp. 440, 442 (D.Md. 1984) (*citing and quoting Manual on Complex Litigation* § 1.46 at 56-57 (5th

ed. 1982). The Court may consider, but not defer to, the opinion of the Receiver when determining whether a proposed settlement is fair and equitable. *See Interlachen Harriet Invs. Ltd. v. Kelley (In re Petters Co.)*, 455 B.R. 166, 176-7 (B.A.P. 8th Cir. 2011).

In order to determine whether a proposed settlement is within the range of reasonableness, the Court may, among potentially other facts, consider: a) the probability of success in the litigation; b) the difficulties, if any, to be encountered in the matter of collection; c) the complexity of the litigation involved, and the expense, inconvenience, and delay; and d) the paramount interests of the creditors of the Receivership Estate. *See Drexel v. Loomis*, 35 F.2d 800, 806 (8th Cir. Neb. 1929); *see also, In re Carragher*, 249 B.R. 817 (Bkrtcy N.D.Ga. 2000); *Wallis v. Justice Oaks II, Ltd. (In re Justice Oaks II, Ltd.)*, 898 F.2d 1544 (11th Cir. 1990), *cert. denied*, 498 U.S. 959, 111 S.Ct. 387, 112 L.Ed.2d 398 (1990). These factors attempt to balance a potential settlement against the probable costs and benefits of continuing to pursue claims and defenses. Under the current circumstances, one factor is neutral and each of the other factors support approval of the Settlement Agreement. With respect to the individual factors, the Receiver respectfully shows as follows:

A. Probability of Success on Merits

The Receiver concedes that the probability of success in recovering the Policy Proceeds is uncertain. The following, however, summarizes the Receiver's understanding of the factual circumstances and legal authorities that would most likely govern or influence the final outcome of the Receiver's claim against Federal. [4]

With respect to Summit's claims, Federal contends alternatively that (A) the policy is void *ab initio* for fraud or material misrepresentations or omissions; (B) The Knowledge Exclusion excludes all claims; (C) the limit of liability is $1 million due to the false Warranty Letters; and/or (D) all claims against Summit, Alleca and likely other Individual Insureds are excluded under the Fraud Exclusion.

With respect to the claims of the Individual Insureds, Federal concedes that claims that would be excludable under the Fraud Exclusion would not serve to exclude claims by any **Individual Insureds** who had no knowledge of the fraud. D above, therefore, would not apply to all **Individual Insureds**. Federal nevertheless contends that A, B and C above apply equally to the claims of Individual Insureds, so that the Policy is either

[4] This is an attempt to summarize Federal's position only for purposes of this Motion and should not be viewed as a complete statement of Federal's position.

void *ab initio*, all Claims are excluded under the Knowledge Exclusion, or the Policy limit is $1 million.

1. The Knowledge Exclusion

On its face, the Knowledge Exclusion gives Federal a reasonable basis to deny any coverage under the Policy if, at the time he signed the Application -- that is on August 20, 2008 -- Alleca "had any knowledge or information of any fact, circumstance or situation that might reasonably be expected to give rise to any claim that would fall within the scope of the proposed insurance." Ex. 2, ¶13(b). There is evidence to support the conclusion that Alleca had such knowledge at that time. For example, in 2011 or 2012 Mr. Alleca wrote a handwritten "confession" in which he admitted using client funds to trade stocks, purchase offices, and cover other firm expenses. Exhibit 10. He stated he had been misusing client funds in that way "over the last 8 years," or for a period that began approximately four to five years prior to his signing the application.

Summit might argue that any knowledge of Alleca at the time of the Application could not be imputed to the Individual Insured who were unaware of said facts. Ample cases, however, hold that, with respect to an insurance contract containing a prior Knowledge Exclusion such as the one at issue here, coverage of all Insureds can be excluded based on a knowledge

of a single insured as of the application date. *See Gluck v. Executive Risk Indemnity, Inc.*, 680 F. Supp. 2d 406 (E.D.N.Y. 2010); *MDL Capital Mgt., Inc. v. Federal Ins. Co*., 2008 WL 2944890 at *44-46 (W.D. Pa. Jul. 25, 2008); *Shapiro V. American Home Assur. Co*., 584 F. Supp. 1245, 1252-3 (D. Mass. 1984); *Sales v. State Farm Fire & Cas. Co.*, 849 F.2d 1383, 1385 (11th Cir. 1988), (language 'any Insured' expresses a contractual intent to prohibit recovery by an innocent co-Insured); *McCauley Enters, Inc. v. The New Hampshire Ins. Co.*, 716 F. Supp. 718, 721 (D. Conn. 1989) (collecting cases).

While there are reported cases in which an exclusion similar to the one at issue here might be subject to a determination of fact as to whether the application signer had "reason to believe" a claim existed or, to use the language at issue here, "reason to suppose" that the facts "might give rise to a future claim," those cases involve applications that were signed by someone other than the perpetrator of the fraud. *See XL Specialty Ins. Co. v. Level Global Investors, L.P.*, 874 F. Supp. 2d 263 (S.D.N.Y. 2012). Here, because Alleca signed the Application, those cases would not necessarily be apposite, and the Court could hold as a matter of law that Alleca had the requisite knowledge at the time he signed the application. *Id*. At 279 (noting that the existence of reasonable inquiry qualification would not change

outcome of *Gluck*, *MDL Capital* and *Shapiro* where perpetrator signs application).

Summit would also argue that the Fraud Exclusion Severability Clause would serve to preclude Federal from contending that the Application Exclusion bars claims by Individual Insureds. That provision, however specifically refers to the exclusions from policy coverage listed in Sections III.(P)(1) and III.(P)(2) of the Policy, and does not mention the Knowledge Exclusion contained in the application. On its face, therefore, it does not purport to sever the knowledge of the insureds other than the person who signed the Application. *See Axis Reassurance Co. v. Bennett WL 2485388* at *14 (S.D.N.Y.) (2008)(severability provision did not apply to the knowledge exclusion because it was not among the exclusions specifically referred to in the severability provision).

Because there is a reasonable possibility that Federal could establish all claims are barred by the Knowledge Exclusion, there is significant risk that the Receiver could recover less than the amount of the settlement consideration. The Settlement should therefore be approved.

2. <u>The Warranty Letters</u>

The effect of the Warranty Letters would likely be determined by reference to the number of reported decisions interpreting similar provisions.

Typical of these is *Rivelli v. Twin City Fire Ins. Co.*, 2008 WL 5054568 (D. Colo.). In that case, the Insured, Fisher Imaging Corporation ("Fisher") obtained a directors and officers liability insurance policy from Federal Insurance Co. ("Federal"). Excess insurance coverage was provided by Twin City Fire Insurance Company ("Twin City"). The Securities and Exchange Commission brought a civil enforcement action against several of the officers and directors of Fisher alleging they participated in a fraudulent scheme involving proper accounting practices. *Id.* at *1.

After initially paying defense under the Policy, Twin City issued a letter declining coverage. In response, the plaintiffs, officers and directors of Fisher, commenced a suit against Twin City seeking a declaratory judgment that Twin City was obligated to pay the losses, including the defense costs. Twin City filed a Motion to Dismiss. Thereafter, plaintiffs moved for partial summary judgment seeking a declaration of coverage, while Twin City cross-moved for summary judgment seeking a declaration of no coverage. *Id.* at *4.

At issue was a Warranty Letter submitted by Fisher to Twin City containing the following representation:

> No person or entity for whom this insurance is intended has any knowledge or information of any act, error, omission, fact or circumstance which may

> give rise to a claim which may follow in the scope of the proposed insurance detailed above.

("Warranty Letter") *Id.* at *2.

The Warranty Letter also provided:

> It is agreed that if such knowledge or information exists, any claim arising therefrom (whether or not disclosed herein) in addition to any other remedy the Insured may have, is excluded from the proposed coverage.
>
> . . . .
>
> It is further agreed that this letter shall be deemed part of the policy and the statement made thereon shall be deemed an express warranty for all Insureds which has been relied upon by the Insurer pursuant to the issuance of this coverage.

In ruling upon the meaning and applicability of the Warranty Letter, the Court held that the letter explicitly stated that it was non-severable. As the Court explained:

> [I]f – at the time the Warranty Letter was signed, - any insured person had knowledge of "any act, error, omission, fact or circumstance" that would give rise to a claim, the top $2.5 million of coverage is affected for all Insured Persons, even those without such personal knowledge. Accordingly, if any of the plaintiffs had such knowledge, all of them are within the exclusion.

Id. at *6.

The Court concluded that the Warranty Letter precluded coverage of all defense costs as to the SEC action for anything in excess of $2.5 million out

of the total of $5 million liability limit provided in the Twin City policy. *Id.* at *9.

If this Court were to find *Rivelli* persuasive, it could agree with Federal's argument that the Policy limits are only $1 million. For this reason, the proposed settlement should be approved.

B. Difficulties, if any, to be encountered in the matter of collection

There are no anticipated difficulties in collection.

C. Complexity of Litigation, Expense, Inconvenience and Delay

In the absence of settlement, Federal's claims of no coverage or limited coverage, or Summit's claim to establish coverage, must be decided in a separate ancillary proceeding. Because litigation in such an ancillary proceeding would be a time consuming and expensive proposition that potentially may not be determined in favor of the Receivership Estate, an early settlement without the expense of litigation is of substantial benefit to the Estate and weighs in favor of approval of the Settlement Agreement. Assuming the Receiver could successfully locate counsel willing to sue Federal or defend a declaratory judgment claim on a contingent fee basis, a full recovery under the Policy would, after the deduction of attorneys' fees, result in a marginal increase in funds to the estate compared to the proposed

settlement.[5] Any final judgment or settlement during the course of the litigation for less than approximately $2,300,000 would, after the deduction of likely attorneys' fees and costs, yield an amount less than would the proposed settlement.

Furthermore, if Federal elects not to seek a declaratory judgment but rather to pay defense costs as they are incurred, it is entirely possible that more than half or more of the total limits of coverage would be used to pay defense costs, leaving only the approximate amount of the Settlement Consideration to pay to creditors of Summit and the Individual Insureds.

The Receiver believes the proposed settlement will benefit all concerned. While the Receiver has not yet proposed how the Policy proceeds be distributed, subject to Court approval, the proceeds would likely be distributed more equitably from the Estate than they would be if claims were simply paid by Federal only on the basis of the order in which they were made. Under the Receiver's proposal, more of the Policy coverage amount would be used to pay investor claims, as opposed to defense costs. Federal would recognize savings in its own litigation and claims-related

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[5] For example, assuming a 35% contingent fee and $50,000 in costs of litigation, recovery of $3 million would result in additional assets to the estate of approximately $412,500.

expenses in seeking determination of coverage issues. All such issues would also fully and finally be decided in a single proceeding.

D. Deference to Reasonable Views of Creditors

Creditors of the Receivership Estate should support the Settlement Agreement since the Settlement Agreement will enhance the possibility and amount of any distribution to creditors generally by minimizing the risks, costs and delay of litigation and costs and risks of collection while allowing the Receiver Estate to recover the Settlement Payment. Nevertheless, the Receiver perceives the possibility that some creditors may object to the proposed settlement and therefore propose that the Court enter an order requiring the Receiver to notify claimants as far as reasonably possible in order to afford interested parties opportunity to object.

VI. Rationale of Settlement

A. Fairness of Monetary Consideration

The Receiver does not concede the validity of Federal's claimed defenses. Nevertheless, the Receiver recognizes the existence of a *bona fide* dispute and believes that the proposed settlement represents a fair compromise of the parties' respective positions regarding coverage, limits of coverage, and all other subsidiary issues affecting Federal's potential liability. In the absence of such an agreement, said issues would only be

decided by this Court after expensive formal litigation, whether that be commenced by the Receiver, other Insureds, or Federal in the form of a declaratory judgment action. Because of the number and geographic dispersal of Individual Insureds (the former Summit employees) and potential claimants, the litigation could be fractured and protracted. Predictability and finality are also important features to Federal of any such proposed settlement. The Receiver believes that the proposed settlement benefits the creditors of the Estate.

The Receiver contends that the Settlement Agreement is fair, equitable, and reasonable and that the net recovery by the Receivership Estate would not be increased materially by the expenditure of additional funds to obtain a judgment. Furthermore, the Settlement Agreement minimizes the burdens on the Court, the Receiver and Federal. The Receiver and Federal desire to resolve the claims fairly and promptly. In summary, the Settlement Agreement provides an immediate and concrete benefit to the Receivership Estate in a fair and efficient manner.

The cash payment is an amount representing approximately 49% of the full limits of liability of the Policy. The Receiver believes this amount fairly resolves the Estate's claims in light of the following factors:

(1) the existence of possible grounds for partial rescission, exclusions of claims, or the voiding of the Policy entirely;

(2) the likelihood that, absent a settlement, the limits of liability that are determined to be applicable will be exhausted or substantially eroded by the payment of defense costs in individual claimants' litigation; and

(3) the pursuit of litigation in order to establish a greater liability is not likely to yield a better result, taking into consideration attorneys' fees and other costs of litigation.

B. Necessity of Bar Order. An essential element of the Settlement Agreement is Federal's ability to close its books on this Policy through a Court order barring additional claims under the Policy. The Court has this ability; "federal courts have inherent equitable authority to issue a variety of 'ancillary relief' measures in actions brought by the SEC to enforce the federal securities laws." *SEC v. Wencke*, 622 F.2d 1363, 1369 (9th Cir. 1980); *see also SEC v. Elliott*, 953 F.2d 1560, 1566 (11th Cir. 1992)("district court has broad powers and wide discretion to determine relief in an equity receivership"); *Gordon v. Dadante*, 336 F. App'x 540, 549 (6th Cir. 2009) ("[N]o federal rules prescribe a particular standard for approving settlements in the context of an equity receivership; instead, a district court has wide discretion to determine what relief is appropriate."). This discretion extends to the issuance of "stay[s],

effective against all persons, of all proceedings against the receivership entities." *Wencke*, 622 F.2d at 1369; *see also SEC v. Stanford Int'l Bank Ltd.*, 424 F. App'x 338, 340 (5th Cir. 2011) ("It is axiomatic that a district court has broad authority to issue blanket stays of litigation to preserve the property placed in receivership pursuant to SEC actions.").

Recent federal decisions support the imposition of bar orders as a means to facilitate the marshalling of receivership assets. For example, in *SEC v. Parish*, an SEC enforcement action regarding an alleged Ponzi scheme, the court approved a settlement barring litigation against the defendant's insurer. *Parish*, No. 2:07-cv-00919-DCN, 2010 WL 5394736, at *1 (D.S.C., Feb. 10, 2010). Specifically, the settlement required the insurer to submit a lump sum to the receiver in return for a bar order prohibiting litigation related to the insurer's underlying policy. The court approved the settlement and issued the bar order, recognizing that "[f]ailing to approve [the] settlement would result in a drawn-out, inefficient, and chaotic administration of justice, assuming justice in [these] circumstances could be achieved at all." *Id.*, at *6.

The Fifth Circuit Court of Appeals recently affirmed the ability of a district court to approve settlements that include a lump sum payment to a receiver by third parties in return for a bar order. *SEC v. Kaleta*, 530 Fed. App'x. 360, 363 (5th Cir. 2013) ("*Kaleta II*"). Affirming the trial court's

settlement approval, the Fifth Circuit "conclude[d] that the district court's analysis was sound and thus [it] did not abuse its discretion in entering the bar order." *Id*.

Similar to *Parish*, the district court, whose order was affirmed in *Kaleta II*, recognized that the "collect[ion of] substantial sums without litigation costs and delay [was] of substantial value" to potential claimants. *SEC v. Kaleta*, No. 4:09-3674, 2012 WL 401069, at *7 (S.D. Tex. Feb. 7, 2012) ("*Kaleta I*"). The Court found persuasive the Receiver's contention that, in the absence of a settlement, the receivership estate could incur $250,000 to $300,000 in litigation fees and expenses, and that those fees would "harmfully reduce available Receivership Estate funds for distribution to claimants." *Id*. at *5. In addition, the settling parties would have to pay defense costs, which would "likely deplete those parties' assets available to the Receiver." *Id*. The same points hold true here. Approval of the settlement will preserve litigation expenses and attorneys' fees that would result if the Receiver sought to establish liability against Federal in litigation, and would simultaneously minimize any depletion of funds Federal may be liable to pay in defense costs under the Policy.

In approving the bar order the *Kaleta I* court concluded:

> The Receiver's goal of limiting litigation involving the [settling parties] . . . is appropriate to enable the Receiver to

> collect as many assets as possible for distribution among all defrauded investors. The Bar Order advances that goal by arranging for reasonably prompt collection of the maximum amount of funds possible from the [settling parties] under the present litigation and financial circumstances. Preclusion of . . . alleged claims . . . in order to collect substantial sums without litigation costs and delay is of substantial value . . . . :

Id., at *7; *see also Gordon*, 336 Fed. Appx. 540 (6th Cir. 2009) (approval of settlement by a receiver against a third-party broker-dealer and barring all claims against broker-dealer by victims of Ponzi scheme); *SEC v. Byers*, 609 F.3d 87, 92-93 (2d Cir. 2010) (affirming third-party bar order and stressing importance of bar orders in permitting receivers to maintain maximum control over estate assets).[6]

The *Kaleta* trial court recently approved a settlement with close parallels to the circumstances here: a settlement between the receiver and an insurer that included a bar order in return for a lump sum payment. *SEC v. Kaleta*, No. H-09-3674, 2013 WL 2408017, at *1 (S.D. Tex. May 31, 2013) ("*Kaleta III*"). In *Kaleta III*, the receiver sought to recover proceeds from an

[6] A majority of the federal judicial circuits, including the Eleventh Circuit, allow bar orders under similar circumstances in bankruptcy court. *See In re Mumford, Inc.*, 97 F.3d 449, 454, 55 (11th Cir. 1996); *In re Drexel Burnham Lambert Group, Inc*. 960 F. 2d 285 (2d Cir. 1992); *In re A.H. Robins Co., Inc*. 880 F.2d 694 (4th Cir. 1989); *In re Dow Corning Corp*., 280 F.3d 648, 657-59 (6th Cir. 2002); *In re Specialty Equip. Companies, Inc.,* 3 F. 3d 1043, 1047 (7th Cir. 1993).

errors and omissions policy possessed by the receivership estate. *Id.* Despite available policy proceeds, the insurer "raised significant Policy coverage issues as to the scope of coverage . . ., as well as several significant Policy exclusions." *Id.*, at *5. Further, the insurer "intend[ed] to defend vigorously against the Receiver's claims for coverage." *Id.* Consequently, "the coverage litigation would be complex, fact intensive, time-consuming, and risky for the Estate." *Id.*

Faced with protracted and risky litigation, the receiver negotiated a settlement similar to the settlement proposed here. Specifically, the insurer paid a lump sum payment in return for finality in the form of a bar order. *Id.* The trial court approved the settlement "[d]ue to the risks inherent in litigation, the expenses that would likely result from protracted litigation, and the limited resources of the Receivership Estate." *Id.* The court recognized that "[t]he Insurance Settlement allow[ed] for immediate and significant value to be obtained by Estate" while "allow[ing] Policy proceeds to be distributed to claimants without the delay and cost associated with determining the extent of the [insurer's] asserted exclusions." *Id.* Those same circumstances are present here, and approval of the settlement will achieve immediate value for the estate and avoid protracted, complex, and risky coverage litigation. At the

same time, it will provide Federal with the necessary finality that it requires as a condition of its agreement to pay the settlement consideration.

VII. Conclusion

WHEREFORE, the Receiver respectfully asks this Court to enter the preliminary order requiring the Receiver to notify all known claimants against the Receivership Estate and known Individual Insureds and, after hearing all objections, enter an order approving the Settlement Agreement attached as Exhibit A to the Motion, to entering a bar order in the form attached as Exhibit C to the Motion, and to take the other actions contemplated therein.

Respectfully submitted this 21st day of May, 2015.

/s/ J. Steven Parker
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CERTIFICATE OF SERVICE

I certify that the foregoing was prepared with one of the font and point selections approved by the Court in LR 5.1B. I further certify that I electronically filed the foregoing with the Clerk of the Court using the CM/ECF system which will send notice of electronic filing to counsel of record.

Respectfully submitted this 21st day of May, 2015.

/s/ J. Steven Parker
J. Steven Parker
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