IN THE DISTRICT COURT
FOR THE DISTRICT OF SOUTH CAROLINA
CHARLESTON DIVISION
CASE NO. 2:09cv00605 (WOB)

CONTINENTAL CASUALTY CO. **PLAINTIFF**

VS. **OPINION AND ORDER**

BATTERY WEALTH, INC., ET AL. **DEFENDANTS**

Introduction

This is a declaratory judgment action by Continental Casualty Company ("Continental") against its insured, Battery Wealth Management, Inc. ("BWM"). Continental seeks a declaration by this court that it has no obligation to provide coverage for claims made against BWM arising out of a Ponzi scheme fabricated by one of its officers/directors. BWM, which was a provider of financial planning and investment services, advised its clients to invest in investment vehicles devised by the Ponzi partner and perhaps even invested the funds directly. There is no contention here that the officers other than the fraudster had actual knowledge of the fraud. The investors, who would otherwise suffer a total loss of their substantial investments, have intervened in support of coverage.

The matter is before the court on cross-motions for summary judgment. (Docs. 48, 50) Extensive oral argument was held on March 23, 2011, after thorough briefing. Following that hearing, the court took these motions under submission. (Doc. 68)

After careful consideration, the court concludes that the summary judgment motion of Continental must be granted, and a judgment entered declaring a lack of coverage.

Factual and Procedural Background

Beginning in 2002, defendant BWM recommended that its clients invest in funds or pools managed by Dr. Albert Parish, Jr. ("Parish") through Parish Economics, LLC. Parish was vice-president, a co-founder, and one-third owner of BWM. Defendant Wayne Cassaday was the President of BWM.

Between 2002 and 2007, twenty-five BWM clients invested $6.5 million in the investment pools. (SEC Findings ¶ 7) (attached to Complaint) These investment pools were actually a fraudulent Ponzi investment scheme for which Parish was criminally prosecuted. (Compl., 17-18 ¶¶ 46-47)

B. <u>The Insurance Applications and Policies</u>

On February 15, 2006, BWM submitted an application to renew its insurance policy with Continental. On the application, BWM stated that it was not aware of any acts or omissions that might become the basis of a future claim or lawsuit. (Compl. ¶¶ 26-27) BWM also provided information regarding its gross annual revenue which included revenue from tax, preparation of financial plans, and discretionary asset management. The application stated that coverage was limited to the recommendation, sale, and/or management of certain financial products. (Compl. ¶ 28)

Continental issued Tax and Financial Services Professional Liability Policies to BWM for the periods May 1, 2006 to May 1, 2007 and May 1, 2007 to May 1, 2008. Except as noted below, these two policies contain the same terms, definitions, conditions, exclusions and endorsements.

C. The Underlying Actions

By telephone and letter dated February 27, 2007, Cassaday notified Continental of potential claims arising out of investments in Parish Economics. (Exh. C to Plf. MSJ) On April 5, 2007, Cassaday again notified Continental by letter as follows:

> On this date, the SEC issued a complaint against Dr. Albert Parish, Jr. for mismanagement of client funds in the United States District Court in Charleston, SC. Dr. Parish was an owner and officer of Battery Wealth Management until recent examinations by the SEC of his activities revealed him unsuitable as an owner/officer of BWM. Certain BWM clients had accounts both here and with Parish Economics, LLC, the entity Dr. Parish used to operate his investment pools.
>
> It is becoming apparent that BWM will be sued for our association to Dr. Parish and we are informing you that we expect your guidance, assistance and protection arising from these claims.

(Exh. D to Plf. MSJ)

At the same time, investors and other claimants began filing a series of lawsuits in both state and federal courts in South Carolina against Parish, Battery Wealth, and Cassaday alleging, inter alia: fraud, misrepresentation, conversion, negligent misrepresentation, breach of fiduciary duty, breach of contract,

breach of contract accompanied by a fraudulent act and violation of the South Carolina Uniform Securities Act. (Exh. E to Plf. MSJ)

In one of the federal actions,[1] investors also sued Charles Schwab & Co., Inc. ("Schwab"), an investment management firm which, in 2000, had entered into an Investment Manager Service Agreement with BWM. Under that agreement, BWM and Schwab agreed to serve as custodian of the Parish investment interests purchased by BWM's clients. The BWM clients who chose to use those custodial services opened Schwab accounts and gave BWM limited powers of attorney to manage their Schwab accounts. Parish used BWM's power of attorney to misappropriate assets in some of those accounts.

Schwab then asserted third-party claims against BWM and Cassaday for breach of contract, breach of covenant of good faith and fair dealing, and constructive fraud, seeking contribution and indemnification related to the investors' claims against Schwab. (Complaint, 15 ¶ 36)

The SEC's declaratory judgment action, filed in federal court in Charleston on April 5, 2007, against Parish and related entities, sought injunctive relief, disgorgement, and other monetary sanctions. (Exh. F to Plf. MSJ)

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[1] *Brown v. Charles Schwab & Co., Inc.*, Case No. 2:07-CV-03852-DCN.

On May 23, 2007, Parish pled guilty to three counts of fraud. On October 2, 2007, Parish entered into a plea agreement in which he admitted to knowingly and willfully defrauding investors. (Doc. 1-2) Specifically, Parish admitted to fraudulent acts on August 1, 2003, May 22, 2006, and between March 21 and 28, 2007. Parish was sentenced to twenty-four years in prison on the federal charges and ten years on the state charges. (Compl. ¶ 11)

On October 15, 2008, the SEC issued an order making findings and imposing sanctions against BWM and Cassaday. The SEC found that although Cassaday reviewed statements and discussed the investment pools with Parish before Battery recommended that its clients invest in the pools, "Cassaday ignored certain facts that strongly suggested that Parish was likely deceiving advisory clients." (SEC Findings ¶ 9)

These facts included: (1) the disparity between Parish's personal financial statements and his lavish lifestyle; (2) the fact that the Loan Pool consisted of Parish's personal notes, so he essentially was borrowing money from many of BWM's clients' IRA accounts; (3) in the fall of 2006, Cassaday learned that Parish was experiencing financial problems and a possible foreclosure; (4) one of the investment pools was unable to return an investor's money within the required time period; and (5) Parish admitted to Cassaday that the delay in the return of funds

was intentional. Despite having this knowledge, Cassaday did not follow up on these red flags or inquire further about the status of the investment pools to ensure the pools were consistent with the representations made to Battery Wealth's clients. (*Id.*)

The SEC therefore found that BWM violated and Cassaday willfully aided and abetted and caused a violation of Section 206(4) of the Advisers Act and Rule 206(4)-(7). (Compl., 19-20 ¶ 51) Because of these violations, the SEC imposed sanctions and disgorgements against BWM and Cassaday. (Compl., 20 ¶ 52)

D. The Instant Litigation and Underlying Settlements

Continental filed this action on March 9, 2009, seeking a declaration that it has no duty under the insurance policies at issue to defend or indemnify BWM or Cassaday in relation to claims against them by the defrauded investors and other claimants. (Doc. 1) In its Complaint, Continental also seeks a declaration that it is entitled to rescind the 2006-2007 policy based on misrepresentations in the policy application.[2]

On December 21, 2009, BWM, Cassaday, and Continental entered into a settlement agreement with several of the investors in the underlying actions. On January 15, 2010, the Receiver in the SEC action also entered into a settlement with BMW, Cassaday and Continental.

[2]The pending motions for summary judgment are based only on coverage issues, however, and do not involve the issue of rescission.

Due to certain conditions of these settlements, Schwab has been enjoined from pursuing its third-party claims against BMW, and its potential recovery against BWM and Cassaday has been limited by court order to any recovery that this court should determine may be had under the Continental policies. The investors have also agreed to release all claims they have against Continental, Cassaday, and BMW in the other actions and to look solely to the coverage, if any, that the court may determine is applicable in this action.

In early to mid 2010, the court granted motions by a group of the investors and by Schwab to intervene herein as defendants. (Docs. 24, 35)

Thereafter, Continental and Intervenors filed the pending cross-motions for summary judgment.

Analysis

A. "Prior Knowledge" Clause

This clause, which is part of the "Coverage Agreement" (*i.e.*, the insuring clause), clearly bars coverage under this policy. It reads:

> We will pay on your behalf all sums in excess of the deductible, up to our limits of liability, that you become legally obligated to pay as **damages** and **claim expenses** because of a **claim** that is both first made against **you** and reported in writing to us during the **policy period** by reason of an act or omission in the performance of **professional services** by **you** or by any person for whom **you** are legally liable provided that:

. . .

2. prior to the effective date of this Policy, none of **you** had a basis to believe that any such act or omission, or **interrelated act or omission**, might reasonably be expected to be the basis of a **claim**.

(Policy at 3)

The policy defines "you," in relevant part, as the Named Insured (BMW) and "any person who is or becomes a partner, officer, director, associate, or employee of the Named Insured but only for the **professional services** performed on behalf of the **Named Insured.**" (Policy at 3)

It is self-evident that Ponzi's disciple, Parish, had knowledge of his own acts, that they were fraudulent and that he "had a basis to believe" that these fraudulent acts "might reasonably be expected to be the basis of a claim." It is further undisputed that the fraudulent acts by Parish out of which the claims against BWM and Cassaday arise began as early as August 2003, approximately three years before the effective date of the 2006-2007 policy.[3] It is equally obvious that he is

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[3]Specifically, in his plea agreement, Parish agreed that, on or about August 1, 2003:

(A) [Parish] knowingly devised or participated in a scheme to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations or promises;

(B) The false or fraudulent pretenses, representations or promises related to a material facts;

© [Parish] acted willfully with an intent to defraud; and

included in the term "you" referring to the insured company and its officers, directors and employees, a point which the intervenors concede.[4]

The United States Court of Appeals for the Fourth Circuit so held in a case decided the day following the oral arguments in this case. *See Bryan Bros. Inc. v. Continental Cas. Co.*, No. 10-1439, 2011 WL 1058851, at *3 (4th Cir. Mar. 24, 2011). In that case, the plaintiff accounting firm purchased an Accountants Professional Liability Policy from Continental containing an identical "prior knowledge" clause in its Coverage Agreement. Prior to the effective date of the policy, one of plaintiff's employees ("Whitworth") had begun embezzling client funds and manipulating internal bookkeeping records to cover her theft. Each of the clients affected later sued the plaintiff, who filed a declaratory judgment action after Continental denied coverage under the policy.

After examining the policy language and noting the parties' stipulation that Whitworth was considered a "you" under the "Prior Knowledge" clause, the district court held:

> (D) [Parish] used a commercial interstate carrier by depositing or causing to be deposited with such carrier some matter or thing for the purposes of executing the scheme to defraud.

(Plea Agreement at 1-2)

[4]Intervenors' MSJ at 16.

> The question before the Court is whether a reasonable person in Whitworth's shoes would have a basis to believe that her actions "might reasonably be expected to be the basis of a claim." . . . It is undisputed that Whitworth embezzled money from client accounts beginning in 2002. With the exception of the Lansing account, she had withdrawn money from each account prior to the policy's effective date. This Court and the Fourth Circuit have held that such intentional illegal acts clearly demonstrate knowledge of a basis for a claim. . . . *The same logic applies in this case. The Court finds as a matter of law that a reasonable person in Whitworth's position would have a basis to believe that commission of intentional and illegal acts "might reasonably be expected to be the basis of a claim." As such, her knowledge clearly implicates the policy's prior knowledge provision for the claims arising from these actions.*

Bryan Bros. Inc. v. Continental Cas. Corp., 704 F. Supp.2d 537, 541 (E.D. Va. 2010) (citations omitted) (emphasis added).

The Fourth Circuit affirmed, holding also that the "prior knowledge" provision is a condition precedent to coverage and not an exception thereto. *Bryan Bros.*, 2011 WL 1058851, at *3.

Intervenors argue that their suit was not against BWM for fraud, but rather for negligent mismanagement in making reports to its clients. This argument, while ingenious, is without merit because, if Parish had notice of his own fraud, he also had knowledge that he and his partners were not reporting to their clients properly, which might itself lead to a claim.[5]

[5]The argument is also not supported by the record. "Questions of coverage and the duty of a liability insurance company to defend are determined by the allegations of the third party's complaint." *Isle of Palms Pest Control Co. v. Monticello Ins. Co.*, 459 S.E.2d 318, 319 (S.C. App. 1994) (citation omitted). A review of Intervenors' underlying complaints against Parish, BMW, and Cassaday demonstrates that, despite their

Intervenors also argue that their cause is saved by the "Innocent Insureds" clause of the policy. The Fourth Circuit flatly rejected this argument in *Bryan Bros.*, and this court is bound by that opinion. *See Bryan Bros.*, 2011 WL 1058851, at *4-*5.

B. The Financial Planning Endorsement and Its Exclusions

Intervenors also argue that they are not seeking recovery under the Financial Planning Endorsement, but rather only under the basic coverage agreement (Policy at 3) for "claims" arising out of the insured's provision of "professional services," which is defined to include the preparation of financial or accounting records. (Policy at 2) That is, as noted, Intervenors argue that their harm arises out of the failure of BWM to render accurate reports rather than Parish's theft of their money.

However, without the Financial Planning Endorsement, there would be no coverage at all, because Section 3 of that endorsement replaces Exclusion L of the main policy, which excludes coverage for "any **claim** based on or arising out of investment advice or services" (Policy at 6), which is what this

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characterization of their claims in this action, the basis for the underlying suits is, at its core, plaintiffs' loss of the money that was invested in the funds managed by Parish. (*See* Complaints attached as Exhibit E to Continental's MSJ, ¶¶ 7, 9, 12, 14, 16, 23, 28) But for Parish's theft, those funds would not have been lost and the Intervenors would have suffered no damages, regardless of the competence or accuracy of BMW's and Cassaday's financial record keeping.

suit is all about.

This language is unambiguous. Exclusion L was removed and replaced by the "Financial Planning Endorsement," which for the first time covered "Investment Services," defined as "the management of client assets by advising on or supervising the purchase or sale of financial products according to an investment management contract." (Financial Planning Endorsement at 1)

It is obvious why Intervenors disclaim any intent to rely on the Financial Planning Endorsement: it contains express and unambiguous terms of its own that clearly exclude coverage in the present situation.

These exclusions include the definition of "Financial Products," which confines coverage to recommendations of United States treasury securities and products sold on recognized stock exchanges and the like. (Financial Planning Endorsement at 1) Intervenors do not contend that the "investments" offered by Parish meet this definition.

Second, exclusion 3(d) of the Financial Planning Endorsement excludes coverage for claims arising out of "the insolvency, receivership, bankruptcy or inability to pay" of any entity in which clients funds are invested. (Financial Planning Endorsement at 2) Because Intervenors' underlying claims arise out of Parish's inability to repay the monies that they invested in the fraudulent (and now defunct) investment pools, this

exclusion also bars coverage. *See American Auto. Ins. Co. v. Valentine*, 131 F. App'x 406, 409-10 (4th Cir. 2005) (holding similar exclusion to be unambiguous and barring claims by clients against former brokers who placed their money with insurance fund that became insolvent); *Associated Cmty. Bancorp, Inc. v. The Travelers Cos., Inc.*, Civil Action No. 3:09-CV-1357(JCH), 2010 WL 1416842, at *4-*5 (D. Conn. April 8, 2010) (holding that insolvency exclusion unambiguously excludes coverage for claims against broker who placed clients' money in scheme that turned out to be fraudulent); *Smith v. Continental Cas. Co.*, No. 07-CV-1214, 2008 WL 4462120, at *11-*12 (M.D. Pa. Sept. 30, 2008) (similar).

Intervenors' only argument against the application of this exclusion is the same discussed above, *i.e.*, that their claims are actually based on BMW's and Cassaday's negligence in their financial reports and record keeping. For the reasons previously discussed, this argument is without merit.

For all of these reasons, there is no coverage under the policies for the underlying claims, and Continental is entitled to judgment as a matter of law.

Therefore, having reviewed this matter, and the court being otherwise advised,

IT IS ORDERED that plaintiff's motion for summary judgment (Doc. 50) be, and is hereby, **GRANTED**, and Intervenors' motion for summary judgment (Doc. 48) be, and is hereby, **DENIED**. A separate judgment shall enter concurrently herewith.

This 5th day of May, 2011.

Signed By:
William O. Bertelsman WOB
United States District Judge