UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MISSOURI
EASTERN DIVISION

SECURITIES AND EXCHANGE COMMISSION,	)	
	)	
Plaintiff,	)	
v.	)	**CASE NO. 4:12-CV-00080-CEJ**
	)	
BURTON DOUGLAS MORRISS,	)	
ACARTHA GROUP, LLC,	)	
MIC VII, LLC,	)	
ACARTHA TECHNOLOGY PARTNERS, LP, and	)	
GRYPHON INVESTMENTS III, LLC	)	
	)	
Defendants, and	)	
	)	
MORRISS HOLDINGS, LLC,	)	
	)	
Relief Defendant.	)	
	)	

REPLY MEMORANDUM OF LAW IN FURTHER SUPPORT OF DEFENDANT BURTON DOUGLAS MORRISS'S MOTION FOR ENTRY OF AN ORDER CONFIRMING THAT INSUREDS ARE ENTITLED TO ADVANCEMENT OF DEFENSE EXPENSES UNDER INSURANCE POLICY NOTWITHSTANDING ASSET FREEZE ORDER

Defendant Burton Douglas Morriss ("Mr. Morriss") respectfully submits this Reply Memorandum of Law in further support of his Motion for entry of an order confirming that Federal Insurance Company ("Federal") may advance defense costs on behalf of Mr. Morriss as an insured under an insurance policy purchased by Acartha Group, LLC ("Acartha") (the "Policy"). Doc. # 72, # 73. This Reply Memorandum is submitted in reply to the Receiver's Memorandum in Opposition. Doc. # 81.

INTRODUCTION

The Receiver's Memorandum in Opposition fails to cite even one case that supports the sweeping holding that she requests from this Court – a ruling that would set aside the plain language of an insurance contract and wipe out the very foundation on which all directors and officers ("D&O") insurance policies rest. Nor has the Receiver sufficiently distinguished the many cases Mr. Morriss has cited upholding the right of insureds to receive proceeds for defense costs under D&O policies. Instead, in the face of extensive authority against her position, the Receiver resorts to arguing that a court has discretion regarding the application of D&O proceeds for a covered insured's defense costs. Mr. Morriss does not dispute that this Court has discretion; however, the Receiver ignores the fact that these cases involve a court exercising its discretion *in favor* of giving defendants like Mr. Morriss access to insurance defense proceeds. In fact, Mr. Morriss was unable to find any case law directly supporting the Receiver's position. If there were any such cases, there likely would not be much of a market for D&O insurance. The Court will find no discussion in the Receiver's brief that confronts a crucial issue: if courts were to deprive insureds of access to defense costs under D&O policies, the utility of such policies – to afford individuals financial protection in the event they are sued in conjunction with the performance of their duties as they relate to the company– would be lost.

The premise of the Receiver's opposition is that this Court should assume that Mr. Morriss is culpable, before this case has been litigated. The Receiver asks this Court to cut Mr. Morriss off from the funds he needs to defend himself in this case. Due process protects all defendants from the rush to judgment the Receiver urges, especially when the issue involves whether a defendant will even have an opportunity to mount a meaningful defense. In this case, the plaintiff is the federal government with its vast resources. In stark terms, if the Receiver and

the SEC are successful in their opposition to this motion, Mr. Morriss, who is bankrupt, will be deprived of counsel. The Receiver's objections are already prejudicing Mr. Morriss, who is unable to retain an accountant as an expert or to review the reams of documentation that have already been produced by third parties to the government or are currently in the possession of the Receiver subject to this Court's order. Both the SEC and the Receiver seek the advantage many before have sought, and which other courts have prudently denied: silencing an adversary before he has even had a chance to mount a defense. Thus, Mr. Morriss respectfully requests that this Court grant his Motion giving Federal the ability to advance defense costs pursuant to the plain language of the Policy.

ARGUMENT

I. The Court Should Hold that the Policy Proceeds Are Not Part of the Receivership Estate Subject to the Asset Freeze Order

Of course, Mr. Morriss does not take issue with the Receiver's statement that district courts have discretion to impose asset freeze orders. Instead, what Mr. Morriss argues is that even if the Policy *itself* may be construed to form part of the receivership estate (*see* Doc. # 81 p. 5), and therefore broadly within the domain of the receivership and the asset freeze, the Policy *proceeds* are not subject to the receivership or the asset freeze.[1] Simply put, Mr. Morriss's assets aren't frozen by order of this Court nor is he, personally, in the receivership. Furthermore, Federal is primarily obligated to advance the proceeds of the Policy for the defense costs of Mr. Morriss, as an insured under the Policy. Indeed, Federal itself has acknowledged that it is obligated to advance policy proceeds to fund Mr. Morriss's defense. This Court should confirm, as other courts have, that the proceeds of the Policy are not part of the receivership estate and thus are not subject to the Court's asset freeze order. *See* Doc. # 73 at pp.7-15.

[1] Nor does Mr. Morriss dispute that the policy itself *may* be part of the receivership estate; as the Receiver points out, Mr. Morriss made this point in his filing with the bankruptcy court. *See* Doc. # 81 p.5.

First, the Receiver has not cited even one case to support her arguments. Instead, she attempts to bolster her position by distinguishing the highly relevant *Stanford* case. The Receiver points to the fact that the court in *Stanford* did not find it necessary to reach the issue of whether the proceeds of the insurance policy were part of the receivership. Importantly, the *Stanford* court held that it need not decide whether the proceeds were part of the estate because, in either case, it is imperative that the directors and officers have access to the insurance coverage to which they are entitled. The Receiver ignores the Court's explanation of its reasoning, as follows:

> The Court finds it in the interest of fairness to allow directors and officers to access insurance proceeds to which they are entitled for several reasons. First, although the Court is sensitive to concerns about preserving coverage dollars for aggrieved investors, the receivership's claim to the policy proceeds is presently speculative. Second, the directors and officers, many of whom deny any knowledge of fraudulent activities, relied on the existence of coverage. They expected that D&O proceeds would afford them a defense were they to be accused of wrongdoing in the course of duty. The potential harm to them if denied coverage is not speculative but real and immediate: they may be unable to defend themselves in civil actions in which they do not have a right to court-appointed counsel.

S.E.C. v. Stanford Int'l Bank, Ltd., No. 3:09-cv-298, 2009 U.S. Dist. Lexis 124377, at *21 (N.D. Tex. Oct. 9, 2009). Similarly here, the case law and equities weigh heavily in favor of enforcing the terms of a valid insurance contract that provides for defense costs for the *alleged* wrongdoing of officers and directors. As in *Stanford*, Mr. Morriss's need for a defense is "not speculative but real and immediate." Without access to this insurance coverage, Mr. Morriss almost certainly will not be able to defend himself against the allegations made by the SEC.

Despite the Receiver's suggestion to the contrary, the principle that proceeds are not part of the receivership estate finds support in case law governing both receivership and bankruptcy estates. The Receiver in fact cites no case in support of her position that D&O policy proceeds

are part of the receivership estate of the corporate entity which purchased the policy. *See* Doc. # 81 p.6. Mr. Morriss refers the Court to the discussion and cases cited in his Memorandum in Support.

II. The Receiver's Equity-Based Arguments Do Not Warrant Denial of Insurance Coverage for Mr. Morriss's Defense Costs

Faced with an absence of case law to support her untenable position, the Receiver claims primarily that the equities of this case argue in favor of preserving the Policy for her use and against providing insurance coverage for Mr. Morriss's defense costs.[2] Mr. Morriss acknowledges that there are competing interests involved whenever a single-limit insurance policy is involved in the receivership or bankruptcy context. However, in all of the cases cited by Mr. Morriss in his previous Memorandum, this legitimate concern was not sufficient to override the unambiguous contractual language contained in the policies at issue.

The Receiver notes that she has made claims against another individual insured (Mr. Dixon Brown), albeit for the same loss she seeks from Mr. Morriss. She argues that the Policy proceeds could be used to satisfy these claims. The Receiver attempts to run up the claims against the Policy limit by attaching to her Memorandum letters making $9 million claims against both Mr. Brown and Mr. Morriss. *See* Doc. # 81-5, # 81-6. However, as this Court is aware, a statement that the Receiver intends to seek recovery of these amounts from these individuals is, at this stage, merely a speculative claim which does not trigger any payment obligation by Federal. In contrast, Mr. Morriss's claim for coverage of his defense costs already

[2] The Receiver also points out that there are claims pending against the receivership entities, including this action, and that the Policy can be used for these claims. Doc. # 81 p.7. It should be noted that the Receiver and the SEC have apparently reached a settlement of these claims. *See* Doc. # 94, # 95. Upon information and belief, these claims are *not* covered by the Policy.

exists and, under the Policy's "priority of payments" clause, takes precedence over the potential claims against the Policy made by the Receiver.

The Receiver's briefing does not even mention the "priority of payments" clause in the contract. As the case law makes clear, this clause and its impact cannot be ignored. The Court should allow Federal to meet its contractual obligations under the Policy. As described at length in Mr. Morriss's previous Memorandum, the Policy contains a "priority of claims" provision, and *first* among those priorities is the coverage of claims of individual directors and officers, including defense costs. *See* Doc. # 73-1, Policy Endorsement 11. *See, e.g., In re Downey Financial Corp.*, 428 B.R. 595, 608 (Bankr. D. Del. 2010) (treating proceeds of debtor's D&O policy as estate property would improperly expand trustee's rights in proceeds where policy's priority provisions established that the entity's coverage was junior to coverage provided to officers and directors); *In re Laminate Kingdom, LLC*, 2008 WL 1766637, *3 (Bankr. S.D. Fla. Mar. 13, 2008) (not reported in B.R.) (policy proceeds not part of estate because "under the language of the Policy itself, the estate has only a contingent, residual interest in the Policy's proceeds; and, payment of the proceeds in accordance with the 'Priority of Payments Endorsement' does not diminish the protection the Policy affords the estate, as such protection is only available after the Costs of Defense are paid"); *In re Allied Digital Technologies Corp.*, 306 B.R. 505, 513 (Bankr. D. Del. 2004) ("The bottom line is that the Trustee seeks to protect the amount he may receive in his suit against the directors and officers while limiting coverage for the defense costs of the directors and officers. This is not what the directors and officers bargained for. In bringing the action against the directors and officers, the Trustee knew that the proceeds could be depleted by legal fees and he took that chance. The law does not support the Trustee's request to regulate defense costs.").

The Receiver mentions claims pending against the receivership entities, including unidentified "claims recently received by the Receiver." Doc. # 81 p.7. Yet again she fails to acknowledge, much less address, the fact that any claims against the receivership entities are subordinate to claims involving Mr. Morriss and other individual insureds by virtue of the Policy's "priority of payments" clause. The Receiver states she has identified "few liquid assets" and that "the Policy is an identifiable asset that could satisfy investor claims." Doc. # 81 p.8. These preliminary and unsubstantiated assessments, however, do not justify a denial of coverage already due under the Policy, pursuant to which Federal is contractually required to pay Mr. Morriss's defense costs ahead of other claims.

Again, the Receiver mistakenly asserts that Mr. Morriss is seeking to "unfreeze" the proceeds of the Policy. Doc. # 81 p.7. Rather, Mr. Morriss merely seeks confirmation from the Court that the Policy proceeds are not subject to the asset freeze order. This is consistent with the view taken by other courts, as well as the position taken by the insurance company itself in this case. *See* Doc. # 73-2.

More troubling, however, is the Receiver's assertion throughout her opposition that Mr. Morriss's guilt precludes his right to the insurance proceeds to fund his defense. *See, e.g.*, Doc. # 81 p.7 ("using the proceeds of a Policy owned by the Receivership Entities to fund his legal defense, when it was his conduct that put the Receivership Entities in the position they are now in, would be fundamentally inequitable"); *id.* p.8 ("Morriss and Morriss Holdings siphoned funds from the Receivership Entities."). This presumption of guilt truly puts the cart before the horse: the Receiver adjudicates Mr. Morriss guilty of all charges and even seeks to deprive him of the insurance coverage procured for the purpose of defending against these unproven charges. *See* Doc. # 81 pp.6-8 (equities weigh in favor of preserving policy proceeds, and against covering

Mr. Morris's defense). Arguments like this, even when camouflaged with words like "equitable," fly in the face of due process. *Cf. Smith v. Copeland*, 87 F.3d 265, 268 (8th Cir. 1996) ("under the Due Process Clause, a [defendant] may not be punished prior to an adjudication of guilt").

III. Case Law Supports the Advancement of Defense Costs to Mr. Morriss

The Receiver dismisses the relevance of the receivership case cited by Mr. Morriss in his Memorandum, summarily concluding, without any explanation, that it did not involve the same "equitable issues" presented in this case. Doc. # 81 p.8 (citing *Executive Risk Indemnity, Inc. v. Integral Equity, L.P.*, 2004 WL 438936 (N.D. Tex. Mar. 10, 2004)). To say a case is different does not distinguish it. The Receiver does not examine the facts of that case. The circumstances of *Executive Risk Indemnity* are, in fact, very similar to this case. There, an insurance company sought to advance defense costs under a similar policy to an individual insured being sued for securities fraud and related claims. The receiver of two corporate insureds argued, like the Receiver here, that this was impermissible because the policy proceeds were part of the receivership estate. Like here, the insured in *Executive Risk Indemnity* was not in the receivership: Mr. Morriss is not personally in the receivership, nor are his assets frozen by this Court's order. The court in *Executive Risk Indemnity* held that the insurer was authorized to advance defense costs under the plain language of the insurance policy. *See id.* at *12. The court further held that nothing in receivership law prevented such a result, and that the same principles in the context of bankruptcy law permitted it. *See id.* at *13 n.13 ("[T]he reasoning used in bankruptcy cases is applicable to cases involving receiverships . . . ."). The court explained that the receivership entities simply had no interest in policy proceeds that would be advanced to the insureds' attorneys for legal fees. *Id.* at *14 ("In other words, any proceeds from

the Policy . . . are owed not to the Insured but to successful third-party claimants against the Insured, as well as to the Insured's attorneys defending against those claims. [T]he two Insured Entities which are currently in receivership have no cognizable interest, in and of themselves, in the proceeds of the Executive Risk policy."). Similarly here, the Receiver, who stands in Acartha's shoes, has no rights to Policy proceeds which must be paid, under the Policy's plain terms, to fund Mr. Morriss's defense.

The Receiver mischaracterizes Mr. Morriss's motion by stating "[c]ontrary to Morriss' argument, there is no *per se* rule to permit individual insureds to deplete the proceeds of insurance that is part of a bankruptcy estate." Doc. # 81 p.9. This is simply not what Mr. Morriss argues in his motion – he argues instead that the Policy *proceeds* in this particular case are not part of the receivership estate. In any event, the Receiver claims that there are "numerous" bankruptcy cases in which policy proceeds are viewed as an estate asset or otherwise protected from exhaustion. Doc. # 81 p.9 (citing cases).

None of the cases cited by the Receiver, however, involve policies with a priority of payments clause. Most of the cases relied on by the Receiver are simply inapposite to the issue before this Court. The *Matter of Vitek* case did not involve a D&O insured's right to defense costs coverage; indeed, the court in that case *stressed* that it did not involve D&O coverage. *See Matter of Vitek, Inc*., 51 F.3d 530, 534 (5th Cir. 1995). *Vitek* held only that the bankruptcy court could approve a product liability settlement which exhausted the insurance policy limits despite the complaint from individual insureds that this left them without any coverage under the policies. The policy in *Vitek* did not provide for defense cost coverage or contain a priority of payments clause, as does the Policy Mr. Morriss is insured under. Further, the *Circle K Corp.* case merely held that the corporate debtor was entitled to have securities fraud litigation against

the debtor and its former officers stayed; it did not involve the officers' claims for defense costs, or any priority of payments issue. 121 B.R. 257 (Bankr. D. Ariz. 1990). Finally, the *Minoco Group* case held that the bankruptcy stay precluded cancellation of the debtor's D&O policies (and did not discuss any priority of payments issue). *See also In re Sacred Heart Hospital of Norristown*, 182 B.R. 413 (Bankr. E.D. Pa. 1995) (no priority of payments clause).

The Receiver also relies on *In re Cybermedica, Inc.*, 280 B.R. 12 (Bankr. D. Mass. 2002). As the court in that case correctly noted, "[w]hether the proceeds of a D & O liability insurance policy is property of the estate must be analyzed in light of the facts of each case." *Id.* at 16. The *Cybermedica* court also recognized that "'[a] bankruptcy estate can have no greater claim to the proceeds of property of the estate than the debtor would have had outside of bankruptcy.'" *Id.* (citation omitted). As discussed in Mr. Morriss's original motion and memorandum in support, this is precisely why the priority of payments clause in the Policy at issue here is so critical – any rights of the corporate insured, and thus the Receiver, are subordinate to those of individual insureds such as Mr. Morriss. In *Cybermedica*, however, there was no priority of payments clause, and the court held that the policy proceeds would be treated as part of the debtor's estate. *Id.* at 17.

Furthermore, even though the policy proceeds in that case were determined to be part of the debtor's estate, the court nonetheless found cause to lift the automatic stay to *allow* the insurer to pay defense costs for two individual insureds. The court explained that the insureds "may suffer substantial and irreparable harm if prevented from exercising their rights to defense payments," and that they "are in need *now* of their contractual right to payment of defense costs and may be harmed if disbursements are not presently made to fund their defense of the Trustee's Complaint." *Id.* at 18 (emphasis in original). The court cited with approval to another

case in which the court granted leave to an insurer to fund defense costs under a D&O policy. *Id.* ("The court . . . found that the directors and officers needed the insurance proceeds in order to retain the experts and that they would be irreparably harmed if they are not distributed in time to conduct their defense. The court concluded that the harm to the debtor is uncertain, less severe than the opposing harm, and probably not irreparable.") (citing *Executive Risk Indemnity, Inc. v. Boston Regional Med. Ctr., Inc. (In re Boston Regional Med. Ctr., Inc.),* Adv. Proc. No. 01–1376, Case No. 99–10860 (Bankr. D. Mass. April 2, 2002)). The court allowed the defense costs to be paid "even though the aggregate claims by the officers, directors, and trustees for coverage of defense costs and liabilities may have substantially exceeded the policy's twenty million coverage limit." *Id.* at 18-19 (citation omitted). The court held that the insurer was authorized to use the D&O policy proceeds to pay the insureds' defense costs and expenses. *Id.* at 19 (declining to grant the trustee's request that the insurer be required to submit fee applications prior to such payments). This case therefore *supports* Mr. Morriss's claim that even if the Policy proceeds were to be considered receivership property, cause exists to allow the insurer to fund his defense out of Policy proceeds.

The Receiver further claims that requests for modification of asset freeze orders in order to pay legal fees are "typically denied," citing three cases. Doc. # 81 p.10. However, as Mr. Morriss has already argued, the Policy proceeds at issue are not part of the receivership estate subject to the asset freeze order. One of the cases cited by the Receiver is plainly inapposite, as it involved a defendant who was himself subject to an asset freeze order and did not involve the matter of insurance proceeds. *S.E.C. v. Coates*, 1994 WL 455558 (S.D.N.Y. Aug. 23, 1994) (addressing whether defendant was entitled to modification of prejudgment freeze of personal assets of defendant and his wife in order to pay living expenses and attorney fees). In the second

case, the court did not deny but had in fact allowed the insurer to fund the defendant's legal fees. *S.E.C. v. Credit Bancorp Ltd.*, 2010 WL 768944 (S.D.N.Y. Mar. 8, 2010) ("The . . . scope of the asset freeze permitted Rittweger to collect reasonable and necessary legal fees pursuant to the applicable insurance policies. Rittweger consented to the payment of these fees directly to his counsel and did not request the modification of the freeze to pay legal expenses from any source other than the insurance policy proceeds."). Similarly, in the *Cherif* case the court actually did permit the defendant access to funds in order to pay defense fees. *See S.E.C. v. Cherif*, 933 F.2d at 417 ("Cherif was permitted by the district court to withdraw $20,000 of the frozen funds to pay attorney's fees," though district court's refusal to further modify freeze order was not abuse of discretion).

In sum, the Receiver fails to acknowledge, must less address, the main point of Mr. Morriss's motion – that in this particular case, the proceeds of the Policy are not part of the receivership estate given the clear and unambiguous policy clause giving individual insureds' claims for defense costs priority over the claims of other insureds. The Receiver also fails to address the important policy reasons for the law governing D&O insurance policies, which indeed is recognized in the cases the Receiver herself cites. *See, e.g., Minoco Group*, 799 F.2d at 518 (noting that D&O insurance is critical to attract and retain competent personnel to serve as corporate officers and directors). Courts in the receivership and bankruptcy contexts have consistently upheld the contractual rights of parties to insurance policies containing priority of payments clauses, refusing to allow receivers and trustees to nullify the contractual terms of these agreements relating to individual insureds.

CONCLUSION

Therefore, Mr. Morriss respectfully requests that the Court enter an order providing that notwithstanding the Court's orders of January 17, 2012, January 27, 2012, or any other similar order which the Court may enter, Federal is authorized to make payments under the Policy up to the Policy's limit of liability to or for the benefit of Mr. Morriss for defense costs incurred in connection with this litigation or any related claim.

Respectfully submitted this 8th day of March, 2012.

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CERTIFICATE OF SERVICE

I hereby certify that on March 8, 2012, the foregoing was filed electronically with the Clerk of the Court to be served by operation of the Court's electronic filing system upon the following:

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