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IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF OREGON

EUGENE DIVISION

UMPQUA BANK, an Oregon chartered  
commercial bank,

CV No.: 10-6423-AA

Plaintiff,

vs.

**PROGRESSIVE'S OPENING BRIEF  
IN SUPPORT OF ITS MOTION FOR  
JUDGMENT ON THE PLEADINGS**

PROGRESSIVE CASUALTY  
INSURANCE COMPANY, an Ohio  
corporation,

Defendant.

**INTRODUCTION**

This insurance coverage action centers on the applicability of an exclusion in a directors and officers liability policy for claims “arising out of or in any way involving” allegations of the insureds “acting in bad faith.” This motion is premised on the straightforward proposition that

litigation against an insured bank alleging that the bank knowingly and for its own financial benefit aided and abetted a multi-million dollar Ponzi scheme is a claim that the bank acted, to say the least, in bad faith. As a result, a payment made to settle such litigation falls within the “bad faith” exclusion and is not a covered loss.

The applicability of the bad faith exclusion can be determined based solely on the undisputed terms of the complaints in the underlying litigation against the bank and the insurance policy, which are attached as exhibits to the pleadings in this action. Accordingly, and for the reasons set forth more fully below, Progressive is entitled to judgment as a matter of law pursuant to FED. R. CIV. P. 12(c) on both the complaint and on its counterclaim.

## **BACKGROUND**

### **A. Summit, Umpqua and the underlying litigation.**

This insurance coverage dispute arises from the joint settlement of two consolidated civil actions against Umpqua Bank (“Umpqua”). Compl. at ¶¶ 7-8.<sup>1</sup> Both lawsuits were brought to recover losses flowing from the collapse of Summit Accommodators, Inc., which had been in the business of facilitating “1031 exchanges” prior to its collapse. The first underlying action was brought in June 2009 by Kevin Padrick as trustee of the Summit Accommodators Liquidating Trust.<sup>2</sup> *Id.* at ¶ 7. Padrick alleged that Umpqua knowingly aided and abetted the principals of Summit in the perpetration of a multi-million dollar Ponzi scheme. *Id.* The second underlying lawsuit was brought three months later by Danae Miller and 56 other former Summit clients whose money was lost when Summit filed for bankruptcy in December 2008. *Id.* at ¶ 8. Like Padrick, the Miller plaintiffs also alleged that Umpqua aided and abetted the principals of Summit in tortious conduct. *Id.* Both actions were pending in the Circuit Court for the State of Oregon, County of Multnomah and were consolidated (the “Consolidated Cases”). *Id.* at ¶¶ 7-8. We summarize the key allegations against Umpqua in the Consolidated cases below.

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<sup>1</sup> The complaint in this action (the “Complaint”) is cited herein as “Compl. at ¶ \_\_\_\_.”

<sup>2</sup> Together with its pre-bankruptcy predecessor, Summit Accommodators, Inc., Summit Accommodators Liquidating Trust is referred to herein as “Summit.”

### 1. The Second Amended Padrick Complaint.

Padrick's Second Amended Complaint (the "SAC," cited as "SAC at ¶ \_\_\_\_")<sup>3</sup> alleges Summit was in the business of facilitating "1031 exchanges." SAC at ¶ 4. A 1031 exchange, also known as a "like-kind exchange," is a transaction in which a person defers capital gains taxes by exchanging like-kind property pursuant to Section 1031 of the Internal Revenue Code. *Id.* Summit allegedly acted as a "qualified intermediary" for the 1031 exchanges executed by its clients. *Id.* In its role as a qualified intermediary, Summit agreed to hold 1031 exchange funds for the benefit of its clients (the "Exchange Funds") while the exchanges were pending. *Id.*

The SAC alleges that, in or about 1995, Summit's principals started to embezzle Exchange Funds by transferring them from Summit's bank accounts to an affiliated company called Inland Capital Corp. ("Inland"). *Id.* at ¶ 6. Inland allegedly then lent the money it received to Summit's principals and related persons/entities for their personal benefit. *Id.* These loans caused Summit to suffer severe liquidity problems, as Summit had insufficient funds to cover its outstanding obligations to clients. *Id.* at ¶ 7. To cover its client obligations, Summit's principals caused Summit to operate as a Ponzi scheme, allegedly using money from new exchange clients to pay back money that should have been held for previous clients. *Id.*

Summit allegedly began to shift its substantial deposit accounts to Umpqua starting in late 2005 or early 2006, making Umpqua its primary bank. *Id.* at ¶ 10. Umpqua and Summit thereafter allegedly began discussions to expand their business relationship. *See, id.* at ¶ 11. During a remarkable meeting on March 2, 2007, Summit's principals allegedly revealed their entire embezzlement scheme to Umpqua's CEO, Ray Davis, and President, Dave Edson, among other senior Umpqua officials. *Id.* at ¶ 12. At the time, Summit allegedly needed and requested a \$10 million loan or equity investment from Umpqua to ensure that it could meet client obligations. *Id.* According to the SAC, from 2005 through 2008, Summit's principals provided

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<sup>3</sup> While the Padrick and Miller actions were consolidated, separate complaints were maintained. At the time of the Settlement (defined below), the operative Padrick complaint was the SAC and the operative Miller complaint was Miller's fourth amended complaint (the "FAC"). The SAC is attached to Progressive's counterclaims as "Exhibit B." The operative Miller FAC is attached to Progressive's counterclaims as "Exhibit C."

additional detailed financial information to Umpqua regarding their scheme, including the specific real estate investments they made with the money funneled through Inland. *Id.* at ¶ 13.

Even after learning the details of the embezzlement scheme, Umpqua allegedly continued to offer and provide the banking services that facilitated Summit's operations and its principals in a variety of ways. According to the SAC, Umpqua "actively encouraged [Summit's] [p]rincipals to continue to use Umpqua's bank accounts to facilitate millions of dollars in exchanges throughout 2007 and 2008." *Id.* at ¶ 14. By encouraging Summit to place its deposits with Umpqua, Umpqua is alleged to have "earn[ed] significant fees and [ ] increase[d] [its] deposit market share" as well as "profit[ed] from lending the deposited funds to third parties." *Id.* at ¶ 14(a).

In addition, according to the SAC, Umpqua "actively promoted Summit's 1031 exchange business, both internally and to the public, in order to assist the [p]rincipals in attracting new customers." *Id.* at ¶ 14(b). Specifically, Umpqua, "at the direction and with the knowledge of the highest level of management: (1) provided the [p]rincipals with the names of potential referral sources and prospects; (2) allowed the [p]rincipals to hold seminars in Umpqua Bank's branches . . . for the purpose of introducing the [p]rincipals and Summit employees to the Umpqua Bank employees who were promoting Summit's business; and[] (3) encouraged Umpqua employees to attend seminars put on by Summit at other locations where referral sources and prospects were in attendance." *Id.* Umpqua also allegedly assisted Summit and its principals by continuing "to make loans and extend credit to Summit, the [p]rincipals and the real estate ventures that were part of the Ponzi scheme." *Id.* at ¶ 14(c).

The very first paragraph of the Second Amended Complaint began with the following summary of allegations against Umpqua:

The principals used the embezzled funds for their own personal benefit and for the benefit of their friends and family members. The highest level of management at Umpqua Bank – including Umpqua's CEP Ray Davis and its then President Dave Edson – became fully aware of this Ponzi scheme and the principals' embezzlement, as well as the substantial financial risks that the principals' misconduct created for Summit and its clients. Yet, Davis, Edson, and other Umpqua officials continued to actively

encourage and materially assist the Summit principals in their tortious conduct, including by encouraging them to use Umpqua's banking services as a depository for the continued flow of embezzled funds, by making substantial loans to Summit's principals and/or for the real estate investments that were part of the Ponzi scheme, and by actively assisting the Principals in generating new customers and victims of the Ponzi scheme – even referring to their relationship as an “alliance.” Umpqua did so because it reaped huge financial rewards from Summit's business.

*Id.* at ¶ 1.

According to the SAC, the Ponzi scheme unraveled when the real estate market began to collapse, because (i) the Exchange Funds diverted to Inland were invested mostly in real estate, and (ii) the 1031 industry declined, meaning that there was less new money to meet client obligations. *Id.* at ¶ 15. As the real estate market collapsed, Summit allegedly had insufficient cash to complete its clients' 1031 exchanges. *Id.* at ¶ 16.

Summit filed a petition for bankruptcy protection on December 19, 2008, and Padrick was appointed Chapter 11 Trustee of Summit two months later. *Id.* at ¶ 2. Based on the foregoing, Padrick asserted a single cause of action against Umpqua for conspiracy/aiding and abetting. *Id.* at ¶¶ 18-26. Specifically, Padrick alleged that Umpqua and Summit's principals “acted in concert in accomplishing the tortious conduct described” in the SAC. *Id.* at ¶ 22. Padrick further alleged that Umpqua “knew that the [p]rincipals' conduct was tortious and/or had a general awareness of the [p]rincipals' tortious scheme” and Umpqua “substantially assisted and encouraged the [p]rincipals in their tortious conduct.” *Id.* at ¶¶ 23-24.

## **2. The Fourth Amended Miller Complaint.**

The allegations in Miller's FAC, the operative complaint at the time of the Settlement, follow the allegations in the Padrick SAC. *See*, FAC at ¶¶ 15-20. Most factual allegations in the Miller FAC regarding Umpqua are taken word-for-word from the Padrick SAC. Based on these facts, the Miller plaintiffs asserted three causes of action, all for allegedly aiding and abetting Summit's tortious conduct. FAC at ¶¶ 21-48. Each count alleges that Umpqua “knew that the Summit Group's conduct was tortious; or (b) had a general awareness of the Summit Group's

tortious scheme” and that Umpqua “substantially assisted or encouraged the Summit Group in their tortious conduct.” *Id.* at ¶¶ 28-29, 38-39, 46-47.

### 3. Settlement of the consolidated cases.

The parties to the Padrick and Miller actions negotiated a settlement in a mediation conducted on September 20 and 21, 2010 (the “Settlement”). Compl. at ¶ 10. The settlement provided, *inter alia*, for a payment from Umpqua to Padrick, the Miller Plaintiffs, and other exchange plaintiffs. *Id.* at ¶ 11. Umpqua demanded that Progressive fund the portion of the Settlement that Umpqua was obligated to pay. CC at ¶ 59;<sup>4</sup> ACC at ¶ 28.<sup>5</sup> Unable to resolve the coverage issues presented by this action at the mediation, Umpqua and Progressive reserved their rights and jointly funded Umpqua’s portion of the Settlement. More specifically, Progressive advanced to Umpqua approximately 41% of the Settlement, subject to a full reservation of Progressive’s rights, including its right to seek reimbursement from Umpqua. *Id.*; *see also* Compl. at ¶ 12.

#### B. The Progressive Policy.

Progressive issued Directors & Officers Liability Policy number 10028871-05 (the “Progressive Policy”) to Umpqua in May of 2009. Compl. at ¶ 5. A copy of the Progressive Policy is attached to Progressive’s Counterclaims as Exhibit A. CC at Exhibit A. In addition to certain coverage for claims against insured directors and officers, the policy was issued with a Broad Form Company Liability Insuring Agreement, which, subject to all of its terms, conditions and exclusions, affords certain coverage for claims made directly against Umpqua. *Id.* The Progressive Policy contains several important exclusions from coverage. *Id.* The only exclusion relevant to this motion, however, is the third prong of the Illegal Profit/Payment Exclusion (the “Bad Faith Exclusion”), which provides:

The **Insurer** shall not be liable to make any payment for **Loss**, other than **Defense Costs**, in connection with any **Claim** arising out of or in any way involving:

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<sup>4</sup> Progressive’s counterclaims against Umpqua (the “Counterclaims”) are cited as “CC at ¶ \_\_\_\_.”

<sup>5</sup> Umpqua’s answer to the Counterclaims (the “ACC”) is cited as “ACC at ¶ \_\_\_\_.”

\* \* \*

3. conflicts of interest, engaging in self-dealing, or acting in bad faith.

Progressive Policy, Section V (Illegal Profit/Payment Exclusion) (emphasis in original to indicate a defined term). The Bad Faith Exclusion incorporates two key defined terms:

- A **Claim** is, in relevant part, “a civil proceeding [against the **Company**] commenced by the service of a complaint or similar pleading . . . for a **Wrongful Act** . . . Progressive Policy, Section IV (emphasis in original to indicate a defined term).
- A **Wrongful Act** is defined as “an actual or alleged error, omission, misstatement, misleading statement, neglect or breach of duty by . . . the **Company**. . .” *Id.*

(Emphasis in original to indicate a defined term.)

### C. This action.

In its Complaint in this action, Umpqua alleges that Progressive breached the Progressive Policy when it refused to fund the entire Settlement, and seeks to compel Progressive to fund the portion of the Settlement that Umpqua paid. Compl. at ¶¶ 14-22. Progressive answered the Complaint on February 7, 2011, and asserted the Counterclaims against Umpqua. *See* CC. Progressive’s Counterclaims assert, *inter alia*, that the Bad Faith Exclusion applies to the Consolidated Cases. *Id.* Consequently, Progressive seeks to recover the Settlement Advance, which it provided under a full reservation of rights, and a declaration that there is no coverage under the Progressive Policy for the Settlement.

## ARGUMENT

### I. Applicable standards.

A party is entitled to judgment on the pleadings when the moving party establishes that no material issue of fact remains, and that it is entitled to judgment as a matter of law based solely on the pleadings. *Westlands Water Dist. v. Firebaugh Canal*, 10 F.3d 667, 670 (9th Cir. 1993) (citing *Hal Roach Studios v. Richard Feiner & Co.*, 896 F.2d 1542, 1550 (9th Cir.1990)). Oregon Courts have held that “interpretation of the language of . . . insurance [policies] is a

matter of law for the court if the language is unambiguous. *American Int’l Specialty Lines Ins. Co. v. Kindercare Learning Ctr., Inc.*, 2011 WL 1002172, at \*5 (D. Or. Mar. 18, 2011) (citing *Timberline Equip. v. St. Paul Fire & Mar. Ins.*, 576 P.2d 1244, 1246 (Or. 1978)); *see also May v. Chicago Ins. Co.*, 490 P.2d 150, 153 (Or. 1971) (“As a general rule, the construction of a contract is a question for the court and is treated as a matter of law.”). Because all facts relevant to the application of the Bad Faith Exclusion have been alleged or admitted by Umpqua in the pleadings, there can be no disputed issues of fact, and this motion is ripe for decision under FED. R. CIV. P. 12(c).

## II. The complaints in the consolidated cases allege that Umpqua acted in bad faith.

The Bad Faith Exclusion, in relevant part, provides:

The **Insurer** shall not be liable to make any payment for **Loss**, other than **Defense Costs**, in connection with any **Claim** arising out of or in any way involving . . . conflicts of interest, engaging in self-dealing, or acting in bad faith.

CC at Exhibit A, Section V. There can be little doubt that Umpqua is *alleged* to have acted in bad faith in the FAC and SAC. How could it be otherwise? Surely a financial institution cannot in good faith *knowingly* facilitate, assist and advance an embezzler that is running a Ponzi scheme.

Progressive understands that Umpqua will attempt to avoid the Bad Faith exclusion by arguing that “bad faith” as used in the exclusion, requires “intentional malfeasance.” Common sense suggests this is overly narrow, but the conduct alleged in the underlying pleadings easily meets Umpqua’s narrow definition of bad faith.<sup>6</sup> As an initial matter, the underlying causes of action against Umpqua were for aiding and abetting (FAC at ¶¶ 21-48; SAC at ¶¶ 18-26), which, under applicable Oregon law, can only be plead by alleging that Umpqua “*knowingly* providing substantial assistance” to Summit’s tortious schemes. *See, Granewich v. Harding*, 985 P.2d 788, 793 (Or. 1999) (emphasis supplied). Because the underlying claims for aiding and abetting

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<sup>6</sup> Progressive does not concede that the term “bad faith” should be limited to intentional malfeasance and reserves its rights accordingly. However, the dispute over the proper scope of the term simply is not germane to Progressive’s motion.

require the allegation of intentional malfeasance, it follows that the SAC and FAC contain allegations of bad faith conduct.

Moreover, the pleadings plainly allege, in detail, that Umpqua engaged in intentional malfeasance. The SAC alleged that “The highest level of management at Umpqua Bank . . . became fully aware of this Ponzi scheme and the principals’ embezzlement, as well as the substantial financial risks that the principals’ misconduct created for Summit and its clients.” SAC at ¶ 1. Despite this knowledge, “Umpqua officials continued to actively encourage and materially assist the Summit principals in their tortuous conduct, including by encouraging them to use Umpqua’s banking services as a depository for the continued flow of embezzled funds, by making substantial loans to Summit’s principals and/or for the real estate investments that were part of the Ponzi scheme, and by actively assisting the Principals in generating new customers and victims of the Ponzi scheme – even referring to their relationship as an ‘alliance.’” *Id.* See also, *supra*, Section II.(A)(1)(describing the SAC’s allegations of Umpqua’s conduct).

Why did Umpqua engage in this alleged intentional malfeasance? According to the SAC, “Umpqua did so because it reaped huge financial rewards from Summit’s business.” *Id.* at ¶ 1.

In sum, Umpqua is alleged not only to have passively tolerated that which it knew to be an active Ponzi scheme by continuing to provide the depository and wire services that facilitated the scheme, but Umpqua also was alleged to have affirmatively sought out new and creative ways to profit from Summit’s misconduct. These alleged attempts to promote and profit from the Summit Ponzi scheme over an extended period of time and *with full knowledge of the wrongdoing*, constitutes alleged bad faith more than sufficient to invoke the Bad Faith Exclusion.

### **III. Application of the bad faith exclusion does not require re-litigation of the consolidated cases.**

Contrary to what Progressive understands Umpqua’s position to be, the application of the Bad Faith Exclusion does not require that Progressive re-litigate the Consolidated Cases in order to prove Umpqua’s bad faith conduct. There are three points to note in this regard.

First, the text of the Bad Faith Exclusion itself does not support Umpqua’s position. Rather, it is the nature of the claim, which is based on what is alleged, that determines whether

the exclusion applies. This common-sense point is borne out by the actual language of the exclusion. As noted above, the Bad Faith Exclusion, in relevant part, provides:

The **Insurer** shall not be liable to make any payment for **Loss**, other than **Defense Costs**, in connection with any **Claim** arising out of or in any way involving... conflicts of interest, engaging in self-dealing, or acting in bad faith.

CC at Exhibit A, Section V. Under the Progressive Policy, a **Claim**, in relevant part, is “a civil proceeding [against the **Company**] commenced by the service of a complaint or similar pleading . . . for a **Wrongful Act**. . . .” *Id.* at Section IV. A **Wrongful Act**, in turn, is defined as “an actual *or alleged* error, omission, misstatement, misleading statement, neglect or breach of duty by. . . the **Company**. . . .” *Id.* (Emphasis supplied.) Thus, when the pertinent definitions are incorporated, the operative passages of the Bad Faith Exclusion provide as follows:

The Insurer shall not be liable to make any payment for Loss, other than Defense Costs, in connection with any civil proceeding against the Company for an **alleged** [act] arising out of or in any way involving acting in bad faith.

(emphasis supplied.)

Second, it is noteworthy that the Illegal Profit/Payment Exclusion has three parts, of which the Bad Faith Exclusion is subpart (3). The contrast between subpart (1), which is not the subject of this motion, and subpart (3), which is the subject of this motion, is illuminating. The entire exclusion states as follows:

The **Insurer** shall not be liable to make any payment for **Loss**, other than **Defense Costs**, in connection with any **Claim** arising out of or in any way involving:

1. any **Insured** gaining, *in fact*, any profit, remuneration, or financial advantage to which the Insured was not legally entitled;
2. payment by the **Company** of inadequate or excessive consideration in connection with its purchase of **Company** securities; or
3. conflicts of interest, engaging in self-dealing, or acting in bad faith.

(Emphasis in italics supplied.)

Through its use of the phrase “in fact,” subpart (1) makes plain that it is not triggered by reference solely to the nature of the claim alleged. Rather, it requires the insurer to establish, in fact, that the excluded conduct occurred. Subpart (3) has no such requirement. It does not use the “in fact” language. Umpqua nevertheless seeks to read subpart (3) as if it also limited its applicability to instances in which the insurer has demonstrated that the excluded conduct “in fact” occurred. There is no basis for doing so. The Policy should be applied as written.

Third, it is noteworthy that while the Bad Faith Exclusion is triggered based on the nature of the claim alleged, the exclusion does not eliminate defense costs coverage for claims alleging bad faith conduct. The exclusion precludes coverage only for any judgment or settlement resulting from a claim for bad faith conduct. Thus, even when the Bad Faith Exclusion is triggered, the Policy affords the insured with a very substantial policy benefit – coverage for the costs incurred to defend against assertions of bad faith conduct. Here, Progressive has paid Umpqua’s substantial defense costs.

### CONCLUSION

For the foregoing reasons, judgment should be entered for Progressive on all claims pending in this case.

DATED this 10th day of August, 2011.

MARKOWITZ, HERBOLD, GLADE  
& MEHLHAF, P.C.

By: */s/ Kerry J. Shepherd*

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**ATTORNEY CERTIFICATE OF SERVICE**

I hereby certify that on August 10, 2011, I have made service of the foregoing **PROGRESSIVE'S OPENING BRIEF IN SUPPORT OF ITS MOTION FOR JUDGMENT ON THE PLEADINGS** on the party listed below in the manner indicated:

Seth H. Rowe / Michael E. Farnell  
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| <input checked="" type="checkbox"/> | Electronically via USDC CM/ECF system |

DATED this 10th day of August, 2011.

*/s/ Kerry J. Shepherd*

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