Retention of Profits May Impact Insurance Coverage for Disgorgement Payments to the SEC

In an opinion by Judge Graffeo, the New York State Court of Appeals unanimously reversed the dismissal of an insured's coverage claims relating to monetary payments made by Bear Stearns & Co. Inc. ("Bear Stearns") to the United States Securities and Exchange Commission ("SEC") in connection with the settlement of claimed violations of the federal securities laws.[1]

I. Factual Background and Procedural History[2]

In 2003, the SEC began investigating Bear Stearns for allegedly facilitating illegal late trading activities and market timing schemes for the benefit of several hedge fund clients.[3] Bear Stearns settled with the SEC for $250 million, which included a $160 million disgorgement penalty, "without admitting or denying the findings." Bear Stearns subsequently sought indemnification from Vigilant Insurance Company, its primary insurance carrier, and six excess carriers (collectively, the "Insurance Companies"). Under their liability policies, the Insurance Companies covered losses incurred by Bear Stearns from claims for wrongful actions, except, among other things, "if the loss consists of fines or penalties imposed by law or matters which are uninsurable under the law."[4] The policies excluded "deliberate, dishonest, fraudulent or criminal acts or omissions."[5]

After the Insurance Companies denied coverage, Bear Stearns, which had merged with J.P. Morgan Securities Inc., brought a breach of contract and declaratory judgment action against the Insurance Companies in the New York State Supreme Court. Bear Stearns claimed that its clients were the primary beneficiaries of its alleged illegal acts and that its own profit represented only a small portion of the disgorgement penalty. The Insurance Companies argued that public policy precluded indemnification. The trial court denied the Insurance Companies' motion to dismiss, holding that it could not find a specific link between the disgorgement penalty and Bear Stearns' profits. On appeal, the Appellate Division reversed, holding that public policy precluded Bear Stearns from seeking indemnification. Bear Stearns appealed, claiming that it was not unjustly enriched by the amounts attributed to the disgorgement payment.[6]

II. The Decision of the New York State Court of Appeals

When examining facts under a CPLR 3211(a)(7) motion to dismiss analysis, the court must accept the facts alleged in the complaint as true and afford the plaintiff "the benefit of every possible favorable inference."[7]

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[1] *J.P. Morgan Securities Inc., et al. v. Vigilant Insurance Company et al.*, No. 113, (NY June 11, 2013), available at http://www.nycourts.gov/ctapps/Decisions/2013/Jun13/113opn13-Decision.pdf (the "Opinion").

[2] The factual background is summarized from the background set forth in the Court's opinion.

[3] The SEC defines late trading as "the practice of placing orders to buy or redeem mutual fund shares after the time as of which a mutual fund has calculated its net asset value (NAV), usually 4pm (EST), but receiving the price based on the prior NAV already determined that day." The alleged market timing schemes involved placing frequent orders for shares in the same mutual funds in order to exploit inefficiencies in pricing. This is deceptive if it compels a mutual fund to accept trades it ordinarily would reject.

[4] *Id.* at 5.

[5] *Id.* at 6.

[6] Bear Stearns contends that of the $160 million disgorgement payment, only $20 million represents firm profits. The rest, it claims, were profits obtained by its clients.

[7] Opinion at 13.

While insurance contracts are typically enforced as written, the New York law recognizes an exception whereby public policy overrides express contractual provisions if indemnification is sought for conduct "with intent to cause injury."[8] Courts have also found that disgorgement of ill-gotten gains is not insurable; otherwise insureds could retain illegal profits by transferring their loss to insurance carriers.

The Court of Appeals began by addressing the intent-based exception, which it stated must be interpreted very narrowly. It found, after giving Bear Stearns the benefit of every possible favorable inference, that there was not enough evidence to show, as a matter of law, that Bear Stearns had the requisite intent. The Court distinguished precedent cases proffered by the Insurance Companies to show that public policy should preclude the insurability of Bear Stearns' disgorgement penalties.[9] In both cases, the insureds were barred from obtaining coverage for disgorgement penalties because the SEC's findings "conclusively link[ed]" the disgorgement payment to the insureds' profits.[10] Bear Stearns alleged that it only retained a small portion of the profit represented by the disgorgement penalty and indemnification would not cause it to be unjustly enriched.

Finally, the Court explained why policy exclusions, cited by the Insurance Companies, do not necessarily preclude coverage. The Court held that one exclusion, which precludes indemnification for personal profit or advantage that the insured is not legally entitled to, does not apply because the illegal profits primarily benefitted Bear Stearns' clients. The second exclusion, which precludes indemnification for acts committed before March 21, 2000, where the insured knew or could have reasonably foreseen a wrongful act, is also inapplicable because knowledge of relevant facts had not been conclusively established.[11]

III. Significance of the Decision

By reversing the dismissal of Bear Stearns' coverage action, the Court of Appeals found that the retention of profits from the illegal acts that lead to a disgorgement penalty may be a factor that impacts the enforceability of professional liability insurance coverage in New York.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com.

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[8] *Id.* at 10.

[9] *Id.* at 13. (Distinguishing *Millennium Partners, L.P. v. Select Ins. Co.*, 68 AD3d 420 [1st Dept 2009] *appeal dismissed* 14 NY3d 856 [2010] and *Vigilant Ins. Co. v. Credit Suisse First Boston Corp.*, 10 AD3d 528, 528 [1st Dept 2004]).

[10] *Id.*

[11] This particular exclusion was only present in the insurance contract between Bear Stearns and a single Insurance Company, Lloyd's.

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