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Court of Appeals Reinstates Insurance Coverage Claim for Disgorgement

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In a decision issued on June 11, the New York Court of Appeals reversed the Appellate Division's dismissal of J.P. Morgan's[1] lawsuit against its insurers for recoupment of disgorgement payments that Bear Stearns made to the SEC in 2006 and related private securities litigation costs.

In its December 2011 ruling,[2] the Appellate Division held that, as a matter of public policy, Bear Stearns could not seek recoupment of disgorgement payments even if a substantial part of the payment was composed of ill-gotten gains by third parties. The Court of Appeals reversed, holding that the public policy principles and specific policy exclusions cited by the Vigilant Insurance Company were not a sufficient basis, at the pleading stage, on which to deny coverage.

The two key rulings by the Court of Appeals addressed (i) whether the public policy rule precluding coverage for disgorgement should apply only where the insured requests coverage for the disgorgement of its own illicit gains, and (ii) whether findings in the SEC order that Bear Stearns had "willfully" violated securities laws precluded coverage under the public policy exception for intentional injuries.

According to the decision, Bear Stearns "acknowledge[d] that it is reasonable to preclude an insured from obtaining indemnity for the disgorgement of its own ill-gotten gains,"[3] but argued that these principles should not be used to bar recoupment where, as here, $140 million of the $160 million labeled "disgorgement" by the SEC constituted improper profits by third-party hedge fund customers. Vigilant countered that, for public policy reasons, Bear Stearns should not be able to obtain coverage for the $160 million disgorgement payment because the ill-gotten gains were a product of "collaboration with its customers in an unlawful trading scheme" and "the securities laws make <u>no</u> distinction between those that retain ill-gotten gains and those that make them possible."[4]

The Court of Appeals agreed with Bear Stearns that the evidence before it did not "decisively repudiate Bear Stearns' allegation that the SEC disgorgement payment was calculated in large measure on the profits of others."[5] Since Vigilant was unable to point to "a single precedent, from New York or otherwise" in which coverage was nullified where the disgorgement payment at issue went to third parties, the court concluded that it could not dismiss Bear Stearns' insurance claims "at this early juncture."[6]

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[1] As a successor-in-interest to Bear Stearns.

[2] *J.P. Morgan Sec. Inc. v Vigilant Ins. Co.,* 91 A.D.3d 226 (N.Y. App. Div. 1st Dep't 2011).

[3] Slip op. at 7.

[4] NY Court of Appeals Brief for Defendants-Respondents at 2 (emph. in original).

[5] Slip op. at 13.

[6] *Id.* at 14.

On the second issue, Vigilant relied on the findings in the SEC order to argue that the public policy exception for intentional injury precluded coverage for Bear Stearns' claims. The court held that "the public policy exception for intentionally harmful conduct is a narrow one, under which it must be established not only that the insured acted intentionally but, further, that it acted with the intent to harm or injure others."[7] On the limited record before it, the court held it could not find as a matter of law that the SEC order conclusively demonstrated that Bear Stearns possessed the required intent to cause harm.

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[7] *Id*. at 10.