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New York's Highest Court Says D&O Insurers Must Cover Disgorgement Payments

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On November 23, 2021, New York's highest court resolved a long-standing dispute between directors and officers (D&O) liability insurers and their insureds, holding that a settlement payment to the U.S. Securities and Exchange Commission (SEC) calculated based on disgorged profits did not constitute a "penalty imposed by law" under the policies and that coverage for the settlement was not barred by public policy.

For more than a decade, *J.P. Morgan Secs. Inc., et al. v. Vigilant Ins. Co., et al.* drew substantial interest from the securities industry as it worked its way through the courts. The New York Court of Appeals's most recent decision offers much-needed clarity to policyholders, insurers, and regulators as to the insurability of disgorged funds and other settlement payments made to resolve government investigations.

Procedural History

In 2000, The Bear Stearns Companies purchased D&O liability insurance providing coverage for all "Loss" that Bear Stearns became legally obligated to pay as the result of any claim for any wrongful act.

In 2003, the SEC and other regulatory agencies began investigating Bear Stearns regarding allegations of deceptive trading practices. Bear Stearns notified the Insurers of the pending investigation and the Insurers disclaimed coverage.

In 2006, Bear Stearns settled with the SEC pursuant to an administrative settlement order. Without admitting the SEC's findings of wrongdoing, Bear Stearns agreed to make a $160 million "disgorgement" payment and a $90 million payment for "civil money penalties." Both payments were deposited in a fund to compensate investors allegedly harmed by the improper trading practices. Further, the settlement order directed that the $90 million payment—but not the disgorgement payment—was ineligible to offset any sums owed by Bear Stearns to private litigants injured by the trading practices.

Bear Stearns' successors subsequently sued the Insurers for breach of the insurance policies and a declaration of coverage for the disgorgement payment and various defense costs. The trial court granted summary judgment for the policyholders, concluding that the disgorgement of $140 million in client gains constituted an insurable loss. The Appellate Division reversed, holding that Bear Stearns was not entitled to coverage for the SEC disgorgement payment because it constituted a "penalty." Bear Stearns appealed.

Summary of the Decision

The policies at issue defined "Loss" to include compensatory damages, punitive damages where insurable by law, multiplied damages, judgments, settlements, costs, and expenses resulting from any claim. "Loss" also encompassed "costs, charges and expenses or other damages incurred in connection with any investigation by any governmental body." However, an exception in the definition of "Loss" provided that "Loss" shall not include "fines or penalties imposed by law." The Court of Appeals framed the dispositive question as:

> Whether the Insurers demonstrated that a reasonable insured purchasing this wrongful act policy in 2000 would have understood the phrase "penalties imposed by law" to preclude coverage for the $140 million SEC disgorgement payment?

The court concluded that the Insurers failed to meet their burden.

The courts' analysis turned on the purpose of disgorgement payments. The phrase "penalties imposed by law" was not defined in the policies; however, the court reasoned that the term "penalty" is "commonly understood to reference a monetary sanction designed to address a public wrong that is sought for purposes of deterrence and punishment rather than to compensate injured parties for their loss." "Thus, at the time the parties contracted, a reasonable insured would likewise have understood the term penalty to refer to non-compensatory, purely punitive monetary sanctions." The court found that the disgorgement payment did not meet that standard.

The court's reasoning was that the disgorgement payment "was calculated based on wrongfully obtained profits as a measure of the harm or damages caused by the alleged wrongdoing that Bear Stearns was accused of facilitating." Simply put, it "served a compensatory goal." In support of that conclusion, the court cited evidence that Bear Stearns submitted "regarding its communications with the SEC throughout the settlement negotiation process indicating that, at the direction of the SEC, Bear Stearns undertook various valuations of its customers' gains and the corresponding injury suffered by investors."

The court contrasted the disgorgement portion of the settlement with the $90 million payment denominated a "penalty," which was "not derived from any estimate of harm or gain flowing from the improper trading practices." In ruling for the policyholders, the court expressed concern that treating disgorgements as excluded penalties would risk "substantially curtail[ing]" D&O coverage industrywide for government investigations "in a manner arguably inconsistent with an average insured's reasonable expectations."

Key Takeaways

- Following the *Vigilant* decision, there is an increased possibility of coverage for settlements with the SEC and other government regulators.
- Policyholders need to be careful in negotiating settlements with regulators and should do so in coordination with experienced insurance coverage counsel. The court cautioned that "neither the label assigned to the payment by the SEC and Bear Stearns, nor the mere fact that injured parties may ultimately receive funds, is dispositive." Rather, courts should consider various additional factors when determining whether a disgorgement payment is a "penalty," including:
  - Whether the payment is derived from estimates of ill-gotten gains
  - Whether the payment effectively constitutes a measure of the victims' losses
- Policyholders need to carefully document in their underlying settlement agreements the rationale for the settlement payment, especially when the driver for the settlement serves a compensatory purpose for victims' losses.
- This decision follows recent Delaware cases holding that insuring disgorgement or restitution was not against public policy. These decisions are correct and should be followed by the many other courts that are currently evaluating insurer efforts to avoid coverage based on public policy grounds. Vigilant and the Delaware decisions put a spotlight on the overuse and overreach of the insurers with respect to this coverage defense.

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