KAUFMAN | DOLOWICH

Mansfield Rule Certified 2022-2023

KD Alert: New York Court Reinforces Rule That Disgorgement Payments Are Not Insurable

A New York appellate court today reinforced the rule that disgorgement payments made as part of a settlement are not recoverable under a professional liability insurance policy. The decision is J.P. Morgan Securities Inc. v. Vigilant Insurance Co.[1]

This case arose out of the SEC's investigation of market timing and late trading activity at Bear Stearns. The SEC and Bear Stearns eventually settled. In a March 2006 "Order Instituting Public Administrative and Cease-and-Desist Proceedings," Bear Stearns agreed to pay the SEC "disgorgement in the total amount of $160,000,000" and "civil money penalties in the amount of $90,000,000" with no admission of liability.

J.P. Morgan sought indemnity for the SEC payments, but its insurers denied coverage on the basis that the SEC payment was not covered "loss" or fell within certain exclusions, including the Personal Profit Exclusion. J.P. Morgan sued, and the trial court denied the insurers' motion to dismiss. On this appeal, however, the First Department reversed.

The court began its analysis with the general rule from other decisions that restitutionary payments or the disgorgement of ill-gotten gains are not insurable as a matter of law.[2] The court noted, "The public policy rationale for this rule is that the deterrent effect of a disgorgement action would be greatly undermined if wrongdoers were permitted to shift the cost of disgorgement to an insurer, thereby allowing the wrongdoer to retain the proceeds of his or her illegal acts."

Importantly, the court provided guidance on how to determine whether a payment under an SEC or regulatory order constitutes disgorgement, rather than compensatory damages for wrongful conduct, especially where the parties' labels might not make it so clear. Referring to findings made in the SEC Order, the court reasoned:

The fact that the SEC did not itemize how it reached the agreed upon disgorgement figure does not raise an issue as to whether the disgorgement payment was in fact compensatory. Although the disgorged amount must be "causally connected to the violation," the SEC "is not required to trace every dollar of proceed[s]" or "to identify misappropriated monies which have been commingled." Accordingly, a disgorgement calculation requires only a "reasonable approximation of profits causally connected to the violation," and the amount of disgorgement should include "all gains flowing from the illegal activities." (internal citations omitted).

Using this guidepost, the court found the SEC action and the resulting settlement made clear the allegations against Bear Stearns were for the disgorgement of funds obtained from illegal activity, so it could not be "seriously argued" the SEC findings against Bear Stearns were merely the result of inadequacies or sloppiness in its work. Rather, the SEC findings showed the settlement payments were the result of illegal mutual fund trading, proscribed from insurance as a matter of law and public policy.

In a final point to its rulings, the court addressed J.P. Morgan's argument that the SEC payment was not disgorgement because it was placed into a fund to compensate harmed investors. The court rejected that notion, finding that the "primary purpose" of disgorgement is to deprive the wrongdoer of the ill-gotten gains, even if secondarily it is meant to return the money to the "victims of the violation."

For insurers issuing policies in the areas of Bankers' and Investment Advisors' Professional Liability, D&O and Financial Institutions, this decision strengthens the existing law and re-affirms the applicability of the Disgorgement and Personal Profit Exclusions.

For more information about this KD Alert, contact Kevin M. Mattessich, Patrick M. Kennell, and Bryce Guingrich, or one of the attorneys from KD's Insurance Coverage and Monitoring practice.

[1] 2011 N.Y. Slip Op. 08995 (1st Dep't, Dec. 13, 2011).

[2] Citing Vigilant Ins. Co. v Credit Suisse First Boston Corp., 782 N.Y.S.2d 19, 10 A.D.3d 528, 528 (1st Dep't 2004); Millennium Partners, L.P. v Select Ins. Co., 889 N.Y.S.2d 575, 68 A.D.3d 420 (1st Dep't 2009), appeal dismissed 14 N.Y.3d 856 (N.Y. 2010); and Reliance Group Holdings v National Union Fire Ins. Co. of Pittsburgh, Pa, 594 N.Y.S.2d 20, 188 A.D.2d 47, 55 (1st Dep't 1993).