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NEWSLETTER

Appellate Court Finds Question of Fact Regarding Whether Amounts Paid Pursuant to Settlement Constitute Disgorgement

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The Appellate Division of the New York Supreme Court has held that disgorgement paid as part of a settlement may be recoverable under professional liability policies. *Vigilant Ins. Co. v. Bear Stearns Cos.*, 824 N.Y.S.2d 91 (N.Y. App. Div. 2006). The court additionally held that settlement payments for independent research and investor education, while not compensatory, also may be recoverable as "loss" under such policies.

The insurers issued a primary professional liability policy and two excess policies to an investment bank. The policies covered "loss" that the policyholder was legally obligated to pay, defined as "(1) compensatory damages, multiplied damages, punitive damages where insurable by law, judgments, settlements, costs, charges and expenses or other sums the Insured shall legally become obligated to pay as damages resulting from any Claim or Claim(s); [or] (2) costs, charges and expenses or other damages incurred in connection with any investigation by any governmental body or self-regulatory organization." The policies also required the insurers' consent to settle claims "in excess of a settlement authority threshold of $5,000,000," and provided that the insurers "shall not be liable for any settlement, Defense Costs, assumed obligation or admission" to which they did not consent.

The SEC, the NASD Regulation, Inc., and the New York Stock Exchange began a "joint inquiry into market practices concerning research analysts and the potential conflicts that can arise from the relationship between research and investment banking." The bank and the regulators agreed to settle the case, and the bank signed a document called "Settlement Principles" without consulting the insurers. The regulators did not sign the document. The bank then signed a consent to entry of judgment and informed its insurers of the consent judgment three days later.

Subsequently, the SEC filed suit against the investment bank, alleging a conflict of interest between the investment banking and research parts of the bank. The case resulted in a court-approved settlement that required the bank to pay monies in the form of penalties, "disgorgement of commissions," and other amounts for independent research and investor education. The judgment provided that the amounts paid for independent research and investor education were not "disgorgement or restitution, and/or used for

compensatory purposes."

The professional liability insurers brought a declaratory judgment action and moved for summary judgment on a number of issues. The New York Supreme Court issued an opinion granting in part and denying in part the insurers' motion. *Vigilant Ins. Co. v. Bear Stearns Cos.*, 814 N.Y.S.2d 566 (N.Y. Sup. Ct. 2006) (summarized in the March 2006 issue of *The Executive Summary*). The lower court determined that the amounts paid as disgorgement were not recoverable under the policies. The Appellate Division, however, modified the lower court's judgment, looking at evidence submitted by the insured that "the settlement amount was based on market share instead of being tied to the amount of commissions or fees it received." The court opined that "the allegations against the [insureds] were very different from those in" *Vigilant Insurance Co. v. Credit Suisse First Boston*, 78 N.Y.S.2d 19 (N.Y. Sup. Ct. 2004), and found an issue of fact as to whether "the portion of the settlement attributed to disgorgement actually represented ill-gotten gains or improperly acquired funds."

The Appellate Division also held that the payments ordered for research and education were loss covered by the policy. The Appellate Division upheld the lower court's denial of the insurers' motion for summary judgment on this issue and, additionally, granted partial summary judgment to the insured, finding that "[t]he policies cover 'loss,' not merely 'damages.'" The court continued, "'loss' includes, *inter alia*, 'judgments and settlements.' It is undisputed that the payments for independent research and investor education were part of a settlement...."

The Appellate Division further held that the primary policy's investment banking exclusion did not apply to the conduct alleged by the SEC. The exclusion barred coverage for claims "based upon, arising from, or in consequence of any underwriting, syndicating, or investment banking work." The Appellate Division found no issue of fact and held that "influencing research analysts is not like the examples of investment banking work listed in the exclusion." The Appellate Division then concluded that, as a matter of law, the investment banking exclusion did not apply and granted partial summary judgment in favor of the insured on this issue.

The Appellate Division also affirmed the lower court's denial of summary judgment for the insurers on the issue of whether the settlements violated the policies' prohibition on settling claims or assuming contractual obligations without the insurers' consent. As to the bank's earlier settlement with the regulators, the Appellate Division held that "a trier of fact could find it was not a binding contract" because it was "subject to the approval of the SEC and state regulatory authorities and required finalization of terms and documentation...." The Appellate Division also found an issue of fact as to whether the bank's later settlement with the SEC violated the policies, because it was "subject to court approval" and there was evidence that the insured "could not be compelled to proceed with the settlement in the absence of court approval."