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NEWSLETTER

Disgorgement Payment for SEC Settlement Held to be Uninsurable Loss

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The New York Supreme Court, Appellate Division, has held that a disgorgement payment to the Securities and Exchange Commission (SEC) in settlement of charges that an insured's predecessors willfully facilitated illegal mutual fund trading practices does not constitute an insurable loss under a professional liability policy. *J.P. Morgan Securities Inc. v. Vigilant Ins. Co., et al.*, No. 600979/09 (N.Y. Sup. Ct., App. Div. Dec. 13, 2011).

The insurers issued professional liability policies to the insured, which operated an introducing broker and a clearing firm, that covered "all Loss which the insured shall become legally obligated to pay as a result of any Claim . . . for any Wrongful Act" on its part. The primary policy contained exclusions for dishonest or fraudulent conduct and for personal profit "to which the insured was not legally entitled." The policy also carved out from the definition of Loss "fines or penalties imposed by law" and "matters which are uninsurable under the law pursuant to which this policy shall be construed."

The insured was notified that the SEC intended to institute proceedings against it seeking monetary sanctions of $720 million and broad injunctive relief in relation to allegations that the insured violated securities law by "knowingly facilitate[in] a substantial amount of late trading and deceptive market timing for certain customers . . . and affirmatively assist[in] them in evading detection . . . ." The insured disputed the allegations, arguing that it did not knowingly violate any law or regulation and that it did not share in the profits or benefit in any way from the late trading, which generated only $16.9 million in revenue for the insured. However, a formal offer of settlement was eventually made to and accepted by the SEC, which included the disgorgement of $160 million and a $90 million civil money penalty. The SEC and New York Stock Exchange (NYSE) then issued orders regarding the settlement. The insured demanded that the insurers indemnify it for the disgorgement payment to the SEC. The insurers refused, arguing that the payment was not insurable loss or was excluded from coverage.

The appellate division stated that under New York law disgorgement payments are not insurable. According to the court, the deterrent effect of a disgorgement action would be greatly undermined if the cost of disgorgement could be shifted to an insurer. The court also explained that the offer of settlement, and the related SEC and NYSE orders, when read as a whole, "are not reasonably susceptible to any interpretation other than that [the insured] knowingly and intentionally facilitated illegal late trading for preferred customers, and that the relief provisions of the SEC order required disgorgement of funds gained through that illegal

activity." The court noted that the SEC order detailed how the insured engaged in illegal trading activity and concluded that the insured "willfully violated" securities laws.

The court also explained that the Sac's failure to itemize how it reached the agreed upon disgorgement figure does not raise an issue as to whether the payment was compensatory. According to the appellate court, "the amount of disgorgement should include all gains flowing from the illegal activities," and "joint and several liability for combined profits may be imposed on collaborating or closely related parties." In support of its holding, the court noted that the insured admitted to generating at least $16.9 million in revenue for itself from the illegal scheme, and "knowingly and affirmatively facilitated an illegal scheme which generated hundreds of millions of dollars for collaborating parties . . . ." The court also held that the nature of the disgorgement payment was not altered by the fact that the funds were placed into a Fair Fund to be distributed to harmed investors.