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New York High Court: Public Policy Does Not Bar Coverage for Portion of "Disgorgement" Not Traceable to Policyholder's Own Improper Gains

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New York's highest court has reinstated a lawsuit seeking coverage for a payment of "disgorgement" as a result of a U.S. Securities and Exchange Commission (SEC) settlement regarding allegations of market timing and late trading by Bear Stearns. The court rejected the carriers' "no loss" defense, holding that, at the motion to dismiss stage, the carriers had not shown as a matter of law that the policyholder was seeking indemnification for amounts traceable to its own improper gains. *J.P. Morgan Sec., Inc. v. Vigilant Ins. Co.*, No. 113 (N.Y. June 11, 2013).

A 2003 SEC investigation of Bear Stearns over allegations of late trading and market timing led to a 2006 settlement in which Bear Stearns agreed to pay $160 million as disgorgement. Bear Stearns settled without admitting liability and maintained that it had received only $16.9 million in commissions from its allegedly wrongful actions. After its insurers declined coverage for the settlement payment, Bear Stearns filed coverage litigation. The trial court denied a motion to dismiss, an intermediate appellate court reversed and New York's highest court agreed to hear the dispute.

The court discussed cases holding that the risk of being ordered to return ill-gotten gains is not insurable and did not express disagreement with those authorities. Accepting Bear Stearns's allegations as true, however, only a portion of the $160 million payment—primarily the commissions Bear Stearns earned—allegedly represented Bear Stearns's own profits. According to Bear Stearns,

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the remainder of the payment, notwithstanding the SEC's "disgorgement" label, allegedly represented improper gains obtained by Bear Stearns's customers. The court opined that in the cases relied upon by the insurers, the SEC's findings conclusively linked the disgorgement payment to improperly acquired funds in the hands of the policyholder. Here, the SEC order recited that Bear Stearns's misconduct had permitted its customers to generate hundreds of millions of dollars in profits. The court accordingly ruled that the trial court properly denied the insurers' motions to dismiss.