Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

A Bear Of An Insurance Issue For JP Morgan

Law360, New York (January 30, 2012, 1:58 PM ET) -- Settlements with the U.S. Securities and Exchange Commission (SEC) often take the form of a complaint filed contemporaneously with a settlement agreement and administrative order. The settlement will often include both SEC findings and a boilerplate disclaimer that the defendant is settling “without admitting or denying the findings.”

In JP Morgan Securities Inc. v. Vigilant Insurance Co., 2011 NY Slip Op 08995 (1st Dep’t Dec. 13, 2011), the Appellate Division, First Department, held that JP Morgan could not require its insurers to pay any of a $250 million settlement with the SEC, notwithstanding the boilerplate protective language in its settlement agreement.

In 2006, Bear Stearns concluded an investigation by the SEC with respect to market timing and late trading, which Bear Stearns had allegedly used to permit its clients to profit wrongfully at the expense of mutual fund shareholders. Bear Stearns argued that it had played only a passive role in the scheme, merely brokering and processing transactions initiated by others, and it consistently denied knowingly violating any law or regulation.

On March 16, 2006, “without admitting or denying the findings” made pursuant to its offer of settlement, Bear Stearns agreed to the entry of a SEC administrative order directing the company to pay $160 million in profit disgorgement and $90 million in civil penalties.

Bear Stearns’ insurance policy covered up to $200 million of the company’s losses, defined to include “compensatory damages” and “settlements.” However, the policy contained an exclusion for claims against Bear Stearns “based upon or arising out of any deliberate, dishonest, fraudulent or criminal act or omission” or “based upon or arising out of the Insured gaining in fact any personal profit or advantage to which the Insured was not legally entitled.”

When Bear Stearns sought indemnification for the SEC settlement amount from its insurers — a group including Vigilant Insurance Co., the Travelers Indemnity Co. and others — they refused to pay.

In 2009, JP Morgan, which had acquired Bear Stearns in 2008, filed a breach of contract claim and sought a declaratory judgment that Bear Stearns’ insurers were required to indemnify the company for the SEC settlement payment as a covered loss.

The insurers filed a motion to dismiss, arguing that, because the SEC's administrative order labeled the $160 million as "disgorgement," Bear Stearns could not recharacterize the payment as compensatory damages, and the company must, as a matter of law, bear its own loss.

On Sept. 14, 2010, Justice Charles E. Ramos of the Commercial Division of the Supreme Court rejected the insurers' motion, holding that the SEC administrative order's use of the term "disgorgement" did not, by itself, conclusively establish that the settlement amounts were precluded from coverage.

Because the order did not contain explicit findings that Bear Stearns directly generated profits for itself as a result of facilitating improper practices, at a minimum, genuine disputes of material fact remained.

On Dec. 13, 2011, in a unanimous opinion signed by Justice Richard T. Andrias, the Appellate Division reversed the lower court and granted the insurers' motion to dismiss. The court held that Bear Stearns' settlement amount did not constitute an "insurable loss" because the conduct that led to the agreement constituted an intentional violation of law.

Andrias wrote:

> "Read as a whole, the offer of settlement, the SEC Order, the NYSE [New York Stock Exchange] order and related documents are not reasonably susceptible to any interpretation other than that Bear Stearns 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."

Both the lower court and the appellate court agreed that, as a matter of law, "disgorgement of ill-gotten gains or restitutionary damages does not constitute an insurable loss." But the Appellate Division differed from the trial court in analyzing how closely the disgorgement payment must be linked to the improper activity, in light of the SEC's findings.

The Appellate Court did not require a precise identification of how the disgorgement amount was linked to the specific wrongdoing; even if Bear Stearns did not itself directly profit, it was enough that profits flowed from an illegal scheme knowingly and affirmatively facilitated by Bear Stearns.

Andrias stated that "[t]he 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."

The court cited a press release by the SEC to further emphasize that the purpose of the SEC administrative order, whether Bear Stearns would "admit or deny" its contents or not, was to not only "deprive Bear Stearns of the gains it reaped by its conduct," but also to strong-arm the company into reforming internal procedures to deter such misconduct.

According to the court, "[u]nder New York law, '[t]he risk of being directed to return improperly acquired funds is not insurable.'" What is most significant about this decision is that it emphasizes the great care that must be taken in structuring regulatory settlements if a company hopes to retain the benefit of its liability insurance.

This case should not be taken to mean that when an SEC settlement characterizes a settlement payment as disgorgement the payment can never constitute an insurable loss. An insured's settlement or consent to entry of an order with the SEC in which it does not admit guilt will not necessarily preclude it from disputing those findings in later litigation.

Rather, the case suggests that where, as here, the findings of the settlement order "conclusively link[ ]" the disgorgement to improper profits received by the insured, there will be a high threshold to establish insurability through litigation.

Companies settling SEC or other regulatory actions should take great care in negotiating the terms of the regulator's findings, and not place too much comfort in the fact that they are neither admitting nor denying those findings.

--By Joseph De Simone and Richard M. Rosenfeld, Mayer Brown LLP

Joe De Simone is a partner in Mayer Brown's New York office. Rich Rosenfeld is a partner in the firm's Washington, D.C., office.

The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media, publisher of Law360. This article is for general information purposes and is not intended to be and should not be taken as legal advice.