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Expert Analysis

SEC Disgorgement: Is It Insurable?

By **Howard B. Epstein** And **Theodore A. Keyes**

First, a tribute: An unfortunate reality of insurance law columns is that they don't tend to develop a huge fan base. Michael S. Kaufman, most recently a vice president and manager at Hudson Bank's NYC Legal Services Group, based out of the Woolworth Building, was one of our best fans. In the early years, before the conveniences of electronic mail were widespread, when our column was published, Michael would wrap a copy in brown paper and send it to our office, following up with a call or a meeting at Starbucks on Broadway to discuss points of interest. Sadly, Michael recently passed away. We will miss him greatly. As a banker of the highest ethical standards, we are certain that issues concerning the disgorgement of a bank or its customer's illicit profits would have been of interest to him. Michael Sam, this one's for you; we will miss your feedback and your insights.

SEC Disgorgement

Disgorgement is a form of "[r]estitution measured by the defendant's wrongful gain." Restatement (Third) of Restitution and Unjust Enrichment §51, Comment a, p. 204 (2010). In Securities and Exchange Commission (SEC) enforcement actions, disgorgement is one of the remedies available to the SEC to address violations of the securities laws. On June 5, 2017, in *Kokesh v. SEC*, the U.S. Supreme Court held that the SEC's use of disgorgement of profits as a remedy in an enforcement action constitutes a penalty that is subject to the federal five-year statute of limitations set forth in 28 U.S.C. §2462. 137 S.Ct. 1635, 1639, 1642 (2017).

The Supreme Court explained that, although initially the only remedy available to the SEC in enforcement actions was an injunction prohibiting future violations, over time the SEC began to ask courts to order disgorgement of wrongfully gained profits as a form of equitable relief. Courts did so, reasoning that disgorgement would "deprive … defendants of their profits in order to remove any monetary reward for violating" securities laws and "protect the investing public by providing an effective deterrent to future violations." Id. at 1640. Then, in 1990, Congress "expanded

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the enforcement tools" statutorily available to the SEC, including by authorizing the SEC to seek monetary penalties. Nevertheless, the SEC continued to ask courts to order disgorgement as a matter of equity. Id.

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Is Disgorgement a 'Penalty'?

28 U.S.C. §2462 establishes a five-year limitations period for "an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture." In *Kokesh v. SEC*, the issue presented was whether the SEC disgorgement claim constituted a penalty governed by that five-year statute of limitations. In that case, after a jury found that Kokesh violated federal securities laws, the court entered a disgorgement judgment in the amount of $34.9 million representing disgorgement of profits that Kokesh had misappropriated from four separate businesses. The district court found that although civil penalties would be barred by the five-year statute of limitations, disgorgement did not trigger the statute of limitations in §2462 because it was not a penalty. The U.S. Court of Appeals for the Tenth Circuit affirmed, adding that disgorgement also did not constitute a forfeiture. Id. at 1641.

The Supreme Court reversed. After analyzing what constitutes a "penalty," the court found that "SEC disgorgement … bears all the hallmarks of a penalty: It is imposed as a consequence of violating a public law and it is intended to deter, not to compensate." Id. at 1644. The court noted that often the disgorged funds are not used to reimburse the injured party and further found that disgorgement often reaches beyond the profits illegally earned by the wrongdoer to disgorgement of profits earned by third parties as a result of the wrongdoer's misconduct, even if the wrongdoer never received those profits. Accordingly, the court found that disgorgement is a penalty, subject to the five-year statute of limitations.

Is Disgorgement Insurable?

In *J.P. Morgan Securities v. Vigilant Insurance*, 21 N.Y.3d 324 (2013), the Court of Appeals considered whether public policy precluded insurance coverage for disgorgement.

The issue before the Court of Appeals concerned Bear Stearns' attempt to recover from its insurers a $160 million disgorgement payment made as part of a settlement with the SEC.

The underlying case began when the SEC commenced an investigation concerning allegations that Bear Stearns had facilitated late trading and deceptive market timing practices for customers purchasing and selling shares of mutual funds. Bear Stearns disputed the charges and also contended that it did not profit from the activities in question beyond the receipt of $16.9 million in commissions earned in connection with the transactions that were the subject of the investigation. Nevertheless, Bear Stearns ultimately entered into a settlement with the SEC pursuant to which it agreed to pay $160 million as "disgorgement" and $90 million as a civil penalty.

The SEC documented the settlement in an Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions (the SEC order), which included factual findings that explained in detail the late trading and market timing scheme. Notably, the SEC order expressly stated that Bear Stearns entered into the order "solely for the purpose of these proceedings" and "without admitting or denying the findings." Id.

Following the SEC settlement, Bear Stearns settled a number of private class action lawsuits concerning similar allegations of late trading and market timing for $14 million, incurring $40 million in legal costs for defense of the SEC proceeding and the class action lawsuits. Bear Stearns then sought to recover from its insurers the $160 disgorgement payment (less a $10 million self-insured retention), the $14 million paid to settle the class actions and

the $40 million in defense costs. Id. After the insurers denied coverage, Bears Stearns filed an action for breach of contract and declaratory judgment in New York State Supreme Court. (The action was filed by J.P. Morgan, into which Bear Stearns merged in 2008. *J.P. Morgan Securities v. Vigilant Insurance*, No. 600979/09 (New York County)).

Public Policy Considerations

In the trial court, the defendant insurers moved to dismiss Bear Stearns' complaint on several grounds, including that public policy barred recovery of the disgorgement payment because an insured should not be allowed to obtain insurance coverage to recover its own ill-gotten gains. The trial court rejected the insurers' position, denying the motion to dismiss because the court could not determine, on the basis of a record limited to the SEC order, that the disgorgement payment was linked to funds improperly acquired by Bear Stearns.

The Appellate Division reversed, granting the insurers' motion to dismiss on the grounds that Bear Stearns could not recover the disgorgement payment as a matter of public policy. *J.P. Morgan Securities v. Vigilant Insurance*, 91 A.D.3d 226 (1st Dept. 2011). The First Department held that "disgorgement of ill-gotten gains or restitutionary damages does not constitute an insurable loss" because the "risk of being directed to return improperly acquired funds is not insurable." The court explained that "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." Id. at 230 (internal quotations omitted). Bear Stearns appealed.

> If under 'Kokesh', SEC disgorgement is now legally a "penalty," it would seem to provide the Bear Stearns insurers a fresh argument that the fines and penalties exclusion bars coverage for disgorgement.

On appeal, Bear Stearns did not contest the validity of this public policy principle. Rather, Bear Stearns argued that the majority of the so-called disgorgement payment—approximately $140 million—did not represent Bear Stearns' profits, but represented profits improperly earned by its fund customers. Bear Stearns argued that since it was not paying disgorgement of its own illicit profits, the public policy bar was inapplicable.

Court of Appeals Weighs In

In an opinion written by Judge Victoria A. Graffeo, the Court of Appeals agreed with Bear Stearns, finding this distinction to be significant. The court differentiated the cases cited by the insurers (and relied on by the First Department), holding that in those cases the SEC disgorgement payment was conclusively linked to "improperly acquired funds in the hands of the insured." Therefore, the court explained, the public policy rationale of preventing "the unjust enrichment of the insured by allowing it to, in effect, retain the ill-gotten gains by transferring the loss to its carrier" was directly implicated. *J.P. Morgan Securities*, 21 N.Y.3d at 336.

In Bear Stearns' case, on the other hand, the court found that on the record presented, it was unclear whether the $160 million payment was actually a disgorgement of Bear Stearns' own profits. The Court of Appeals stressed that, on a motion to dismiss, Bear Stearns' allegations must be accepted as true unless contradicted by the relevant documentary evidence. Judge Graffeo explained that the "SEC order recited that Bear Stearns' misconduct enabled its 'customers to generate hundreds of millions of dollars in profits.'" Therefore, since the relevant documentary evidence did not contradict Bear Stearns' contention that the SEC disgorgement payment was calculated "in large measure on the profits of others," the Court of Appeals reversed and reinstated the complaint. Id.

Trial Court Takes a Second Look

Back at the trial court, Bear Stearns moved for summary judgment, seeking dismissal of the insurers'

defenses, and argued that the disgorgement payments constituted an insurable loss under the policies because they were undisputedly payments made for the illicit gains of third parties, rather than profits obtained by Bear Stearns. In a decision issued on April 17, 2017, the trial court acknowledged that public policy would bar an insured from obtaining coverage for a settlement payment made for disgorgement if the disgorgement was for profits in the "hands of the insured." Citing to the prior Court of Appeals' decision, the court explained that "the return of improperly acquired funds does not constitute a 'loss' or 'damages' within the meaning of insurance policies." *J.P. Morgan Securities v. Vigilant Insurance*, 51 N.Y.S.3d 369, 373 (Sup. Ct. New York County 2017).

The court then looked to the evidence submitted to determine whether, in fact, the payment made by Bear Stearns to the SEC as "disgorgement" represented gains acquired by Bear Stearns or its customers. The court reviewed evidence offered by Bear Stearns, including documents submitted in response to the SEC investigation, testimony and notes of Bear Stearns' defense counsel and calculations of revenues presented to SEC staff. The insurers submitted no evidence in response, relying instead on the mere fact that the SEC order contained no language specifying the basis for the disgorgement payment. The court held that the lack of specific detail in the SEC order did not on its face preclude coverage and concluded instead that the "extensive evidence" submitted by Bear Stearns proved that $140 million of the disgorgement settlement payment represented gains acquired by Bears Stearns' customers and not by Bear Stearns itself. Accordingly, the court granted Bear Stearns' motion to dismiss the insurers' public policy defenses and, based on this and other grounds, denied the insurers' motions for summary judgment and awarded coverage. Id.

Looking Forward

In the Bear Stearns coverage action, in addition to the public policy arguments with respect to ill-gotten gains, the insurers raised defenses related to other public policies, to the reasonableness of settlement, and to various policy exclusions including the known wrongful acts exclusion and the personal profit exclusion. Notably, the fines and penalties exclusion was not at issue. In fact, Bear Stearns did not seek to recover the $90 million penalty, presumably because the insurance policies contained an explicit exclusion for "fines or penalties imposed by law." However, if under *Kokesh*, SEC disgorgement is now legally a "penalty," it would seem to provide the Bear Stearns insurers a fresh argument that the fines and penalties exclusion bars coverage for disgorgement. And, in fact, the day after the *Kokesh* decision was issued, insurers' counsel sought leave from the court to renew their motions to dismiss and for summary judgment on this very basis. The trial court initially suggested that this was an issue for the Court of Appeals. Nevertheless, the insurers filed the motion on the basis of *Kokesh* and Bear Stearns opposed it on the grounds that it is law of the case that the disgorgement at issue is insurable and that the disgorgement here was in fact compensatory and not intended to constitute a penalty. Regardless of how the trial court rules, absent a settlement, we expect this issue to make its way to the First Department and likely to the Court of Appeals as well.

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