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Expert Analysis

1st Dep't Relies on 'Kokesh' to Rule That SEC Disgorgement Is Barred From Coverage


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

In the summer of 2017, the U.S. Supreme Court held that an SEC claim seeking disgorgement of profits as a remedy in an enforcement action constitutes a penalty claim that is subject to a five-year statute of limitations. *Kokesh v. SEC*, 137 S.Ct. 1635 (2017). While the *Kokesh* ruling is not an insurance ruling, we wrote at the time (as did others) that it might very well have an impact on pending disputes over the insurability of disgorgement payments. The First Department took notice of the ruling and recently held, relying on *Kokesh*, that because SEC disgorgement constitutes a penalty, disgorged funds did not fall within the definition of loss under the insurance policies at issue. Consequently, in *J.P. Morgan Securities v. Vigilant Ins. Co.*, 166 A.D.3d 1 (1st Dep't Sept. 20, 2018), the First Department reversed the order of the trial court and granted summary judgment to the defendant insurers.

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The Bear Stearns Insurance Dispute

In prior columns, we have covered, in some detail, the long and winding dispute between Bear Stearns and its insurers over Bear Stearns' settlement of an SEC investigation concerning allegations that Bear Stearns knowingly facilitated late trading and deceptive marking timing activities for certain hedge fund customers, enabling those customers to earn hundreds of millions of dollars in profits at the expense of mutual fund shareholders. As part of that SEC settlement, Bear Stearns paid $160 million in disgorgement and then sought to recover $140 million of the disgorged funds from its insurers.

Under the insurance policies issued to Bear Stearns, "fines or penalties imposed by law" are expressly carved out of the definition of "Loss." In a prior ruling, the Court of Appeals distinguished between payments that represented disgorgement of Bear Stearns' own profits and payments that represented disgorgement of Bear Stearns' customers' profits. The Court of Appeals held that, to the extent that the settlement payment was a disgorgement of Bear Stearns' own profits, it would be considered a penalty and therefore

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could not be covered Loss. In contrast, the Court of Appeals left open the possibility that a payment that represented disgorgement of a third party's profits might not be considered a penalty and therefore could constitute Loss under the policies. In so holding, the Court of Appeals reversed an earlier ruling in which the First Department had held that public policy prohibited Bear Stearns from recovering the forfeiture payment from its insurers. *J.P. Morgan Securities v. Vigilant Ins. Co.*, 21 N.Y.3d. 324 (2013). The trial court followed the lead of the Court of Appeals and, on remand, found that Bear Stearns was entitled to coverage for the $140 million payment because disgorgement of customer profits was not a penalty.

Supreme Court's 'Kokesh' Ruling

In *Kokesh*, the question presented was whether an SEC disgorgement claim constituted a penalty claim governed by the five-year federal statute of limitations applicable to penalty claims. After a jury found that Kokesh violated federal securities laws, the district court entered a $34.9 million judgment which represented disgorgement of profits that Kokesh had misappropriated from four separate businesses. The district court found that, although a claim for civil penalties would have been barred by the five-year statute of limitations, the disgorgement claim was not barred because it was not a penalty claim. *Kokesh v. SEC*, 137 S.Ct. 1635 (2017).

The U.S. Court of Appeals for the Tenth Circuit affirmed but the U.S. Supreme Court reversed, finding that disgorgement is—by definition—a penalty. The Supreme Court explained 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." 137 S.Ct. at 1644. The court further explained that disgorged funds are not necessarily used to reimburse an injured party for its loss and that disgorgement judgments regularly reach beyond profits illegally earned by the wrongdoer to profits earned by third parties as a result of the wrongdoer's misconduct. Accordingly, the Supreme Court ruled that disgorgement is a penalty and a claim for disgorgement is consequently subject to the five-year statute of limitations.

> It would not be surprising for this dispute to return to the Court of Appeals for a second time so that the court can address the insurability of SEC disgorgement payments in the post-'Kokesh' world. In the interim, however, the First Department's ruling should guide policyholder expectations.

First Department Applies 'Kokesh'

Following the *Kokesh* ruling, the First Department addressed the insurers' appeal of the trial court order which had held that the Bear Stearns disgorgement payment is covered loss and ordered the insurers to pay $140 million plus prejudgment interest. The First Department expressly relied on *Kokesh* to reverse the trial court, ruling that the disgorgement payment is a penalty and therefore cannot be Loss within the policy definition. *J.P. Morgan v. Vigilant Ins. Co.*, 166 A.D.3d 1 (1st Dep't Sept. 20, 2018).

The First Department quoted the Supreme Court's *Kokesh* opinion to emphasize the rationale for determining that disgorgement constitutes a penalty: "SEC disgorgement (i) is imposed as a consequence for a wrong committed against the public, rather than a wrong against particular individuals; (ii) is meant to punish the violator and deter others from similar violations; and (iii) in many cases, does not compensate the victims of securities violations; rather the wrongdoer pays disgorged profits to the district court, which has discretion to determine how and to whom to distribute the money." *J.P. Morgan Securities v. Vigilant Ins. Co.*, 166

A.D.3d at 3 (quoting *Kokesh,* 137 S.Ct. at 1643-44).

Although the Supreme Court's ruling only addressed the statute of limitations question, the First Department determined that the court's rationale applies "with equal force" to the insurance dispute between Bear Stearns and its insurers because the court had held that disgorgement is a "punitive sanction intended to deter." As the First Department explained, "[t]o allow a wrongdoer to pass on its loss emanating from the disgorgement payment to the insurer, thereby shielding the wrongdoer from the consequences of its deliberate malfeasance, undermines this goal and 'violate[s] the fundamental principle that no one should be permitted to take advantage of his own wrong.'" Id. at 4.

Law of the Case Doctrine Inapplicable

Bear Stearns argued to the First Department that the law of the case doctrine prohibited reversal of the trial court because the Court of Appeals had already ruled that disgorgement of customer profits is recoverable under the insurance policies. The First Department rejected this argument on the grounds that the law of the case doctrine only applies "to legal determinations that were necessarily resolved on the merits in a prior decision." Id. at 8. According to the First Department, on the prior appeal, the Court of Appeals addressed whether public policy prohibited the recovery of the disgorgement payment from the insurers but did not focus on whether the disgorgement payment was within the definition of Loss. Thus, the controlling issue was not previously addressed on the merits by the Court of Appeals. Further, the First Department explained that the law of the case doctrine is not absolute and does not limit an "appellate court's power to reconsider issues where there are extraordinary circumstances, such as subsequent evidence affecting the prior determination or a change of law." Id. at 9. The court held that the U.S. Supreme Court's decision in *Kokesh* represented a change in law with regard to the characterization of disgorgement as a penalty. Consequently, the First Department held that the law of the case doctrine was inapplicable.

Looking Forward

Following the First Department ruling, Bear Stearns filed a motion to reargue or, in the alternative, leave to appeal to the Court of Appeals. In its motion papers, Bear Stearns argues that the First Department wrongly extended the *Kokesh* rationale beyond the statute of limitations question. The insurers, of course, disagreed and opposed the motion.

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