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Expert Analysis

2011 Wrap-Up: New Agency, Other Noteworthy Developments

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In the last few months, we have seen a number of developments, mostly in the courts, that may influence corporate insurance issues in 2012 and beyond. Our initial column of the year is devoted to a discussion of those developments. We start, however, not in the courts, but in government, with the creation of the New York State Department of Financial Services (DFS).

Newest Regulatory Agency

Governor Andrew M. Cuomo originally announced the plan to create the DFS in his 2011 State of the State address. On Oct. 3, 2011, New York's newest regulatory agency opened its doors. The DFS combines the functions and regulatory authority of the former New York State Insurance Department and the former New York State Banking Department into one agency. The merger of the Insurance and Banking departments is intended to modernize regulation of the financial services industry by establishing a single agency to regulate the entire range of financial services, to fill some perceived regulatory gaps and to create a more effective and efficient agency.[1]

The DFS is organized into five divisions: (1) the Insurance Division; (2) the Banking Division: (3) the Financial Frauds and Consumer Protection Division; (4) the Real Estate Finance Division; and (5) the Capital Markets Division. The Insurance Division will continue to perform the core regulatory functions regarding insurance activities in New York, including life, health and property and casualty insurance activities. The Banking Division will regulate state chartered banks as well as other financial service providers like mortgage loan servicers and originators, budget planners, check cashers and money transmitters.

The Financial Frauds and Consumer Protection Division is responsible for protecting and educating consumers and combating financial fraud. The Real Estate Finance Division will regulate all real estate and homeowner issues, including mortgage origination and servicing, title and mortgage insurance and foreclosure issues. Finally, the Capital Markets Division is responsible for monitoring the latest developments in the financial services marketplace.[2]

Mr. Cuomo appointed his former chief of staff, Benjamin M. Lawsky, as superintendent of the DFS. Perhaps it is appropriate that Mr. Lawsky is also a former prosecutor, as the superintendent has broad powers to regulate financial products and services and to protect the users of those products and services. These powers include, for example, investigating and preventing fraud and other criminal activity and coordinating with the Attorney General.[3] In fact, the Financial Frauds and Consumer Protection Division is expressly empowered to investigate suspected fraud or misconduct related to insurance or banking activities.[4]

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Nevertheless, while fighting insurance and banking fraud is undeniably an important function of the DFS, the DFS has also been charged with improving regulatory efficiency and effectiveness in order to encourage financial services firms to locate more jobs in New York and to improve responsiveness to both industry filings and consumer complaints.[5]

Claims Against Countrywide

Speaking of fraud allegations concerning banking and insurance, Justice Eileen Bransten recently issued two companion rulings that clarified the burden of proof with regard to fraud claims in cases brought by two bond insurers against Bank of America's Countrywide Financial Unit.

In separate actions filed in the Supreme Court, New York County, MBIA Insurance Corporation and Syncora Guarantee Inc. claimed that Countrywide fraudulently induced them to insure billions of dollars of mortgage-backed securities.[6] Both insurers moved for summary judgment seeking a declaration clarifying their burden of proof with regard to the fraud claims as well as other issues.

The bond insurers argued that, to succeed on their insurance fraud claims, they need only prove that Countrywide made material misrepresentations that, "had the insurer known of the true facts, would have led the insurer to either not issue the policy or to issue the policy on different terms."[7] Countrywide contended that the insurers must also prove that the claims payments made by the insurers were "directly and proximately caused" by the alleged misrepresentations, and "not by another cause, including the economic downturn that began in late 2007."[8]

Justice Bransten ruled in favor of the insurers, finding that, as a matter of law, the insurers need only prove that misrepresentations by Countrywide induced the insurers to issue policies on terms to which they would not otherwise have agreed. In so ruling, Justice Bransten stressed that, under New York law, the fraud occurs when the misrepresentation induces the action resulting in damages. Justice Bransten also held that the insurers would be required to show that Countrywide's misrepresentations were material to the decision to issue the policies. Under New York law, to do so, the insurers will need to show that they relied on the alleged misrepresentations "to take action which [they] might otherwise not have taken, or would have taken in a different manner."[9]

Bear Stearns Settlement

From fraud allegations, we move on to the Securities and Exchange Commission's investigation into alleged illegal late trading and market timing by units of Bear Stearns. To resolve the SEC's claims, in 2006, Bear Stearns agreed to a settlement in which, despite not admitting or denying the SEC's findings, Bear Stearns agreed to pay a total of $215 million, of which $160 million was labeled "disgorgement" and $90 million was characterized as a civil penalty. Following the settlement, Bear Stearns, since acquired by J.P. Morgan, sought to recover the $160 million disgorgement payment from its D&O insurers. The insurers declined, and Bear Stearns filed suit.

Although the Supreme Court, New York County, denied the insurers' motion to dismiss, in a decision issued on Dec. 13, 2011, the First Department reversed and dismissed Bear Stearns'

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case.[10] Justice Richard T. Andrias, writing for a unanimous panel, held that the disgorgement payment was uninsurable under New York law.

The insurance policies issued to Bear Stearns covered "Loss which the insured shall become legally obligated to pay as a result of any Claim… for any Wrongful Act." However, the definition of Loss did not include "matters which are uninsurable under the law pursuant to which this policy shall be construed." In addition, the policies excluded claims "based upon or arising out of the Insured gaining in fact any personal profit or advantage to which the Insured was not legally entitled."[11]

Justice Andrias, ruling for the insurers, held that the SEC order concerning the settlement was "not reasonably susceptible to any interpretation other than that Bear Stearns knowingly and intentionally facilitated illegal trading for preferred customers, and that the relief provisions of the SEC Order required disgorgement of funds gained through that illegal activity."[12] He further explained that disgorgement is an equitable remedy which forces the defendant to "give up the amount by which he is unjustly enriched" through securities law violations and that the risk of being directed to return such improperly required funds is not an insurable loss under New York law. In holding that Bear Stearns could not recover the disgorgement payment, Justice Andrias stressed the public policy considerations: "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…"[13]

Martin Act Ruling

From insurance coverage claims, we move on to trends related to underlying claims that may impact insurance issues. Our first stop, still in the securities law context, concerns the Martin Act's impact on the claims of injured investors. On Dec. 20, 2011, in the case of *Assured Guaranty v. J.P. Morgan*, the Court of Appeals held that the Martin Act does not preempt an injured investor's common law claims for breach of fiduciary duty and gross negligence.[14]

The Martin Act, New York State's "blue sky" law, authorizes the Attorney General to investigate and enjoin fraudulent practices in the marketing of securities. In contrast to a common law fraud claim, the Martin Act permits the Attorney General to prosecute securities law claims without requiring proof of scienter or intentional fraud.[15] However, the Martin Act does not create a private right of action for investors.

Over the years, a split developed within both the New York State and federal courts as to whether the Martin Act preempted investors' non-fraud common law claims. Courts that viewed the Martin Act as preemptive routinely dismissed investors' common law negligence and breach of fiduciary duty claims. In *Assured Guaranty*, the Court of Appeals resolved this split, finding that the Martin Act does not preempt non-fraud common law causes of action concerning securities law claims.

As a result of the Court of Appeals ruling, we can expect claimants to plead common law claims alongside their federal securities law claims. Since common law claims such as negligence and breach of fiduciary duty are typically covered under D&O insurance policies (subject, of course, to potential exclusions), the *Assured Guaranty* case may result in an increase in covered claims, or at minimum, an increase in covered defense costs associated with alleged securities law violations.

Increase in M&A Claims

For many years, the main threat of litigation faced by public companies was the threat of a federal securities class action lawsuit. However, there has recently been a dramatic increase in the number of lawsuits challenging mergers and acquisitions. The D&O Diary recently addressed this trend in a series of blog posts that discuss the increase as well as some of the implications for insurers and insureds.[16]

Like the common law securities claims that will be encouraged by the Martin Act ruling, the increase in merger and acquisition-related claims has and will continue to impact insurance companies and their insureds. Lawsuits challenging mergers and acquisitions typically include claims for breach of fiduciary duty against the directors and officers—just the type of claims that D&O insurance policies usually cover. But the merger and acquisition lawsuits raise other insurance issues that the courts are only just beginning to address. For example, disputes can arise over whether a judgment or settlement is really just an increase in consideration paid for the acquisition and whether that constitutes covered loss.

Since common law claims such as negligence and breach of fiduciary duty are typically covered under D&O insurance policies (subject, of course, to potential exclusions), the 'Assured Guaranty' case may result in an increase in covered claims, or at minimum, an increase in covered defense costs associated with alleged securities law violations.

In addition, while many of these cases will be resolved by modifications to disclosures or to other aspects of the transaction without any award of damages, plaintiffs' counsel is often entitled to a fee award. Whether that fee award is covered loss is an issue that carriers and the courts have only recently begun to address. For example, the First Department recently ruled that a fee award entered in connection with a derivative lawsuit was covered loss under a D&O policy.[17]

Lox & Bagels

Finally, what better way to wrap up the old year and start the new year than with lox and bagels from that venerable Upper West Side appetizing restaurant, Barney Greengrass. In fact, Barney Greengrass, known for its sturgeon, salmon and whitefish, prevailed last year in an insurance coverage dispute that arose out of alleged odors from the restaurant.[18]

The resident of a co-op apartment that sits above the restaurant complained that food odors from the restaurant underneath one of his windows had become so overpowering that he was unable to use his living room. The resident sued the co-op owners which triggered a series of lawsuits and ultimately a claim against Barney Greengrass, a subtenant. When the restaurant tendered the claim to its insurer, Lumbermens denied coverage, asserting that the claim was barred by the pollution exclusion.

The Southern District rejected Lumbermens' position, holding that "[t]o read 'pollution' as encompassing 'restaurant odors,' as defendant urges here, would contradict 'common speech' and the 'reasonable expectations of a business person,' who has come to understand standard pollution exclusions as addressing environmental-type harms."[19] In November, the U.S. Court of Appeals for the Second Circuit affirmed, agreeing that the restaurant odors at issue do not constitute the type of traditional environmental pollution to which the pollution exclusion applies.[20] Enjoy your lox and bagels, and have a happy new year.

1. New York State Department of Financial Services Working Group Report on Ways to Improve Efficiency and Effectiveness of Regulation, http://www.dfs.ny.gov/reportpub/dfsrpt_205a.pdf (Dec. 30, 2011).
2. Id.
3. FSL, Art. 2, §202.
4. FSL, Art. 4, §404(b).
5. FSL, Art. 1, §102.
6. *MBIA Insurance Corp. v. Countrywide Home Loans Inc. et al.*, Index No. 602825/08 (N.Y. County, Jan. 3, 2012); *Syncora Guarantee Inc. v. Countrywide Home Loans Inc. et al.*, Index No. 650042/09 (N.Y. County, Jan. 3, 2012).
7. *MBIA Insurance Corp. v. Countrywide Home Loans Inc. et al.*, Index No. 602825/08.
8. Id.
9. Id.
10. *J.P. Morgan Securities Inc., et al. v. Vigilant Insurance Co.*, Index No. 600979/09 (First Dept., Dec. 13, 2003).
11. Id.
12. Id.
13. Id.
14. *Assured Guaranty v. J.P. Morgan*, __N.E.2d__, 2011 WL 6338898 (Dec. 20, 2011).
15. Id.
16. http://www.dandodiary.com/; http://www.dandodiary.com/2012/01/articles/securities-litigation/an-early-look-at-cornerstone-researchs-analysis-of-current-marelated-litigation-trends/; http://www.dandodiary.com/2011/12/articles/securities-litigation/marelated-litigation-has-replaced-stock-drop-suits-as-plaintiffs-securities-lawyers-lawsuit-of-choice/; http://www.dandodiary.com/2011/11/articles/securities-litigation/why-marelated-litigation-is-a-serious-problem/.
17. *XL Specialty Insurance Co. v. Loral Space & Communication*, 82 A.D.3d 108, 918 N.Y.S.2d 57 (1st Dept. 2011).
18. *Barney Greengrass v. Lumbermens*, No. 10-3467-cv, 2011 WL 5248293 (2d Cir. Nov. 4, 2011).
19. *Barney Greengrass v. Lumbermens*, No. 09 Civ. 7697 (NRB), 2010 WL 3069560 at *7 (S.D.N.Y. July 27, 2010).
20. 2011 WL 5248293 at *3.

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