

CORPORATE INSURANCE LAW

Expert Analysis

Courts of Appeal Issue Rulings On D&O Insurance Disputes

We tend generally to think of insurance cases as state law cases, because contractual disputes are governed by state law. In truth, however, there are numerous federal court decisions that resolve insurance disputes by interpreting state law. Earlier this summer, the New York State Court of Appeals and the U.S. Court of Appeals for the Second Circuit each issued equally important rulings in cases concerning claims submitted under directors and officers (D&O) insurance policies.

In the first case, *J.P. Morgan Securities v. Vigilant Insurance*,¹ the state Court of Appeals addressed coverage questions concerning an insured's claim for recovery of disgorgement payments made as part of an SEC settlement. In the second case, *Ali v. Federal Insurance*,² the Second Circuit addressed the issue of whether underlying layers of insurance must be exhausted by actual payment as a condition to triggering excess insurance. Both of these cases established precedent but, because of the facts presented and the nature of the rulings, also raised issues likely to be litigated in subsequent cases.

'Disgorgement' Claim

In *J.P. Morgan Securities*, 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. While the Court of Appeals denied the insurers' motion to dismiss, leaving open the possibility that the payment might be insurable, upon careful examination, the decision appears to turn on the question of whether the settlement payment was or was not actually a disgorgement of the insured's profits.

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



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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 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 issued an order memorializing the settlement, making certain findings and imposing remedial sanctions.

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 indemnity from its insurers for the \$160 million 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. Bear Stearns did not seek to recover the \$90 million penalty.³

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. 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 motion to dismiss on the grounds that Bear Stearns could not

recover the disgorgement payment as a matter of public policy.

On appeal, the Court of Appeals identified two scenarios in which public policy precludes recovery under an insurance contract. First, New York courts have recognized that an insurance policy clause purporting to provide coverage for punitive damages is unenforceable. Public policy bars such recovery because it would defeat the purpose of punitive damages, which is to punish and deter. Second, public policy bars recovery under an insurance policy where the insured engages in conduct with an intent to injure. As the Court of Appeals noted, however, this is a narrowly construed public policy exception which only applies where the insured not only acted intentionally, but with the intent to harm others. The Bear Stearns claim did not fall within the scope of either of these scenarios.

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The insurers argued that Bear Stearns' claim was barred by a separate public policy principle, which prohibits an insured from receiving indemnification for loss of its own illegally obtained profits. The rationale for this public policy argument is that it prevents the unjust enrichment that would occur if the insured were permitted to shift liability for its illegal profits on to its insurer. In fact, Bear Stearns did not contest the validity of this public policy principle. Rather, it 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. In effect, Bear Stearns argued that since it was not paying disgorgement of its own illicit profits, the public policy bar was inapplicable.

In an opinion written by Judge Victoria A. Graffeo, the Court of Appeals agreed with Bear Stearns, finding that on the record presented, it was unclear whether the \$160 million payment

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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. 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 denied the insurers' motion to dismiss.⁴

Triggering Excess Limits

In *Ali v. Federal Insurance*,⁵ the Second Circuit was presented with a dispute over whether underlying insurance limits must be exhausted by payment in order to trigger excess insurance. In addressing this issue, the Second Circuit also had the opportunity to review the longstanding precedent established by its 1928 decision in *Zeig v. Massachusetts Bonding & Insurance*.⁶

In two columns published in 2011, we covered what appeared to be the eroding vitality of *Zeig*.⁷ We also discussed the emergence of limits shaving endorsements, which resolve many exhaustion disputes by expressly providing that excess insurance is triggered whether underlying limits are exhausted through payments by the underlying insurers or through payments made by or on behalf of the insured. However, cases like *Ali* remain important because not all policies have limits shaving endorsements and also because such endorsements may not resolve every dispute over exhaustion of underlying limits.

Commodore Computer Case

In *Ali*, the Second Circuit considered an appeal by the directors and officers of the defunct Commodore International computer company, makers of the Commodore 64 computer. In connection with Commodore's bankruptcy proceeding, claimants filed claims seeking millions of dollars in damages from the individual directors and officers. The directors and officers in turn sought coverage from Commodore's insurers.

Commodore had maintained a tower of insurance with policy limits in excess of \$50 million. Unfortunately, Reliance and Home Insurance, the insurers that issued excess coverage to Commodore at the first, third and fourth layers, had become insolvent in 2001 and 2003.

In anticipation of disputes over insurance claims, including claims for millions of dollars in defense costs, the Commodore directors and officers and the insurers sparred over the excess insurers' obligations. The excess insurers sought an order declaring that they are not required to drop down to cover liability that would have otherwise been covered by the insolvent insurers. In turn, the directors and officers sought a declaratory judgment ordering that the excess insurers' "coverage obligations are triggered once the total amount of [the directors'] defense and/

or indemnity obligations exceeds the limits of any insurance policies underlying their respective policies, regardless of whether such amounts have actually been paid by those underlying insurance companies."⁸

The Southern District denied the directors' and officers' motion for partial summary judgment, holding that, according to the policy terms, the excess policies were not triggered until the underlying insurance is exhausted "solely as a result of payment of losses thereunder..." Consequently, Judge Richard J. Sullivan ruled that the excess coverage is not triggered merely by the aggregation of covered losses, but rather only after there is actual payment of the underlying losses.⁹

In 'Ali,' the Second Circuit approved of the district court's ruling and affirmed, firmly establishing that payment of the underlying limits is a condition to trigger of excess insurance but leaving for another day the issue of whether those payments, even in the absence of a limits shaving endorsement, can be made by the insured.

The Second Circuit agreed with Sullivan, explaining, in a decision authored by Judge Jose' A. Cabranes, that the excess policies at issue expressly state that they are triggered only by "payment" and not merely by aggregation of covered loss. However, in an interesting act of restraint, the Second Circuit refrained from deciding whether the payment of underlying loss must be made by the underlying insurer, or whether excess insurance could also be triggered by the payment of loss by the insured. Instead, the Second Circuit emphasized that the Southern District had not ruled that "the underlying insurers must make payments before the obligations under the relevant excess policies are triggered," but rather had "described the exhaustion requirement in the passive voice and did not specify which party was obligated to make the requisite payment."¹⁰

The Second Circuit approved of the district court's ruling and affirmed, firmly establishing that payment of the underlying limits is a condition to trigger of excess insurance but leaving for another day the issue of whether those payments, even in the absence of a limits shaving endorsement, can be made by the insured. The Second Circuit also left for another day a final determination as to the continuing vitality of *Zeig*. Instead, the Second Circuit merely rejected the directors' and officers' reliance on *Zeig*, distinguishing it on the grounds that it concerned first-party property insurance as opposed to excess liability insurance and on

the fact that it addressed an insured's settlement of undisputed property loss that had exceeded the underlying limits.

Looking Forward

In the two cases discussed above, the courts of appeal addressed important issues in the D&O insurance area. However, the unresolved issues in each of these decisions will likely lead to additional litigation.

Following *J.P. Morgan Securities*, we can expect additional disputes over whether an insured can be entitled to coverage for disgorgement of illegally obtained profits. While the Court of Appeals' decision appears to rest on the determination that, at least based on the SEC order, it was not clear that what was labeled a disgorgement payment actually represented illegal profits earned by the insured, an aggressive insured may try to gloss over that potentially inconvenient factor. At minimum, we can expect insureds to champion a broad interpretation of the ruling to support an argument that particular payments are not uninsurable due to public policy because they do not actually represent disgorgement of the insured's profits.

In *Ali*, the Second Circuit made clear that the amount of covered loss, in and of itself, does not trigger excess insurance policies which specifically require exhaustion of underlying limits by payment. Neither the Second Circuit nor the Southern District, however, addressed whether the underlying limits must be paid by the underlying insurers, or whether payments by the insured will suffice. While in the current market, this issue is specifically addressed in policies that contain limits shaving endorsements, it remains a contested issue under many policies issued before the advent of such endorsements. Consequently, we can expect additional litigation over the issue of whether an insured's payment of covered loss in an amount equal to the underlying limits is sufficient to trigger excess insurance.

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1. *J.P. Morgan Securities v. Vigilant Insurance*, ___N.E.2d___, 2013 WL 2475864, 2013 N.Y. Slip Op. 04272 (June 11, 2013)

2. *Ali v. Federal Insurance*, 719 F.3d 83 (2d Cir. 2013).

3. *Id.*

4. *Id.*

5. *Ali*, 719 F.3d 83.

6. *Zeig v. Massachusetts Bonding & Ins.*, F.2d 665 (2d Cir. 1928).

7. "New York Courts May Be Wavering on 'Zeig,'" NYLJ, Volume 246-No. 110 (Dec. 8, 2011); "Zeig Still Governs Exhaustion of Underlying Policy Limits in New York," NYLJ, Volume 245-No. 125 (June 30, 2011).

8. *Ali*, 719 F.3d at 87.

9. *Id.*

10. *Id.*

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