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Expert Analysis

Return to the Bear Stearns' D&O Insurance Dispute

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In 2003, the Securities and Exchange Commission and other regulatory agencies commenced an investigation into allegations that Bear Stearns had facilitated late-trading and deceptive market timing practices for customers purchasing and selling shares of mutual funds. The investigation primarily concerned Bear Stearns & Co., Inc.'s activities as a broker-dealer and Bear Stearns Securities Corp.'s activities as a clearing firm and focused predominantly on the trades of Bear Stearns' large hedge fund customers.

Bear Stearns denied the allegations contending, in summary, that it did not knowingly violate any law; its management did not facilitate late trading or market timing transactions; as a clearing broker, it merely processed transactions initiated by others; and it did not share in the profits from the late trading, from which it received only $16.9 million in commissions.

Despite its denials, Bear Stearns ultimately entered into a settlement agreement with the SEC in which it agreed to pay $160 million as "disgorgement" and $90 million as a civil penalty. Bear Stearns also entered into a related stipulation with the New York Stock Exchange. 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."[1] In addition to the SEC order, Bear Stearns settled certain related private lawsuits for $14 million, incurring a total of $40 million in legal fees and costs to defend the SEC proceedings and the private lawsuits.

Bear Stearns sought indemnification from its primary insurer, Vigilant Insurance, and six excess insurers for (i) the $160 million "disgorgement" payment; (ii) the $40 million in legal defense fees; and (iii) the $14 million paid to settle the private lawsuits. Bear Stearns did not seek coverage for the $90 million penalty paid to settle the SEC proceedings. After the insurers denied coverage, Bear Stearns filed an action for breach of contract and declaratory judgment in New York State Supreme Court.[2]

The insurance dispute remains pending, but it has already yielded five motion rulings in just over four years—two from the trial court, two from the Appellate Division, including the most recent one, handed down on Jan. 15, 2015, and one from the Court of Appeals, which we addressed in our October 2013 Corporate Insurance Law column.[3]

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These rulings set forth the most recent judicial discussion of New York insurance law regarding (i) disgorgement; (ii) public policy; and (iii) final adjudication requirements. However, even after five opinions, there remain open issues that are the subject of continuing litigation in the trial court.

Bear Stearns I

The defendant insurers initially moved to dismiss Bear Stearns' complaint on several grounds, including that public policy precluded recovery of the disgorgement payment.[4] In the trial court, the insurers' motion to dismiss was denied by Justice Charles E. Ramos. Ramos did not disagree with the insurers' contention that "the risk of being directed to return improperly acquired funds is not insurable." Rather, the court denied the motion because the SEC order does not "conclusively link the disgorgement to improperly acquired funds."

While the SEC order detailed improper trading practices and how they benefitted Bear Stearns' customers, according to Ramos, the order contained no direct findings as to how the practices directly generated profits for Bear Stearns. In fact, Bear Stearns argued that the majority of the $160 million so-called disgorgement payment—approximately $140 million—represented profits earned by its customers. Since it was not repaying its own illicit profits, but those of its customers, Bear Stearns argued that the payment could not be considered uninsurable disgorgement.[5]

The insurers appealed the denial of their motion to dismiss to the Appellate Division and found a more receptive audience. The First Department, in a decision authored by Justice Richard T. Andrias, focused on the detailed findings of the SEC order, which explained how Bear Stearns operated its late trading and market timing scheme "in direct disregard of demands by mutual funds that Bear Stearns stop" these practices and in violation of SEC rules and statutes.

The First Department emphasized that "Bear Stearns knowingly and affirmatively facilitated an illegal scheme which generated hundreds of millions of dollars for collaborating parties and agreed to disgorge $160 million in its offer of settlement." According to the First Department, "the 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." Accordingly, the First Department reversed the trial court and dismissed Bear Stearns' complaint on the grounds that the disgorgement payment was not insurable.[6]

Bear Stearns then took the matter up to the Court of Appeals. In an opinion authored by Judge Victoria A. Graffeo, the Court of Appeals reversed the order of the First Department and reinstated Bear Stearns' complaint, based in part on the reasoning of the trial court and in part on a discussion of public policy.

The Court of Appeals explained that New York has recognized two situations where public policy will override the freedom to contract for insurance. First, New York courts have held that

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public policy prohibits an insurance policy from providing coverage for punitive damages, because that would defeat the purpose of punitive damages, which is to punish and deter. Second, an insurance policy may not provide coverage where the insured engages in conduct with an intent to injure.

While the insurers contended that the SEC order amply demonstrated that Bear Stearns had acted with the intent to injure, the Court of Appeals disagreed, explaining that "the public policy exception for intentionally harmful conduct is a narrow one, under which it must be established not only that the insured acted intentionally but, further, that it acted with the intent to harm or injure others." The court determined that on the limited motion record, the insurers had failed to demonstrate that Bear Stearns had acted with that requisite intent to cause harm.[7]

The insurers also argued that Bear Stearns' claim was barred by a separate public policy principle, which prohibits indemnification for loss of an insured's own illegally obtained profits. According to the insurers, this public policy prevents the unjust enrichment that would occur if an insured could shift liability for its illegal profits to its insurer. Bear Stearns argued, however, as it did to the trial court, that the bulk of the so-called disgorgement payment represented the profits of its third-party hedge fund customers. Consequently, Bear Stearns contended that the payment was not a disgorgement payment and that therefore the insurers' public policy argument was misplaced.

The court agreed with Bear Stearns, finding that on the record presented, it could not determine that the payment at issue was a disgorgement payment, and therefore the insurers' motion to dismiss should have been denied.[8]

Bear Stearns II

While the appeals relating to the insurers' motion to dismiss in Bear Stearns I were pending, Bear Stearns filed a motion for summary judgment in the trial court seeking dismissal of certain affirmative defenses, including defenses based on the dishonest acts exclusion and on the public policy prohibiting coverage for intentional harmful conduct. The insurers moved for partial summary judgment based on the dishonest acts exclusion.

The policies' exclusion bars coverage for claims arising out of "any deliberate, dishonest, fraudulent or criminal act or omission." However, the exclusion is only applicable if a "judgment or other final adjudication thereof adverse to such insured(s) shall establish that such insured(s) were guilty of any deliberate, dishonest, fraudulent or criminal act or omission."[9]

The trial court denied the insurers' motion for partial summary judgment and granted Bear Stearns' motion with regard to the dishonest acts exclusion and the public policy defense. Although the SEC order contains factual findings describing Bear Stearns' illegal late trading and market timing scheme, the order was the product of a settlement between the SEC and Bear Stearns. The trial court noted that the findings were not the subject of a hearing or rulings by a trier of fact, the findings were neither admitted nor denied by Bear Stearns and Bear Stearns expressly reserved the right to take contrary legal and factual positions in other proceedings in which the SEC was not a party. Consequently, Justice Ramos ruled that the SEC order did not constitute a judgment or final adjudication sufficient to meet the requirements of the dishonest acts exclusion.

Based on largely the same rationale, the trial court also rejected the insurers' position that the SEC order conclusively demonstrates that Bear Stearns acted with the intent to injure. The trial court pointed to the final adjudication requirement of the dishonest acts exclusion, holding that in the absence of such a final adjudication, the court cannot rely on the findings of the SEC order to establish the requisite intentional conduct. Ramos did indicate that the case would continue, consistent with the Court of Appeals' direction, in order to assess whether there is evidence that establishes that Bear Stearns did, in fact, act with the requisite intent to cause harm and whether the so-called disgorgement payment is linked to funds improperly acquired by Bear Stearns.[10]

Despite the breadth of these rulings, it appears that this dispute is far from over. We can expect the insurers to seek Court of Appeals' review of the dismissal of their affirmative defense based on the dishonest acts exclusion.

The insurers filed an appeal, again seeking a more receptive audience in the Appellate Division. This time, the First Department issued what could be described as a split decision, reversing only part of the trial court's order. In an opinion authored by Justice Angela M. Mazzarelli, the First Department affirmed the trial court's ruling that the dishonest acts exclusion did not apply. In so ruling, the First Department emphasized that, even if the SEC order could be considered an adjudication, the exclusion requires that the adjudication "establish that such Insured(s) were guilty" of dishonest or criminal conduct.

The First Department explained that the SEC order fails to meet this requirement: "It can hardly be said that the SEC order and the NYSE stipulation put Bear Stearns's guilt 'beyond doubt,' when those very same documents expressly provided that Bear Stearns did not admit guilt, and reserved the right to profess its innocence in unrelated proceedings."[11]

The First Department differed with Justice Ramos with regard to the public policy issues, finding that the trial court should not have dismissed the insurers' public policy defense and reversing the trial court's ruling on that issue. The First Department held that, even though the SEC order did not constitute a final adjudication and therefore could not support the application of the dishonest acts exclusion, the court can still consider the findings of the SEC order in assessing whether or not the settlement payment constituted disgorgement for purposes of addressing the insurers' public policy defense: "[w]e do not find it contradictory to rely on a settlement agreement for the limited purpose of establishing whether a payment constituted disgorgement, even if the insured did not admit guilt, but not for the purpose of determining whether the agreement was an adjudication that established guilt for the purpose of satisfying the exclusion."[12]

As a result, the First Department affirmed the trial court's dismissal of the insurers' defense based on the dishonest acts exclusion, but reversed the ruling to the extent that it had dismissed the insurers' public policy defense.

Looking Forward

Despite the breadth of these rulings, it appears that this dispute is far from over. We can expect the insurers to seek Court of Appeals' review of the dismissal of their affirmative defense based on the dishonest acts exclusion. Regardless of the insurers' success on such an appeal, absent settlement, the case will continue in the trial court with regard to the issue of whether Bear Stearns acted with intent to injure and whether the $160 million settlement payment should be deemed to be uninsurable disgorgement.

1. *J.P. Morgan v. Vigilant Insurance*, 21 N.Y.3d 324, 970 N.Y.S.2d 733 (2013).
2. The action was filed by J. P. Morgan, into which Bear Stearns merged in 2008. *J.P. Morgan v. Vigilant Insurance*, No. 600979/09 (New York County).
3. "Courts of Appeal Issue Rulings on D&O Insurance Disputes," NYLJ, Vol. 250-No. 66 (Oct. 2, 2013).
4. "Disgorgement is an equitable remedy aimed at 'forcing a defendant to give up the amount by which he was unjustly enriched' through a violation of the federal securities laws." *J.P. Morgan v. Vigilant Insurance*, 91 A.D.2d 226, 936 N.Y.S.2d 102 (1st Dept. Dec. 13, 2011).
5. *J.P. Morgan v. Vigilant Insurance*, 2010 WL 9502067 (New York County Sept. 13, 2010).
6. *J.P. Morgan v. Vigilant Insurance*, 91 A.D.2d 226, 936 N.Y.S.2d 102 (Ist Dept. Dec. 13, 2011).
7. *J.P. Morgan v. Vigilant Insurance*, 21 N.Y.3d 324, 970 N.Y.S.2d 733 (2013).
8. Id.
9. *J.P. Morgan v. Vigilant Insurance*, 42 Misc.3d 1230(A), 2014 WL 804129 (New York County Feb. 28, 2014).
10. Id.
11. *J.P. Morgan v. Vigilant Insurance*, 2015 WL 175512 (1st Dept. Jan. 15, 2015).
12. Id.

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