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J.P. MORGAN SECURITIES: ILL-GOTTEN PROFITS ARE NOT A PREREQUISITE FOR DISGORGEMENT

Angelo G. Savino • 212.908.1248 • *asavino@cozen.com*
Aaron Tilley • 212.453.3848 • *atilley@cozen.com*

On December 13, 2011, the New York Appellate Division, First Department, issued a decision in *J.P. Morgan Securities Inc. v. Vigilant Insurance Co.*, Index No. 600979/09 (N.Y.A.D. 1st Dep't Dec. 13, 2011), that significantly adds to the jurisprudence regarding what constitutes disgorgement that is uninsurable under a directors and officers liability policy.

In 2006 the SEC accused Bear Stearns & Co., Inc. (Bear Stearns) of facilitating illegal late trading and market timing mutual fund trades for preferred customers between 1999 and September 2003 and sought sanctions of $720 million. Bear Stearns contended that its activities generated only $16.9 million in revenues for itself. The parties entered into a settlement agreement obligating Bear Stearns to pay disgorgement in the total amount of $160 million and civil monetary penalties in the amount of $90 million. Bear Stearns neither admitted nor denied the SEC's allegations. The New York Stock Exchange (NYSE) also issued an exchange hearing panel decision identical to the SEC order.

In a subsequent declaratory judgment action filed in the New York Supreme Court, New York County, plaintiff[1] demanded that its D&O insurers cover the portion of the disgorgement payment that exceeded the $10 million retention, or $150 million. The insurers moved to dismiss citing New York law deeming "disgorgement" uninsurable. Rejecting these arguments, the lower court held an insured's settlement or consent to entry of an SEC order, in which it does not admit guilt, will not preclude it from disputing those findings when seeking coverage from insurers, particularly when that settlement does not explicitly find direct profits flowing to the settling party.

The First Department disagreed. It concluded that Bear Stearns' offer of settlement, the SEC order, the NYSE order, and related documents are not susceptible to any interpretation other than that Bear Stearns knowingly and intentionally facilitated illegal late trading for preferred customers, and that the SEC order required disgorgement of funds gained through the illegal activity. The court, therefore, held that disgorgement may be found as a matter of law when settlement funds are identified as "disgorgement," the facts establish that those amounts arose from an illegal enterprise, and the amounts paid constitute a reasonable approximation of the total profits from that enterprise. It is not necessary that the individual party profit directly to the full extent of the amount disgorged.

Failure by the SEC to itemize damages did not mean those amounts were presumed to be compensatory. Instead, disgorgement calculations require only a reasonable approximation of profits causally connected to the violation. Moreover, collaborating, or closely related, parties may be subject to joint and several liability for the violations. The First Department noted that, in addition to generating $16.9 million in revenues for itself, Bear Stearns knowingly facilitated an illegal scheme that generated hundreds of millions of dollars for collaborating parties. Thus, Bear Stearns could be required to disgorge amounts by which other participants in the enterprise profited.

The court also observed that placement of the total $250 million payment into an SEC Fair Fund for distribution to victims of the scheme did not alter the nature of the $160 million as disgorgement. As the court explained, "[t]his is because 'once the primary purpose of disgorgement has been served by depriving the wrongdoer of illegal profits, the equitable result is to return the money to the victims of

[1] J.P. Morgan Chase purchased Bear Stearns in 2008.

the violations.'"

The *J.P. Morgan* decision is another in a long line of decisions from around the country holding that disgorgement is not an insurable loss under a professional liability insurance policy. Beyond that, however, the decision is noteworthy for rejecting Bear Stearns' argument that its payment was compensatory in nature rather than disgorgement because the alleged gain from the scheme accrued not to itself but to third parties. Similar arguments are frequently made in other contexts such as by director defendants in Section 11 claims or in M&A "bump up" claims, asserting that any gain accrued to the corporate defendant and, therefore, payments on behalf of the directors are not disgorgement or restitution. *J.P. Morgan* now provides solid legal reasoning with which insurers may contest such arguments.

To discuss any questions you may have regarding the issues discussed in this alert, or how they may apply to your particular circumstances, please contact Angelo G. Savino at 212.908.1248 or asavino@cozen.com or Aaron Tilley at 212.453.3848 or atilley@cozen.com.

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