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Practice Group(s):
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The New York Court of Appeals' *Vigilant* Decision: A Welcome Return to Enforcing Insurance Contracts as Written

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In a much-anticipated decision, New York's highest court, the New York Court of Appeals, on June 11, 2013, unanimously rejected a group of insurers' attempt to invoke purported "public policy" considerations to avoid covering a settlement between a former broker-dealer and clearing firm and the Securities and Exchange Commission ("SEC"). The opinion in *J.P. Morgan Securities Inc. v. Vigilant Insurance Co.,* No. 113 (N.Y. Ct. App. June 11, 2013), is welcome news for policyholders forced to deal with the insurance industry's increasingly aggressive assertions of purported "public policy" principles to disavow obligations imposed under insurance contracts, especially when seeking coverage for "disgorgement" claims asserted by government authorities and private parties.

BACKGROUND

The underlying claims giving rise to the coverage dispute involved allegations that a former broker-dealer and clearing firm (the "Insureds") improperly facilitated "late trading" and "market timing" on behalf of certain of their customers. The SEC's investigation into these matters was resolved through an Order pursuant to which the Insureds agreed to

- pay $90 million as a civil penalty; and
- pay $160 million as "disgorgement."

The $250 million settlement was deposited into a fund to compensate mutual fund investors that had suffered losses. The Insureds also agreed not to seek any recovery from third parties for the $90 million civil penalty.

After their insurers denied coverage, the Insureds initiated a coverage action seeking, among other things, recovery of the $160 million payment (but not the civil penalty). At the trial court, the insurers moved for dismissal on the basis, among other things, that the $160 million payment was a form of "disgorgement" representing return of moneys wrongfully obtained and thus did not constitute insurable loss as a matter of public policy. While the trial court ruled against the insurers, on appeal, the Appellate Division reversed, holding that, as a matter of public policy, the Insureds could not recover the $160 million "disgorgement" payment to the SEC.

THE COURT OF APPEALS' DECISION

In reversing the Appellate Division's decision and reinstating the Insureds' coverage action, the Court of Appeals carefully considered the insurers' arguments and legal authorities purportedly showing that disgorgement payments to the SEC and others are not "loss" within the meaning of the insurers' policies and that covering such a payment would be a violation of public policy. Rejecting the insurers' position, the Court recognized the necessity of considering the actual circumstances presented by the claim for coverage, not merely labels such as disgorgement.

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In that regard, the Court noted that the Insureds contended -- and the Order either supported or did not contradict such contentions -- that it was the Insureds' hedge fund customers, not the Insureds themselves, that received the "gains" from the late trading and market timing transactions, that the Insureds' did not retain any such profits, that the Insureds' commissions from the offending trades were a small fraction of the profits and the "disgorgement" payment, and that the Insureds actions were not intended to cause harm to the potential claimants. Without deciding any factual issues, the Court of Appeals had little difficulty in determining that the insurers' public policy/disgorgement defense did not support a dismissal of the Insureds' coverage claim, notwithstanding the "disgorgement" label. Accordingly, for purposes of the motion to dismiss, the Court noted that the payments fell within the insurance contracts' definition of "loss" and that the public policy prohibitions were narrow and inapplicable. Slip op. at 9-14.

CONCLUSION

The Court of Appeals' decision is a very important and favorable decision for policyholders seeking to recover payments labeled as "disgorgement" in settlements with the SEC, at least, or especially, where the settling insured itself did not receive the benefit of the sums "disgorged." Nevertheless, the decision's true significance may well be far broader. For, by looking beyond the superficial label assigned to a form of relief (disgorgement), by parsing the alleged "public policy" prohibitions on insuring loss and by carefully analyzing circumstances of the particular claim -- including the question whether the insured itself received the economic benefit of the sums disgorged -- the Court reaffirmed the traditional and appropriate approach of courts, which rejects insurer attempts to override contractual provisions through overly broad statements of extra-contractual "public policy."

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