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The Catch with Kokesh: Insurers Refusing to Cover Disgorgement to SEC

In the wake of the Supreme Court's unanimous decision in *Kokesh v. SEC*, which defined disgorgement as a penalty subject to the five-year statute of limitations, we observed that the decision was likely to have far-reaching implications beyond the potential disgorgement recovery period and associated effect on the Securities and Exchange Commission's ("SEC" or "Commission") investigation timelines.¹ Among other questions, we noted that because Commission settlements have generally prohibited defendants from seeking or accepting reimbursement or indemnification for "penalties," while not including similar prohibitions for disgorgement, *Kokesh* raised whether "defendants and respondents [can] still seek indemnification or insurance coverage for disgorgement and pre-judgment interest?"² Indeed, within days after the *Kokesh* decision, counsel for insurance companies asked to renew a motion to dismiss and argued that they were not required to indemnify Bear, Stearns & Co., Inc. ("Bear Stearns") for disgorgement payments in a long-running dispute regarding a Commission settlement.³

On September 20, 2018, a panel of the New York Appellate Division's First Department reversed a lower court decision and held that in light of *Kokesh*, J.P. Morgan and Bear Stearns' insurers were not required to cover \$140 million disgorgement related to the illicit gains of Bear Stearns' customers that the firm paid in 2006 to settle SEC charges of "late trading" and "market timing."⁴ The policies in question excluded "fines or penalties imposed by law" from the definition of a covered "loss." The panel found that because *Kokesh* had determined that disgorgement paid to the SEC is a "penalty" regardless of whether the funds are linked to the wrongdoer's illicit gains or the illicit gains of third parties, the disgorgement paid by Bear Stearns was not covered.⁵

While the *J.P. Morgan* decision will not be the final word on the insurability of disgorgement, the policy language at issue is commonplace and insurers certainly will cite the case to support denials of coverage. Additionally, courts in a number of states have held that fines and penalties



are not insurable as a matter of public policy.⁶ It remains to be seen whether parties facing SEC investigations will be more reluctant to settle if they are unable to obtain coverage for amounts they would be required to pay in disgorgement. It also remains to be seen whether insurance providers, in an effort to gain a competitive market advantage, will revise their forms and/or offer endorsements specifically agreeing to cover disgorgement wherever permissible under the law.

NEW NAME, SAME POLICY: FROM BEAR STEARNS' TO J.P. MORGAN

The First Department's decision is the latest chapter in a lengthy legal battle between J.P. Morgan and the defendant insurance companies.⁷ In March 2006, Bear Stearns entered into a settlement with the Commission for \$250 million to resolve charges that Bear Stearns facilitated "late trading" and deceptive "market timing" by certain hedge fund customers, who allegedly earned hundreds of millions of dollars at the expense of mutual fund shareholders. The "no admit, no deny" settlement included \$160 million in disgorgement, \$140 million of which was attributable to the hedge funds' profits, rather than Bear Stearns' own gains.⁸ Vigilant Insurance Company and the other defendants refused to indemnify Bear Stearns. J.P. Morgan instituted the coverage action against the defendant insurers after it acquired Bear Stearns in 2008.

A lengthy cycle of appeals began after Justice Ramos at the New York Supreme Court for New York County, Manhattan, refused to dismiss the claims against the insurers on the grounds that the court could not conclude, based on the SEC's order, that disgorgement was specifically linked to improperly acquired funds and that no public policy reason mandated dismissal.⁹ On appeal in 2011, a First Department panel reversed that decision and dismissed the case, ruling that public policy barred Bear Stearns from receiving insurance coverage for any of the \$160 million disgorgement payment.¹⁰ That decision was then appealed and the Court of Appeals reversed and reinstated the complaint in 2013.

The Court of Appeals noted that the defendant insurers did not establish that Bear Stearns' disgorgement-related losses were barred from insurance coverage under their policies. In doing so, the Court of Appeals noted that, although other courts have found the risk of being forced to disgorge "ill-gotten gains" uninsurable "as a matter of contract interpretation or public policy," the evidence did not decisively show that the Commission's disgorgement calculation was based on Bear Stearns' own profits, which would fall outside of the policies' definition of covered "loss," rather than third party profits, which would fall within the policies' definition of covered "loss." For this same reason, the court rejected the insurer's arguments that the policies' personal profit exclusion barred coverage. Finally, the Court explained that the insurers did not meet the standard to invoke either "public policy exception" they cited. The Court rejected the first exception, that coverage is barred when an insured acts with "intent to cause injury," because the record did not conclusively show that Bear Stearns had this intent. The Court also rejected the second exception, which prohibits indemnification of an insured's illicit gains.

Following the Court of Appeals' decision, Judge Ramos granted the plaintiffs' motion for summary judgment and ordered the insurers to indemnify Bear Stearns for the \$140 million in disgorgement it paid based on the hedge funds' gains.¹¹ Judge Ramos' rationale rested on five key findings. First, based on the policy's broad definition, the \$140 million disgorgement payment constituted a covered "loss" because it represented third-party gain. Second, the public policy exception for loss arising out of intentionally harmful conduct did not bar coverage because there was no evidence that Bear Stearns intended to cause injury to mutual fund investors. Third, the personal profit exclusion did not bar coverage because it applied to claims based on or arising out of the insured gaining personal profit or advantage. But here, third parties realized profits while Bear Stearns did not receive any additional compensation for its late trading and market timing transactions beyond what it would have for other mutual fund trades. Fourth, the prior knowledge exclusion did not bar coverage because, when construing the policy's ambiguity in favor of the insured, the term "officer" was limited to employees who had important executive and managerial duties, and not anyone whose job title included the term "officer." And fifth, the \$140 million settlement was reasonable in view of Bear Stearns' exposure and the probability that



the Commission would prove its claims.

After *Kokesh* was decided on June 5, 2017, however, the Bear Stearns' insurers asked the Supreme Court for leave to renew their previous motion to dismiss on the grounds that the New York Court of Appeals had previously held in this action that penalties were not insurable under New York law.¹² Judge Ramos responded, “[y]ou want an adjudication of this thing, make a motion before them. I’m not going to overrule the Court of Appeals,” and “[w]hether the SEC case is binding on them is their decision, not mine.”

The insurers accepted Judge Ramos' invitation and appealed to the New York Appellate Division's First Department. The Court considered only whether insurers “should have been granted summary judgment dismissing the complaint because SEC disgorgement is an uninsurable penalty and not a ‘loss’ covered by the insurance policy.”¹³ The insurance companies, relying on *Kokesh*, argued that they had no obligation to provide coverage because the Supreme Court had conclusively defined the Commission's disgorgement remedy to be a penalty and the policies provided that “loss” did not include “fines or penalties imposed by law; or ... matters which are uninsurable under the law pursuant to which this policy shall be construed.”

The appellate panel found that *Kokesh* provided the “missing precedent” that established the Bear Stearns' disgorgement payment was an uninsurable penalty as opposed to an insured “loss,” regardless of “whether it is linked to the wrongdoer's gains or gains that went to others.” The panel flatly stated:

The Supreme Court's rationale as to the nature of disgorgement in *Kokesh* applies with equal force to the issue of whether the disgorgement paid by Bear Stearns, even if representing third-party gains, was a “Loss” within the meaning of the policy and whether public policy bars insurance companies from indemnifying insureds paying SEC disgorgement. In both instances disgorgement is a punitive sanction intended to deter.¹⁴

The panel's reasoning tracked *Kokesh*, including that to allow the wrongdoer to pass on disgorgement liability undermined its purpose. The Court found that disgorgement can include both the wrongdoer's unlawful gains and benefits that accrued to third parties.¹⁵ In these situations, the status quo is not restored, but rather the defendant is left “worse off” than the place he would have occupied had he not violated the securities laws. To the Court, the facts of this case clearly illustrated that disgorgement was punitive and not remedial: “if the \$140 million portion of the disgorgement payment Bear Stearns seeks to recover reflects the gains of Bear Stearns' customers rather than of Bear Stearns itself, it makes it more, not less, of a penalty.”¹⁶

WHAT'S LEFT UNADJUSTED: INDEMNIFICATION AFTER J.P. MORGAN'S COVERAGE IS DENIED

The panel's decision aptly noted that “*Kokesh* has significance beyond the narrow issue of the statute of limitations.”¹⁷ The panel's finding highlights the broad-reaching implications of *Kokesh*— it found that disgorgement was an uncovered “penalty” regardless of whether the claimant sought relief for disgorgement based on its own gains or those of related parties. While this decision is arguably limited to the specific language of the insurance policy or to state's that bar coverage for penalties as a matter of public policy, such language is common and insurers can be expected to cite this case when denying coverage for disgorgement going forward.

However, even with this guidance, the question of coverage for third party disgorgement in SEC settlements has not been definitively answered. The insurance policies covering Bear Stearns excluded “fines or penalties imposed by law.” Policyholders are likely to argue that disgorgement agreed to in a settlement or otherwise negotiated resolution is not a penalty “imposed by law,” but is rather an agreed-upon element of a compromise. It remains to be seen whether any courts will agree and adopt this position. Conversely, to negate any uncertainty about the impact of *Kokesh*, insurers could make the exclusionary language in their policies broader in scope. At a minimum, however, it is clear that entities



and/or individual defendants – who are hit the most hard if they cannot seek indemnification from any source – now face more uncertainty about the insurability of their settlement payments.

Alternatively, will insurance companies offer policies explicitly stating that disgorgement *will* be covered to the fullest extent permissible under state law? Is this something that insurance companies could use to gain a competitive advantage in the market place? At least in New York, it appears that the onus will thus be on contract negotiation, settlement discussions, state law, and perhaps future litigation to determine if the courts, regulators, or the industry will define whether *Kokesh* clearly delineates disgorgement as a penalty in the insurance arena.

BEYOND INDEMNIFICATION: IMPACT ON INVESTIGATION TIMELINE AND DISGORGEMENT RECOVERY

Outside of the insurance context, the Commission has been direct about *Kokesh*'s impact on its ability to seek or obtain disgorgement. A few weeks ago, co-director of Enforcement Steven Peikin noted that according to a May 2018 calculation, the Commission has foregone approximately \$800 million in potential disgorgement since the decision and expects that number to continue to rise.¹⁸ Accordingly, the *Kokesh* decision provides yet another incentive for the Commission to bring enforcement actions as quickly as possible and at least before the expiration of the 5-year statute of limitations.

Echoing this theme, the Commission's Inspector General, Carl Hoecker, stated in his October 2018 report that "it is imperative that Enforcement uncover, investigate and bring cases as quickly as possible." He observed that Enforcement missed its 2017 target of 65% of first enforcement actions filed within 2 years of opening an investigation, achieving 52% instead, a decrease from FYs 2012-2016. To act more quickly, Hoecker explained that Enforcement is "emphasizing expediency in quarterly case reviews, promoting best practices regarding efficiencies in various phases of the investigative process, leveraging data analytics capabilities, and conducting training on tools that expedite investigations."¹⁹ Given the complexity of its cases, limited resources and increasing oversight responsibilities over an expanding and changing securities market, striving for "real time enforcement" will continue to be a challenge for the SEC. In the meantime, *Kokesh* will continue to impede the Commission's ability to obtain monetary recovery for investors.

CONCLUSION

It has been over a year since the Supreme Court decided *Kokesh* and we are still spotting "Elephants in Mouseholes."²⁰ With this decision, the New York courts have provided one answer to the question: "[c]an defendants and respondents still seek indemnification or insurance coverage for disgorgement and pre-judgment interest?"²¹ Responses to this decision by insurers and insureds will be worth watching: will additional disgorgement coverage become an angle to gain competitive advantage? And how will all of this impact SEC settlement agreements, which generally prohibit indemnification for penalties? The lack of indemnification for disgorgement will surely be a factor in a potential defendant's consideration of whether to settle with the SEC and on what terms, but time will tell whether it changes the calculus to any degree.

Although there will undoubtedly be more to come on this issue, in the short term, companies should carefully review the definition of "loss" under their current insurance policies and determine whether they need to seek modifications and if so, the best time to do so. The best time to do so may be sooner rather than later, as the SEC has already made clear that it will be using all available tools in an effort to bring its enforcement actions within the five year statute of limitations period. Among all the uncertainty at least one thing is certain, *Kokesh*'s reach goes significantly beyond the SEC's enforcement program and counsels in favor of careful reconsideration of other important factors that come into play – like insurance – when resolving an SEC enforcement action.



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¹ K&S Client Alert, Reflections on *Kokesh v. SEC*: Potential Ramifications of SEC Disgorgement Being a Penalty, (June 14, 2017) <https://s3.amazonaws.com/kslaw-staging/attachments/000/004/567/original/ca061417.pdf?1498139481> (*Kokesh* "rejected the Securities and Exchange Commission's longstanding position that disgorgement was an equitable remedy not subject to the five-year statute of limitations in 28 U.S.C. § 2462.")

² *Id.*

³ *Id.*

⁴ *J.P. Morgan Sec. Inc., v. Vigilant Ins. Co.*, 2018 NY Slip Op 06146, No. 600979/2009 (1st Dept. Sept. 20, 2018); *Kokesh v. SEC*, 137 S. Ct. 1635 (2017).

⁵ *J.P. Morgan*, 2018 NY Slip Op 06146.

⁶ See, e.g., *State Farm Fire & Cas. Co. v. Martinez*, 26 Kan. App. 2d 869, 995 P.2d 890 (2000); *Drexel Burnham Lambert Group, Inc. v. Vigilant Ins. Co.*, 157 Misc.2d 198, 595 N.Y.S.2d 999 (Sup. Ct. 2010).

⁷ The defendant insurance companies include Vigilant Insurance company, Federal Insurance Company, Liberty Mutual, Travelers Indemnity Company, National Union Fire Insurance Company, Certain Underwriters at Lloyd's, London, and American Alternative Insurance Corporation.

⁸ In the Matter of Bear, Stearns & Co., Inc., Securities Act Release No. 8668 (March 16, 2006), <https://www.sec.gov/litigation/admin/33-8668.pdf>

⁹ *J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 2010 N.Y. Slip Op. 33799(U) (N.Y. Cty. Sep. 13, 2010)

¹⁰ *J.P. Morgan Sec. Inc., v. Vigilant Ins. Co.*, 91 A.D.3d 226 (1st Dept. 2011)

¹¹ *J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 57 Misc. 3d 171 (2017).

¹² *Kokesh v. SEC*, 137 S. Ct. 1635 (2017); Stewart Bishop Insurers Make Last-Ditch *Kokesh* Play In Bear Stearns Fight, LAW360 (June 6, 2016), available at <https://www.law360.com/securities/articles/931944> (citing Letter to Judge Ramos, *J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, Index No. 600979/09 (June 6, 2017)).

¹³ *J.P. Morgan*, 2018 NY Slip Op 06146.

¹⁴ *J.P. Morgan*, 2018 NY Slip Op 06146.

¹⁵ *SEC v. Contorinis*, 743 F.3d 296, 302 (2d Cir. 2014).

¹⁶ *J.P. Morgan*, 2018 NY Slip Op 06146 (The panel also rejected J.P. Morgan's "law of the case" theory, whereby JPMorgan argued that *Kokesh* should not apply as the Court of Appeals previously rejected the defendants' argument that the instant claim was not a loss under the policies and that a disgorgement of a third-party gain was recoverable under an insurance policy.)

¹⁷ *Id.*

¹⁸ Steve Peikin, Co-Director, Division of Enforcement, Securities and Exchange Commission, PLI White Collar Crime 2018: Prosecutors and Regulators Speak: Remedies and Relief in SEC Enforcement Actions (Oct. 3, 2018)

¹⁹ Memorandum from Carl W. Hoecker, Inspector General to Jay Clayton, Chairman of the Securities and Exchange Commission regarding The Inspector General's Statement on the SEC's Management and Performance Challenges (Oct. 5, 2018)

²⁰ *SEC v. Jammin Java Corp.*, No. 2:15-cv-08921 SVW (MRWx), 2017 WL 4286180, at *2 (C.D. Cal. Sept. 14, 2017).; K&S Client Alert, Reflections on *Kokesh v. SEC*: On the Lookout for "Elephants in Mouseholes", (February 9, 2018) <https://www.kslaw.com/attachments/000/005/640/original/ca020918.pdf?1518193236>

²¹ K&S Client Alert, Reflections on *Kokesh v. SEC*: Potential Ramifications of SEC Disgorgement Being a Penalty, (June 14, 2017) <https://s3.amazonaws.com/kslaw-staging/attachments/000/004/567/original/ca061417.pdf?1498139481>