E-FILE

SUPREME COURT OF THE STATE OF NEW YORK — NEW YORK COUNTY

PART 53

Index Number : 600979/2009

J.P. MORGAN SECURITIES

vs.

VIGILANT INSURANCE

SEQUENCE NUMBER : 002

DISMISS

INDEX NO. ______

MOTION DATE ______

MOTION SEQ. NO. ______

MOTION CAL. NO. ______

The following papers, numbered 1 to ______ were read on this motion to/for ______

	PAPERS NUMBERED
Notice of Motion/ Order to Show Cause — Affidavits — Exhibits ...	
Answering Affidavits — Exhibits	
Replying Affidavits	

Cross-Motion: ☐ Yes ☐ No

Upon the foregoing papers, it is ordered that this motion

MOTION/CASE IS RESPECTFULLY REFERRED TO JUSTICE FOR THE FOLLOWING REASON(S):

MOTION IS DECIDED IN ACCORDANCE WITH ACCOMPANYING MEMORANDUM DECISION IN MOTION SEQUENCE . 001.

NYS SUPREME COURT RECEIVED
SEP 14 2010
MOTION SUPPORT OFFICE

Dated: 9/15/2010

CHARLES E. RAMOS
J.S.C.

Check one: ☐ FINAL DISPOSITION ☑ NON-FINAL DISPOSITION

Check if appropriate: ☐ DO NOT POST ☐ REFERENCE

E-FILE

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: COMMERCIAL DIVISION

J.P. MORGAN SECURITIES INC., J.P. MORGAN CLEARING CORP., and THE BEAR STEARNS COMPANIES LLC,

Index No. 600979/09

Plaintiff,

-against-

VIGILANT INSURANCE COMPANY, THE TRAVELERS INDEMNITY COMPANY, FEDERAL INSURANCE COMPANY, NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, P.A., LIBERTY MUTUAL INSURANCE COMPANY, CERTAIN UNDERWRITERS AT LLOYD'S, LONDON and AMERICAN ALTERNATIVE INSURANCE CORPORATION,

Defendants.

Charles Edward Ramos, J.S.C.:

In this insurance coverage action, plaintiffs[1] seek a declaration that its insurers are required to indemnify it for losses stemming from a disgorgement and penalty payment that it made to the Securities and Exchange Commission (SEC) following its settlement of charges that it facilitated its customers' deceptive market timing and late trading.

Motion sequence numbers 001 and 002 are consolidated for disposition.

In motion sequence numbers 001 and 002, defendants Vigilant Insurance Co., The Travelers Indemnity Company, Federal Insurance

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[1] Plaintiffs are J.P. Morgan Securities Inc. (JP Morgan), formerly known as Bear, Stearns & Co. Inc. (BS&Co.), and J.P. Morgan Clearing Corp., formerly known as Bear Stearns Securities Corporation (BSSCorp.), and The Bear Stearns Companies LLC, formerly known as The Bear Stearns Companies Inc. (TBSC) (together, Bear Stearns).

In 2008, TBSC, through its merger with a subsidiary of JPMorgan Chase & Co. became a subsidiary of JPMorgan Chase & Co.

Company, National Union Fire Insurance Company of Pittsburgh, P.A. and Liberty Mutual Insurance Company (together, Insurers) move to dismiss Bear Stearns' amended complaint (CPLR 3211 [a], [1], [7]).

Background[2]

The Insurers are participating carriers in an insurance program that provided professional liability coverage to Bear Stearns for the period May 5, 2000 through May 5, 2003, with an extended discovery period of one year providing coverage for claims made through May 5, 2004 (Exhibit A, annexed to the Sharp Aff.). Within the limits of the policies and in accordance with a primary policy (Vigilant Policy), the Insurers are required to pay Bear Stearns for losses that it becomes legally obligated to pay as the result of any claim for any "Wrongful Act."[3]

In addition, the Insurers issued an excess policy (Excess Policy) applicable to their layer that contain exclusions for Wrongful Acts committed prior to March 21, 2000, if "any officer knew or could have reasonably foreseen that such Wrongful Act(s) could lead to a Claim" (Known Wrongful Acts Exclusion), and for claims made against the Insured arising out of its gain of personal profit or advantage to which it was not entitled

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[2] The allegations set forth herein are taken from the allegations of Bear Stearns' amended complaint (Complaint), unless otherwise, noted, and are assumed to be true for purposes of disposition.

[3] Wrongful Act is defined as "any actual or alleged act, error, omission, misstatement, misleading statement, neglect or breach of duty by the Insured[s] in providing services" as a broker dealer (Vigilant Policy, Exhibit A, annexed to the Sharp Aff.).

(Profit/Advantage Exclusion) (Exhibit 1, annexed to the Sonenshein Aff.).

Prior to merging with JP Morgan, Bear Stearns was the subject of investigations by the SEC, the New York Stock Exchange (NYSE), and other regulatory authorities for allegedly facilitating, as a broker-dealer and securities clearing firm, certain of its customers' late trading and deceptive market timing in connection with the buying and selling of shares in mutual funds, that resulted in the dilution of the shareholders' value in the affected mutual funds.[4]

In early 2006, the SEC commenced a civil enforcement action against Bear Stearns seeking broad injunctive relief and monetary sanctions of $720 million (Exhibit 2, annexed to the Landrey Aff.).

Bear Stearns refuted the charges, and in a detailed response to the SEC, it asserted that it did not actually share in the profits enjoyed or otherwise receive any special fees or financial benefits for permitting these trading practices (Exhibit 2, annexed to the Landrey Aff.).

Nonetheless, Bear Stearns made an offer of settlement, and without admitting or denying the findings contained therein, it consented to the entry of the Administrative Order and its

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[4] Late trading is the practice of placing orders to buy, redeem or exchange mutual fund shares after the time as of which mutual funds calculate their net asset value. Deceptive market timing includes frequent buying and selling of shares of the same mutual fund, and buying or selling mutual fund shares to exploit inefficiencies in mutual fund pricing (Complaint, ¶ 5).

findings (Administrative Order at 1-2, Exhibit B, annexed to the Sharp Aff.). To resolve the claims, Bear Stearns agreed to pay $215 million, of which $160 million was labeled "disgorgement" and $90 million as a penalty. In February 2009, the SEC approved the plan of distribution of the funds.

In addition, Bear Stearns was named as defendants in thirteen civil class actions commenced on behalf of mutual fund investors allegedly damaged by Bear Stearns' conduct, which Bear Stearns subsequently settled for $14 million.

Following Bear Stearns' payment to settle the charges, the Insurers refused to indemnify it for the losses that it incurred. The Insurers assert that, because the Administrative Order labeled a portion of the payment as disgorgement, it does not constitute a "loss" under the Policies.

Following the Insurers' refusal to indemnify it, Bear Stearns commenced this action seeking $150 million (the $160 million non-penalty portion of the SEC settlement less a $10 million retention), plus defense costs in the amount of $40 million under the Policies.

Discussion

The Insurers[5] move to dismiss the complaint on the ground that the Administrative Order unequivocally demonstrates that Bear Stearns' claims for insurance coverage fail as a matter of law. The Insurers reason that New York public policy precludes

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[5] The Insurers submit separate memoranda in support of their motions to dismiss.

insurance coverage for intentionally harmful conduct, disgorgement is not an insurable loss as a matter of law, and on the basis of the Wrongful Acts and Profit/Advantage Exclusions contained in the Policies.

In opposition, Bear Stearns asserts that numerous disputed issues of fact remain as to whether its officers knew of "Wrongful Acts" committed before March 21, 2000, within the meaning of the Known Wrongful Acts Exclusion, and argues against the applicability of the Profit/Advantage Exclusion. Further, Bear Stearns contends that SEC settlements, such as the Administrative Order, have a non-preclusive effect with respect to establishing whether a known act exclusion applies in underlying litigation. On this basis, Bear Stearns argues that the Insurers have not demonstrated that the Administrative Order conclusively refutes its claims for insurance coverage.

I. Disgorgement

The issue confronting the Court is whether the label "disgorgement," contained within an SEC administrative order that the insured consented to, albeit without admitting to its findings, conclusively establishes as a matter of law that losses are excluded from coverage and uninsurable under New York public policy.[6]

For the reasons set forth below, the Court determines that

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[6] Dismissal under CPLR 3211 (a) (1) is warranted only if the documentary evidence submitted conclusively establishes a defense to the asserted claims as a matter of law.

it does not, and the motion to dismiss is denied.

The risk of being directed to return improperly acquired funds is not insurable, and restitution of such funds does not constitute a loss as that term is used in insurance policies (*Shapiro v One Beacon Ins. Co.*, 34 AD3d 259 [1st Dept 2006], *lv denied* 9 NY3d 803 [2007]; *Vigilant Ins. Co. v Credit Suisse First Boston Corp.*, 10 AD3d 528 [1st Dept 2004]).

Nonetheless, an insured's settlement or consent to entry of an order with the SEC, wherein it did not admit guilt, will not preclude it from disputing those findings in subsequent litigation with its insurers concerning whether the settlement is a covered loss (*National Union Fire Ins. Co. of Pittsburgh, PA v Xerox Corp.*, 25 AD3d 309, 309-10 [1st Dept], *lv dismissed* 7 NY3d 886 [2006]), unless the settlement or order "conclusively link[s] ... disgorgement to improperly acquired funds" (*Millennium Partners, L.P. v Select Ins. Co.*, 68 AD3d 420 [1st Dept 2009], *appeal dismissed* 14 NY3d 856 [2010]).

Despite labeling a portion of the penalty imposed on Bear Stearns as "disgorgement," the Administrative Order does not contain an explicit finding that Bear Stearns directly obtained ill-gotten gains or profited by facilitating these trading practices. Consequently, the findings of the Administrative Order alone do not establish as a matter of law that Bear Stearns seeks coverage for losses that include the disgorgement of improperly acquired funds.

According to the findings contained in the Administrative

Order, Bear Stearns facilitated late trading and deceptive market timing practices of certain of its customers "by knowingly processing large numbers of late trades," and taking "affirmative steps" to hide the identity of these customers from mutual funds (*Id.* at 2, 30-). Additionally, it cleared all of these trades, and, inter alia, "knowingly or recklessly processed thousands of late trades" (*Id.* at 3).

The findings also concluded that Bear Stearns' conduct "benefitted their customers and customers of corespondent firms by enabling those customers to generate hundreds of million of dollars in profits from these trading tactics at the expense of mutual fund shareholders" (*Id.* at 3).

Contrary to the Insurers' assertions, the Administrative Order does not "conclusively link the disgorgement to improperly acquired funds."

Millennium Partners, L.P. (68 AD3d 420) and *Vigilant Ins. Co.* (10 AD3d 528), upon which the Insurers rely for the principle that the Administrative Order's characterization of a portion of the payment as disgorgement conclusively establishes that it is uninsurable as a matter of law, are distinguishable.

First, *Millennium Partners, L.P.* involved a hedge fund's attempt to obtain reimbursement of defense costs incurred in defending SEC and New York Attorney General (NYAG) charges that it directly obtained tens of millions of dollars in ill-gotten profit through its involvement in market timing trades of mutual shares (24 Misc 3d 212).

In granting summary judgment, the trial court considered the SEC and NYAG settlements, in addition to a subsequent SEC filing by the insured (*Id.*). The court concluded that no triable issues of fact remained because the findings contained in the SEC settlement, including that the fraudulent activities at issue, permitted the insured to generate tens of millions of dollars in profit "conclusively link the disgorgement to improperly acquired funds" (*Id.*).

With respect to the SEC and NYAG settlements, "read as a whole, the settlements are not reasonably susceptible to any other interpretation than that the relief provisions require disgorgement of funds gained through improper market timing activities" (*Id.*). This conclusion, that the settlements conclusively linked disgorgement to improperly acquired funds, was confirmed by a subsequent SEC filing by the insured (*Id.*).

Unlike in *Millennium Partners, L.P.* (*Id.*), where the insured was found to be directly engaging in improper market timing that resulting in obtaining tens and millions of dollars in actual profit, the Administrative Order concludes that Bear Stearns facilitated the improper trading practices, which benefitted Bear Stearns' customers and customers of corespondent firms. Notably, there are no findings that Bear Stearns directly generated profits for itself as the result of this conduct.

Moreover, *Millennium Partners, L.P.* (*Id.*) was decided on a motion for summary judgment on a full evidentiary record.

In contrast, the record before this Court consists of the

findings of the Administrative Order alone. This Court is unable to conclude that the language of Administrate Order alone is "not reasonably susceptible to any other interpretation" other than that the disgorgement portion of the payment is for improperly acquired funds, in light of the absence of any explicit finding that Bear Stearns generated profits for itself by its facilitation of these trading practices.

To find otherwise would be to resolve disputed issues of fact, which is improper on a motion to dismiss the complaint on the basis of documentary evidence (*Wiener v Spahn,* 60 AD3d 586, 586 [1st Dept 2009]).

Similarly, in *Vigilant Ins. Co.* (*Id.*), the insured, Credit Suisse First Boston Corporation (Credit Suisse), was accused of coercing customers into paying over a portion of their profits by flipping Credit Suisse underwritten IP stock, that generated excessive brokerage commissions for itself totaling tens of millions of dollars in profits.

In granting summary judgment to the insurers, the trial court concluded that, on the basis of the language of the SEC settlement alone and under the "particular facts of this case," the settlement "specifically links the disgorgement payment to the improper activity" (*Id.*).

Therefore, because the Court is unable to conclude, on the basis of the language of the Administrative Order alone that disgorgement is specifically linked to improperly acquired funds, it rejects the Insurers' argument that dismissal of the complaint

is mandated at this pre-answer stage.

II. Policy Exclusions

Alternatively, the Insurers seek dismissal under the Known Wrongful Acts and Profit/Advantage Exclusions.

Under the Known Wrongful Acts Exclusion contained in the Policies, the insured may not obtain coverage for a loss if any officer of Bear Stearns "knew or could have reasonably foreseen" a Wrongful Act that could lead to a claim (Exhibit 1, annexed to the Sonenshein Aff.).

Generally, an insurer bears the burden of proof to demonstrate application of an exclusion (*Belt Painting Corp. v TIG Ins. Co.,* 100 NY2d 377, 383 [2003]). Exclusions to coverage must be specific, clear and subject to no other reasonable interpretation, and are accorded a strict and narrow construction (*Id.*). They are not to be extended by interpretation or implication (*Id.*).

With respect to the prior known loss or wrongful acts exclusions, the New York Court of Appeals has yet to address the appropriate standard under New York law, but applied a mixed subjective/objective standard to such an exclusion under Pennsylvania law (*Executive Risk Indem. Inc. v Pepper Hamilton LLP,* 56 AD3d 196 [1st Dept 2008], *affirmed as modified* 13 NY3d 313 [2009], *rearg denied* 13 NY3d 927 [2010]).

Under this standard, a court must first consider the subjective knowledge of the insured, and second, the objective question of whether a reasonable person in the insured's position

would foresee that those facts might be the basis of a claim (*Id.*).

Although it applied Pennsylvania law, this Court finds the Court of Appeals' analysis of prior known loss exclusions in *Executive Risk Indem. Inc.* (*Id.*), persuasive (*accord Qanta Lines Ins. Co. v Investors Capital Corp.,* 2009 WL 4884096, *16-17 [SD NY 2009]; *but see United Nat. Ins. Co. v Granoff, Walker & Forlenza, P.C.,* 598 F Supp 2d 540, 547-48 [SD NY 2009] [applying an objective standard]).

In the absence of conclusively established facts as to the degree and timing of an insured's knowledge of the substantial probability of loss, determination of whether the exclusion is applicable is ordinarily a question of fact (*see Executive Risk Indem.,* 56 AD3d at 205).

Here, numerous disputed factual assertions remain concerning Bear Stearns' knowledge of the relevant facts prior to March 21, 2000, and whether a person in Bear Stearns' position could have reasonably foreseen that those facts might be the basis of a claim under the Policies (*compare United Nat. Ins. Co.,* 598 F Supp 2d at 547-48).

The Profit/Advantage Exclusion bars coverage for any claim made against Bear Stearns "based upon or arising out of the Insured gaining in fact any personal profit or advantage to which the Insured was not legally entitled" (Vigilant Policy, Exhibit A, annexed to the Sharpe Aff.).

The Insurers urge a construction of this exclusion that bars

coverage irrespective of whether or not the profit or advantage received by the insured is itself unlawful or improper. The Court rejects this construction.

The exclusion states that the Insurers are not liable for any claim made against Bear Stearns "based upon or arising out of the Insured gaining in fact any **personal profit or advantage to which the Insured was not legally entitled**" (emphasis added). Insertion of this phrase suggests that the exclusion has no application unless the insured personally profited, which profit was itself unlawful or illegal, rather than receiving an incidental gain or profit (*see Federal Ins. Co. v Kozlowski,* 18 AD3d 33, 41 [1st Dept 2005]; *Astrin v St Paul Mercury Ins. Co.,* 179 F Supp 2d 376, 400-01 [D Del 2002] [applying Delaware law]).

Here, although the findings of the Administrative Order refer to Bear Stearns' wrongful acts in facilitating late trading and market timing, the Insurers point to no specific finding that any officer committed an act for which it received an illegal profit or advantage.

Moreover, for the exclusion to apply, the claim must be based upon "personal profit or advantage," and thus, does not apply if the profit or advantage actually accrued to some other person (*Pereira v National Union Fire Ins. Co. of Pittsburgh, Pa.,* 2006 WL 1982789, *6 [SD NY 2006]; *Astrin,* 179 F Supp 2d at 400-01).

However, the findings contained in the Administrative Order conclude that Bear Stearns' unlawful facilitation of its

customers' late trading and market timing "benefitted their customers and customers of corespondent firms by enabling those customers to generate .... profits" (Administrative Order at 3).

The Court has considered the Insurers' remaining arguments and find them meritless.

Therefore, the Insurers fail to demonstrate that the Administrative Order conclusively establishes that Bear Stearns' losses are not covered by the Policies.

Accordingly, it is

ORDERED that defendants' motions (001, 002) to dismiss the complaint are denied; and it is further

ORDERED that defendants are directed to serve an answer to the compliant within 20 days after service of a copy of this order with notice of entry.

Dated: September 13, 2010

ENTER:

J.S.C.

CHARLES E. RAMOS