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NEWSLETTER

Disgorgement Not Recoverable Under Professional Liability Policies

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On the insurers' motion for summary judgment, a New York trial court, applying New York law, has held that disgorgement paid as part of a settlement is not recoverable under professional liability policies. *Vigilant Ins. Co. v. Bear Stearns Cos. Inc.*, 2006 WL 118368 (N.Y. Sup. Ct. Jan. 11, 2006). The court also held that amounts paid for investor education and research were recoverable, finding that although these amounts were not compensatory, the policies did not limit recovery to amounts paid in compensation.

The policyholder, an investment bank, purchased a professional liability policy and two excess policies that covered "loss" that the policyholder was legally obligated to pay. "Loss" was defined as "(1) compensatory damages, multiplied damages, punitive damages where insurable by law, judgments, settlements, costs, charges and expenses or other sums the Insured shall legally become obligated to pay as damages resulting from any Claim or Claim(s); [or] (2) costs, charges and expense or other damages incurred in connection with any investigation by any governmental body or self-regulatory organization." Additionally, the policies required the insurers' consent to settle claims "in excess of a settlement authority threshold of $5,000,000," and provided that the insurers "shall not be liable for any settlement, Defense Costs, assumed obligation or admission" to which they did not consent.

The U.S. Securities and Exchange Commission (SEC), NASD and the New York Stock Exchange began a "joint inquiry into market practices concerning research analysts and the potential conflicts that can arise from the relationship between research and investment banking." The investment bank and the regulators agreed to settle the case, and the investment bank signed a document called "Settlement Principles" without consulting the insurers. The regulators did not sign the document. The investment bank then signed a consent to entry of judgment and informed its insurers of the consent judgment three days later.

Subsequently, the SEC filed suit against the investment bank, alleging a conflict of interest between the investment banking and research parts of the bank. The case resulted in a final judgment whereby the policyholder was required to pay monies in the form of penalties, "disgorgement of commissions" and other amounts for independent research and investor education. The judgment provided that the amounts paid for independent research and investor education were not "disgorgement or restitution, and/or used for compensatory purposes."

On summary judgment, the court held that the settlement amounts paid as disgorgement were not recoverable under the policies. Citing *Vigilant Insurance Co. v. Credit Suisse First Boston Corp.*, 782 N.Y.S.2d 19 (1st Dep't. 2004), the court explained that "[r]estitution of ill-gotten funds does not constitute 'damages' or a 'loss' as those terms are used in insurance policies . . . . In general, a party may not recover disgorged funds through insurance because to do so would enable that party to retain the proceeds of its wrongful acts and shift the burden of the loss to its insurer." Here, the court explained that "the payment is specifically labeled 'disgorgement,' [and] [the Final Judgment] specifically links the disgorged commissions to the wrongful acts set forth in the Complaint." According to the court, "it is clear that [the investment bank] was disgorging money that it had obtained as the result of wrongful acts that the Complaint describes," even though there was no trial on the issue.

The court denied summary judgment on the issue of whether the amounts paid for investor education and research were "loss" as defined by the policies. While the judgment stated that these amounts were not compensatory, the court found that "the policy does not set forth a definition of damages or otherwise limit that term to monies paid to compensate past injuries."

The court then found a genuine issue of fact regarding whether the investment bank settled without the insurers' consent. The court explained that even though the investment bank signed the settlement document and consented to final judgment, these documents were not effective because the regulators had not signed them. Additionally, if the judge in the underlying action changed the terms of the settlement, the investment bank's consent was not required. According to the court, "it is not clear whether the documents at issue were final agreements that were binding on [the investment bank] or subject to further negotiation and ultimately approval of the court. Thus, it is not clear at what point the Insurers' consent was required."

Last, the court found an issue of fact regarding whether the policies' investment banking exclusion barred coverage. The investment banking exclusion barred coverage for claims "based upon, arising from or in consequence of any underwriting, syndicating, or investment banking work." The court explained that "it is not clear at this point that the entirety of the alleged wrongful conduct that formed the basis for the settlement was connected to [the policyholder's] investment banking activities" since the allegations involved the investment banking and research divisions of the bank.