

New York's Highest Court Sends Strong Signal That Insurance Companies Will Be Held To Their Coverage Obligations

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On June 11, 2013, the New York Court of Appeals decided two groundbreaking insurance coverage cases on public policy grounds. These cases, in combination, send a strong signal from New York's highest court that insurance companies will be strictly held to their coverage obligations in the absence of clearly applicable policy exclusions, and that they may lose the right to rely on policy exclusions if they are found to have breached their duty to defend.

1. The J.P. Morgan Decision Upholding Coverage for Disgorgement

In the first case, *J.P. Morgan Securities, Inc. v. Vigilant Insurance Co.*, No. 113 (N.Y. June 11, 2013), in which Proskauer represented the policyholder, the Court of Appeals reversed a lower court decision that had dismissed, on public policy grounds, a coverage action brought by Bear Stearns (now part of J.P. Morgan Chase). Bear Stearns, a broker-dealer, had sought coverage for settlement of claims brought by the SEC and the New York Stock Exchange, which had charged it with facilitating late trading and market-timing in mutual funds by its customers in violation of the securities laws. In settlement of these claims, without admitting or denying the facts recited by the SEC pursuant to an Administrative Order entered on consent, Bear Stearns agreed to make two payments: \$160 million denominated as disgorgement, for which Bear Stearns sought insurance coverage; and an additional \$90 million penalty for which it did not.

Bear Stearns argued that the SEC had not precluded it from seeking coverage for the disgorgement payment and, in fact, had allowed it to obtain an offset in the amount of the payment against compensatory damages liability in connection with pending civil actions brought by mutual fund shareholders. Moreover, the amount of the disgorgement payment had not been calculated on the basis of gains that Bear Stearns itself received but, instead, was based almost entirely on the trading gains allegedly achieved directly by its customers and clients as a result of their own misconduct. Thus, Bear Stearns argued, although certain courts had rejected coverage for disgorgement payments where the insured had returned its own improper gain — some on public policy grounds (to prevent the insured's unjust enrichment) and others on the ground that the return of ill-gotten gains is not a loss — neither rationale was applicable to the situation at hand. It urged the court to be very wary of extending public policy prohibitions to insurance coverage expressly provided by the policy — which included coverage for regulatory claims by the SEC and other governmental and self-regulatory bodies — by endorsing the Appellate Division's rationale that insurance should be disallowed in order to preserve the deterrent effect of an SEC disgorgement remedy.

The Court of Appeals accepted Bear Stearns's arguments. Noting the complete absence of precedent from any other court prohibiting coverage for disgorgement where the insured was not required to return gains that it had received, the court declined to adopt a public policy-based prohibition of insurance coverage for the disgorgement payment made by Bear Stearns. Instead, the court found that public policy mandated enforcement of insurance contracts freely entered into by the parties according to their terms. It explained that the court previously had recognized countervailing exceptions to this public policy in only two narrowly defined circumstances: for punitive damages, where the purpose of the remedy is to punish as well as deter wrongdoing, and where the insured had engaged in conduct specifically intended to harm third parties. On the record before it, which included the SEC's Administrative Order and findings, the court found that neither exception applied: Bear Stearns was not seeking coverage for punitive damages and had not been found to have engaged in intentionally harmful conduct. The court emphasized that the public policy exception for intentionally harmful conduct is a narrow one, under which it must be established not only that the insured acted intentionally but, further, that it acted with the intent to harm or injure others. The SEC's findings that Bear Stearns willfully committed securities law violations did not establish that it acted with the requisite intent to cause harm. The court left open for determination on remand the impact of a policy provision that expressly promised that coverage would be provided for allegations of deliberate, dishonest, fraudulent or criminal acts or omissions by the insured that had not been established by a judgment or other final adjudication in the underlying action.

The J.P. Morgan decision not only creates a potential for coverage of SEC disgorgement remedies; in addition, the Court of Appeal's strong endorsement of enforcement of the express terms of freely negotiated insurance contracts will make it harder for insurance companies to rely on public policy arguments about insurability as a basis to avoid their coverage obligations.

2. K2 Investment Group and the Perils of Breach of the Duty to Defend

In the second case, *K2 Investment Group, LLC. v. American Guarantee & Liability Insurance Co.*, No. 106 (N.Y. June 11, 2013), the Court of Appeals held that where a liability insurer breaches its duty to defend, it will not be permitted to rely on policy exclusions (other than possibly the public policy-based exclusion of coverage for intentional infliction of harm) to avoid the duty to indemnify its insured for a resulting judgment.

In *K2 Investment Group*, a malpractice insurer wrongfully refused to defend an attorney for a legal malpractice claim. In doing so, the insurer relied on two policy exclusions: an "insured status" exclusion and a "business enterprise" exclusion. Upon the insurer's refusal to defend, the attorney defaulted, leading to entry of a default judgment. The attorney then assigned his rights under the policy to the claimants, who sued the insurer.

The Appellate Division, First Department, with two justices dissenting, granted summary judgment in favor of the insured. All of the justices agreed that the insurer had breached its duty to defend and that the insurer was therefore prohibited from attacking the basis for the judgment against the insured. This meant the insurer could not invoke the "insured status" exclusion, as the judgment had conclusively determined that the attorney was liable for legal malpractice, which would be inconsistent with application of the exclusion. However, with respect to the "business enterprise" exclusion, the justices differed on whether the exclusion was clearly inapplicable, with the majority concluding that it was and, therefore, summary judgment in favor of the insured was appropriate, and the minority concluding that it was not, and therefore a material question of fact existed precluding summary judgment.

Rather than resolve the issue that divided the Appellate Division, the Court of Appeals took the occasion to articulate a broader rationale for affirmance: that where an insurance company breaches its duty to defend, its sole recourse is to litigate the validity of the disclaimer of the defense obligation. If that disclaimer is found wanting, the insurance company must indemnify its insured for a resulting judgment — even if policy exclusions would otherwise have negated the duty to indemnify. According to the court, this rule is intended to incentivize insurers to give their insured the full benefit of bargained-for defense coverage, rather than forcing the insured to litigate the effect of policy exclusions after having been abandoned by the insurer in defense of the underlying case, a result that the court considered unfair to the insured and conducive to unnecessary and wasteful litigation. The only possible exception to the rule announced by the court, which it left open for future consideration, is where the insurer asserts that public policy bars coverage because the insured injured the claimant intentionally.

The rule announced by the court in *K2 Investment Group* barring assertion of coverage defenses where the insurance company breaches its duty to defend is a welcome and powerful endorsement of the breadth and paramount importance of an insurance company's defense obligation, and a stern admonishment to insurers of the risk of failing to discharge that obligation without prior court sanction. Although the decision involved a default judgment, the same rationale should apply to good faith settlements entered into following breach of the duty to defend.

Seth Schafler, a partner in Proskauer's Insurance Recovery & Counseling group, was a member of the Proskauer team that represented JP Morgan in this matter. Proskauer partner John Gross argued the case in the Court of Appeals.