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PERSPECTIVE

'J.P. Morgan v. Vigilant' and Post-Loss Underwriting: The New York Court of Appeals Should Continue To Modernize New York Insurance Law

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In a case currently scheduled for argument on Oct. 6, 2021, before the New York Court of Appeals, *J.P. Morgan Securities v. Vigilant Insurance Company*, No. APL-2020-00044, the Court of Appeals has an opportunity to join the majority of states and continue to modernize New York insurance common law.

J.P. Morgan seeks coverage for $140 million that Bear Stearns (later acquired by JPM) paid to the SEC to settle claims related to trading that generated profits for Bear's hedge fund customers. The court agreed to hear the appeal of a First Department panel's September 2018 ruling, which overturned an August 2017 order by Judge Charles Ramos finding coverage. The First Department based its reversal on a U.S. Supreme Court finding in *Kokesh v. SEC* that for statute of limitations purposes SEC-ordered disgorgement is a penalty under 28 U. S. C. §2462. In its appeal, J.P. Morgan argues that the reversal applied *Kokesh* too broadly, as that decision addressed the statute of limitations applicable to SEC disgorgement claims.

The proper functioning of the New York liability insurance system requires that D&O liability insurance companies seeking to exclude predictable types of liability use clear and unambiguous policy language. Prominent among these predictable liabilities are settlements with the SEC and other regulators. When faced with such claims, insurance companies should not be seen to expand unwritten exclusions, or to hide within expanded "public policy" exceptions to the terms of the insurance policies they sell.

Courts Should Not Be Asked To Act as Post-Loss Underwriters After a Claim Is Made. In broad terms, the insurance industry seeks to have New York courts sit as "post-loss underwriter" to insert exclusions into the insurance policies they sell in New York. The industry would have New York courts re-underwrite the policies and add exclusions for coverage for claims for (1) third-party gain conveniently called "disgorgement"; and (2) allegedly intentional harm to investors based on an expansion of a "public policy" exception to insurance coverage. If insurance markets are to function properly in New York, exclusions should be clear on the face of the insurance policies and not added after the fact through insurance nullification by litigation.

New York Courts Should Not Be Asked To Add an Exclusion for Losses Related to Third-Party Gain Even If Called 'Disgorgement'. The insurance industry knows better than courts and indeed better than most policyholders the risks they face. The risk of claims by securities regulators that produce the kind of losses before the court in the *J.P. Morgan* case is one obvious example.

This truth—that underwriters know what they are doing when they sell a policy covering a policyholder and collect premiums—has been black letter common law for hundreds of years. That every insurance company is presumed to know its policyholder has been true since the time of Lord Mansfield, the founder of insurance law. In *Noble v. Kennoway*, 2 Doug. 511, 513 (K.B. 1780) (Mansfield, C.J.), the court stated that: "[E]very underwriter is presumed to be acquainted with the practice of the trade he insures, and that whether it is recently established, or not. If he does not know it, he ought to inform himself. It is no matter if the usage has only been for a year."

Indeed New York courts respect this principle when they refuse to rewrite insurance policies after loss to undo losses for which underwriters collected insurance premiums. See *Zurich Insurance Co. v. Shearson Lehman Hutton*, 84 N.Y.2d 309, 316-17 (1994) (found dual purpose remedy with "both punitive and compensatory elements" insurable).

Courts have rejected insurance company attempts to limit insurance coverage based on a disgorgement exclusion not contained in the policy. *U.S. Bank N.A. v. Indian Harbor Ins. Co.*, 68 F. Supp. 3d 1044 (D. Minn. 2014) (the author represented U.S. Bank). Indeed, the insurance industry, through its use of so-called "bad acts" exclusions, has directly addressed the issue of "ill-gotten gains" or "disgorgement" for years. The market for D&O liability insurance initially included exclusions for "fraud" or for "ill-gotten gains", but quickly evolved only to exclude such claims that were finally adjudicated in the underlying action after appeal. Why? Because underwriters could not sell D&O liability insurance policies containing broader exclusions. Thus, underwriters instead sell policies which by their terms cover most claims of fraud, most claims of ill-gotten gains, and most claims of "bad acts." Covered claims generally include settlements in which the charged company neither admits nor denies guilt—as is the case here. But J.P. Morgan's insurance companies are effectively asking the courts of New York to add a disgorgement exclusion to the policies.

Had the insurance companies *really* wanted to exclude the losses such as the sort at issue in *J.P. Morgan* they could have done so with clear exclusions from coverage at the time that they sold the insurance policies. They did not, and New York courts should not be asked to add exclusions after a loss has happened.

New York Courts Should Not Expand the Public Policy Exception to Insurance Coverage for Intentional Conduct Causing Intentional Harm. Liability insurance by its nature involves compensating injured claimants for alleged injuries. For over a century, New York courts have recognized that the fault of the policyholder should not be a bar to insurance. *Messersmith v. American Fidelity Co.*, 232 N.Y. 161, 163 (1921) (Cardozo, J.) ("[t]o restrict insurance to cases where liability is incurred without fault of the insured would reduce indemnity to a shadow.").

That the fault of the insured should not be a bar to insurance recovery is particularly true where the insurance policy itself does not contain a clear exclusion eliminating coverage, but instead the insurance companies argue after a loss has happened that a vague—and, in their telling, broad—public policy exception to insurance for loss should apply. This court should not expand the extremely narrow public policy exception for intentional harm intentionally caused into a court-made rule with the potential to swallow liability insurance.

The J.P. Morgan case currently before the New York Court of Appeals provides an opportunity for New York courts to announce a rule that gets the courts of this state out of the role of being asked to add exclusions to liability insurance policies after a loss has happened.

This New York Court of Appeals previously in the same case currently before it found 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." *J.P. Morgan*, 21 N.Y.3d at 335 (citing *Goldfarb*, 53 N.Y.2d at 399). If the New York Court of Appeals opts to continue its public policy exception at all, it should narrowly prescribe the exception's scope to avoid eliminating whole areas for which liability insurance should be available to protect defendants and to compensate claimants.

New York Should Modernize Its Restriction on Insurance Coverage for Certain Punitive Damages. The issues before the Court in *J.P.* Morgan engage stakes more modest than a test of insurance coverage for punitive damages, but New York courts should indeed go further. Most states clearly permit insurance for punitive damages assessed for the defendant own conduct.

Insurance markets exist today to sell coverage for punitive damage insurance. Indeed, common law restrictions on coverage for punitive damages have resulted in a thriving non-admitted market and offshore market for such insurance.

Continuing to modernize New York common law regarding insurance coverage by articulating clearly that an underwriter may decide to sell—or not sell—a New York policyholder an insurance policy to cover punitive damages will bring this market back to New York. It also will remove a legal hurdle which has led to needless contortions—involving out-of-state and off-shore insurance markets—to protect defendants, and compensate plaintiffs, while complying with the law.

Conclusion

The *J.P. Morgan* case currently before the New York Court of Appeals provides an opportunity for New York courts to announce a rule that gets the courts of this state out of the role of being asked to add exclusions to liability insurance policies after a loss has happened; and to continue to modernize the insurance market of New York by broadly permitting insurance coverage for punitive damages. Ultimately, such an approach is good for policyholders, claimants and insurance companies seeking to bring insurance business back to New York.

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