PALEY
ROTHMAN
ATTORNEYS AT LAW

New York's Highest Court's Rejection of a Narrow View of Covered Damages Has Wide Application

By

In a highly anticipated decision, New York's highest court held in a securities-related dispute that funds the insureds *disgorged* as part of a settlement with the SEC did not constitute a "penalty imposed by law" under the policies at issue. *J.P Morgan Securities Inc., et al. v. Vigilant Ins. Co., et al. (N.Y. Ct. App. Nov. 23, 2021).* Accordingly, the Court found that such payments were covered *damages* for purposes of insurance coverage. While the decision has important implications for insurance coverage in the securities context, it also is grounded in a number of propositions that have broad application and significance in other areas. Specifically, remedies such as *disgorgement, restitution, unjust enrichment, abatement* and other quasi-equitable or purported penalty-type forms of relief pervade current disputes arising out of climate change, baby food, plastics, opioids and other areas. Each of these remedies serves some compensatory goal connected to a loss, injury or damage. *J.P. Morgan* shows how they are covered.

The Court initiated its analysis with the principle that whether the SEC-ordered disgorgement at issue in *J.P Morgan* constituted "a penalty imposed by law" is a question of contract interpretation. This is because "insurance contracts are subject to the general rules of contract interpretation. Like other agreements, insurance contracts are typically 'enforced as written'; *absent a violation of public policy*,' parties to an insurance arrangement may generally contract as they wish and the courts will enforce their agreements.'" Op. at 6. (citations omitted, emphasis added). Importantly, in a prior decision in the same case, the Court held that *disgorgement "was not clearly uninsurable as a matter of public policy."* Op. at 4 (citation omitted, emphasis added).

As a factual predicate to support its holding, the Court noted that the insured argued "that the $140 million disgorgement for which it seeks coverage was derived from *estimates of client gain and investor harm….*" Op. at 6 (emphasis added). The development of a factual record was critical to the decision. Notably, the policyholder expressly put in evidence as to the nature of the payments; the carriers never refuted that evidence, relying instead on dubious technical legal arguments.

Although the Court's analysis is built on the contrast between what constitutes a *penalty* or compensatory damages, the discussion of compensatory damages applies across-the-board. Thus, the Court noted that "a penalty is often characterized as monetary 'recovery without reference or regard to the actual damage sustained' that 'is not designed to compensate anyone.'" Op. at 9 (citations omitted). As the Court explained, a penalty is *not measured by the losses caused by the wrongdoing.* This concept is the foundation in connecting any loss to covered damages and the ultimate measure of damages.

The Court found that, under New York law, "*where a sanction **has both** compensatory and punitive components*, ***it should not be*** *characterized as punitive in the context of interpreting insurance policies."* Op. at 10 (citations omitted). In other words, unless a settlement or award is *purely* non-compensatory it may be covered. As such, the main evidentiary focus for purposes of determining coverage is whether a settlement or award "*served a compensatory goal." Id*. at 13. In the context of *J.P. Morgan, "neither **the label assigned** to the payment by the SEC and [J.P. Morgan/Bear Stearns], nor the mere fact that the injured parties may ultimately receive the payments is dispositive." Id*. at 13 (emphasis added, citations omitted). Rather, those factors are taken into account with "*the fact that the payment effectively constituted **a measure** of the investors' losses."* Id. (emphasis added). Thus, a key takeaway is that policyholders should build compensatory components or goals into any resolution, whether by settlement or otherwise.

The Court also clarified how non-insurance decisions affect the interpretation of an insurance policy. The carriers embraced a U.S. Supreme Court decision that, in the context of a statute of limitations for SEC actions seeking disgorgement, held that the five-year limitations period for actions to enforce a "penalty" encompassed "disgorgement" claims as a matter of statutory interpretation. *Kokesh v. SEC, 137 S Ct 1635 (2017)*. In short, the *J.P Morgan* Court held that *Kokesh* did not control: "*Initially the Supreme Court was not interpreting the term 'penalty' in and insurance contract (**much less one governed by New York law)** and, as we have cautioned, the meaning of that term may very **based on context."*** Op. at 16 (emphasis added). The significance of this aspect of the *J.P Morgan* decision is that the applicable insurance-related state law decisions should be analyzed in conjunction with the actual context of the exposure and/or dispute at issue. Correctly framed, the insurance industry should not be able to shut down coverage as a matter of law or by simply referencing allegations in pleadings.

Taking all of this together and applying the reasoning underlying the *J.P Morgan* decision, insurance policies "*must be construed in a manner consistent with the expectations of a reasonable insured at the time of contracting…."* Op. at 17 (emphasis added). Notably, the Court was "*mindful"* that the policyholder purchased insurance to cover liability arising from its business. Op. at 14. As such, policyholders should not lose sight of the fact that every problem has a story; the *J.P Morgan* decision provides an intuitive framework to set out a covered insurance narrative. Policyholders should ensure that any resolution of the underlying dispute is aligned with the principles set out in *J.P. Morgan.*