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J.P. Morgan Decision Curtails the Phantom "Restitution Defense" to D&O Coverage

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In a case closely watched by industry observers, the New York Court of Appeals, in J.P. Morgan Securities v. Vigilant Insurance Company*, No. 113 (NY, June 13, 2013), issued an important ruling in the field of directors and officers liability insurance, curtailing to some extent insurers' ability to use a phantom exclusion to deny coverage. Insurers increasingly have argued that their policies do not cover damages that can be characterized as restitutionary in nature, even where the policy may be silent on the issue. The contention is based on two theories: (1) that notwithstanding contract language providing coverage, the policy is unenforceable in that respect because in some states coverage for damages in the form of restitution (or disgorgement of ill-gotten gains) is unenforceable as a matter of public policy; and (2) from an economic standpoint, when a policyholder returns monies it has obtained improperly, there is no basis for coverage because the policyholder has not incurred any "Loss."*

The New York high court called foul on this encroachment on policyholders' contractual rights, holding that policyholder Bear Stearns was entitled to pursue its claim to coverage for a $160 million payment incurred as a result of settlement of an SEC enforcement proceeding, even though the agreement expressly characterized the payment as "disgorgement." As the Court made clear, there is no public policy in the State of New York barring coverage for restitution or disgorgement, and the limited public policy exception to the enforceability of contracts for "intentionally harmful conduct" could not be sustained by insurers on the record before the court. (Slip Op. at 9-11). More important to policyholders, the court also held that the bulk of the payment characterized in the settlement agreement as "disgorgement" was actually compensation for profits improperly received by Bear Stearns' hedge fund customers, not the result of gain by Bear Stearns. Given that the "policy rationale for precluding indemnity for disgorgement – to prevent the

unjust enrichment of the insured by allowing it to, in effect, retain the ill-gotten gains by transferring the loss to its carrier," was not implicated because Bear Stearns was "not pursuing recoupment for the turnover of its own improperly acquired profits," the court denied insurers' motion to dismiss. As Justice Smith put it during oral argument before the appellate court, "how can you disgorge something that you haven't 'gorged'?"

The ruling is critically important in that it curtails the use of the unwritten "restitution defense" by D&O insurers subject to New York law, unless the restitution payments at issue corresponded to benefits actually received by the insured. Under this test, the restitution defense would not apply to any claim, such as a claim for breach of fiduciary duties by directors or officers, where the individuals did not receive the benefit of a distribution or other transaction. Likewise, this matching test should limit use of the restitution defense in response to Side B claims (reimbursing a company for amounts paid as indemnity to individual directors or officers), where the company has paid restitution to a third party, but individual directors or officers did not actually benefit from the funds being disgorged.

Left unaddressed by the New York court, however, is one of the nagging issues in this area: whether the restitution defense requires the insurer to prove not only that the insured was the actual beneficiary of the amount being disgorged, but also that the gains were "ill-gotten." In many cases, the recipient actually earned the amounts being disgorged, lawfully and properly, but is required to turn over its gains for technical legal reasons, regardless of fault. This may occur in a fraudulent transfer action brought by a bankruptcy trustee under Section 548 of the Bankruptcy Code (allowing avoidance of certain types of payments, such as severance payments to executives, made by an insolvent company less than two years prior to the bankruptcy petition date, in return for less than reasonably equivalent value). At least one court has held that in a fraudulent transfer action brought by a debtor company's bankruptcy trustee against the company's former CEO, the employee severance payment the CEO was ordered to disgorge did not constitute "Loss" within the meaning of the D&O policy. *In re Transtexas Gas Corp.,* 597 F.3d 298, 310 (5th Cir. 2010)("Payments fraudulent as to creditors that must therefore be repaid due to bankruptcy court order [are] a disgorgement of ill-gotten gains and a restitutionary payment."). Other courts have rejected such an approach as an overbroad application of vague notions of public policy. In *Federal Ins. Co. v. Continental Casualty Co.*, 2006 WL 3386625 (W.D. Pa. Nov. 22, 2006), a case arising from an action to recover alleged fraudulent transfers to former directors and officers under the Bankruptcy Code, the court refused to find that public policy rendered the preferential transfers uninsurable under state law. The court recognized that because liability in a fraudulent transfer action is strict, without regard to fault, "allowing the insured to collect under its insurance policy would not encourage others to intentionally engage in unlawful activity with the purpose of reaping a benefit from such activity through its insurance." Id. at 23. The court observed that the insurance company already had a safeguard in place to prevent the insureds from reaping a windfall, namely, the Illegal Profit Exclusion. Id. Thus the court properly refused to second-guess an expressly stated term of the policy based on public policy arguments.

In light of the J.P. Morgan ruling, insurers and insureds alike are well advised to take a fresh look at their policy wordings. The expanding use of the restitution defense, and the inherent difficulty in applying policy language to contractual terms such as restitution and disgorgement, strongly suggest that policyholders should demand clearer policy language. On the negative side, a few policies now expressly exclude restitution and disgorgement from the definition of Loss, without defining those terms. Some policies are silent and some exclude from Loss any damages that are uninsurable as a matter of state law. From a policyholder's standpoint, it makes good sense to insist on coverage for restitution/disgorgement to the fullest extent insurable under the law, absent final adjudication that the disgorgement was to remedy illegal profit or criminal conduct. Even in the unlikely event that a state's "public policy" would prohibit enforcement of such contracts, an insurer can surely stipulate in its policy that it will not assert that

restitutionary damages are uninsurable unless there is a final adjudication of illegal profit or conduct. It is already widely accepted wording in almost every D&O policy (usually in the definition of "Loss") that the insurer will not assert that (restitutionary) damages imposed under Sections 11 or 13 of the Securities Act are uninsurable as a matter of law; so this recommendation is in no way a "stretch." Given the decade of litigation over these issues, for insurers to continue to assert this phantom exclusion instead of setting forth a clear statement in their policies is the real violation of public policy.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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