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Developments in the Insurability of "Loss" and Disgorgement: The U.S. Supreme Court in *Kokesh* Adds Support for Disgorgement as an Uninsurable "Penalty"

by Bonnie M. Hoffman and Matthew N. Klebanoff

The issue of whether an insured's "Loss" constitutes insurable damages, settlements, or judgments versus uninsurable disgorgement, restitution, fines or penalties—either pursuant to the contractual definition of "Loss" or as a matter of public policy—is often the subject coverage litigation. While the issue is not confined to D&O and management liability insurance policies, issues of "Loss" and disgorgement do arise frequently in that context given the nature of claims and relief commonly at issue. This article briefly discusses the genesis of this coverage issue, explaining that while the principles underlying it may seem straightforward (*i.e.*, that a "thief" cannot insure itself against "ill-gotten gains"), the issue has received mixed treatment in the courts. Next, the article discusses significant developments in this area, including the Supreme Court's recent ruling in *Kokesh v. S.E.C.*, __ U.S. __, 137 S. Ct. 1635, 1642, 198 L. Ed. 2d 86 (2017), in which the Court unanimously held in the context of an SEC enforcement action that "disgorgement constitutes a penalty" – even if aspects of disgorgement are "compensatory" in nature. The article then discusses a recent decision, *J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 51 N.Y.S.3d 369 (N.Y. Sup. Ct. 2017) (finding $160 million SEC "disgorgement" payment is insurable), where *Kokesh* will play a lead role on appeal. The article concludes by offering some practical guidance for insurers faced with "Loss" and disgorgement issues.

Background: "Loss" Does Not Include the Restoration of Ill-Gotten Gains

D&O insurance policies provide coverage for "Loss," a term typically defined to include damages, settlements, judgments and defense costs, and defined to not include fines, penalties, and matters deemed uninsurable by law. *See* Knepper & Bailey, Liability of Corporate Officers and Directors § 24.07 (8th ed. 2016). In *Level 3 Commc'ns, Inc. v. Fed. Ins. Co.*, 272 F.3d 908 (7th Cir. 2001), Judge Richard Posner explained that "'loss' within the meaning of an insurance contract does not include the restoration of an ill-gotten gain." *Id.* at 911. In addition to the moral hazard it would create, this is because "[a]n insured incurs no loss within the meaning of the insurance contract by being compelled to return property that it had stolen, even if a more polite word than 'stolen' is used to characterize the claim for the property's return." *Id.* at 911; *see also id.* at 910 ("if such an insurance policy did insure a thief against the cost to him of disgorging the proceeds of the theft it would be against public policy and so would be unenforceable"). Other courts also "have emphasized that public policy prohibits an insured from receiving indemnification for the disgorgement of its own illicit gains." *J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 21 N.Y.3d 324, 336, 992 N.E.2d 1076, 1082 (2013) (citing *Bank of the W. v. Superior Ct.*, 2 Cal.4th 1254, 1269, 10 Cal.Rptr.2d 538, 833 P.2d 545, 555 (1992)). Some states do not hold that insurance of disgorgement violates public policy (*e.g.*, Washington) and other states have not yet spoken on the issue at the highest level (*e.g.*, Delaware), but the clear majority rule is that disgorgement is uninsurable. The *Level 3* court additionally explained that the insured – "seeing the handwriting on the wall" — cannot simply settle to avoid a judgment that would otherwise be determinative of the insurability issue; rather, the nature of the claims and relief determines whether "Loss" is or is not insurable. 272 F.3d at 911. Likewise, the labels or characterizations of the claims and remedies at issue do not alone dictate whether "Loss" is insurable or uninsurable. *See Unified W. Grocers, Inc. v. Twin

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City Fire Ins. Co., 457 F.3d 1106, 1115 (9th Cir. 2006) ("The label of 'restitution' or 'damages' does not dictate whether a loss is insurable."). Typically, such inquiries are highly fact-specific and dependent on the nature of the claims and relief actually being pursued or settled.

While the basic principles may seem straightforward, courts have reached mixed results both in scope and application when assessing "Loss" and disgorgement issues. *Compare In the Matter of Transtexas Gas Corp.*, 597 F.3d 298, 310 (5th Cir. 2010) (Texas law) (finding that a "[p]ayment[] fraudulent as to creditors that must therefore be repaid due to bankruptcy court order" is not an insurable "loss" because it is "a disgorgement of ill-gotten gains and a restitutionary payment"); *CNL Hotels & Resorts v. Twin City Fire Ins. Co.*, 291 Fed. Appx. 220, 223 (11th Cir. 2008) (Florida law) ("The return of money received through a violation of law, even if the actions of the recipient were innocent, constitutes a restitutionary payment, not a 'loss.'"), *with Chubb Custom Ins. Co. v. Grange Mutual Casualty Co.*, 2011 WL 4543896, *5, 11 (S.D. Ohio Sept. 29, 2011) (settlement of underlying class action lawsuits based on allegedly underpaid auto insurance claims not deemed uninsurable restitution or disgorgement under Ohio law because although the insurer allegedly received a "benefit" through its alleged underpayment of the claims, "it did not 'wrongfully acquire' this money—it simply retained it"); *Burks v. XL Specialty Ins. Co.*, Civ. A. No. 14-14-00740-CV, 2015 WL 6949610, at *10 (Tex. App. Nov. 10, 2015) (finding "a genuine issue of material fact on whether [the insured CFO's] settlement was for disgorgement and [is] therefore uninsurable under the law' of Texas," and further noting that "we find no Texas authority precluding coverage for such a settlement as a matter of law").

The Supreme Court's *Kokesh* Decision Adds a Twist

The recent case of *Kokesh v. S.E.C.*, __ U.S. __, 137 S. Ct. 1635, 1642, 198 L. Ed. 2d 86 (2017) adds a twist to the disgorgement analysis, and suggests that, even if a court or particular state has hesitated to find disgorgement uninsurable as a matter of law, insurers may lead with arguments that disgorgement constitutes a "penalty"—as the Court held in *Kokesh* – and therefore fails to constitute "Loss" and/or that this further supports the public policy bar. Penalties are typically either expressly carved out of the definition of "Loss" or are otherwise uninsurable as a matter of law and public policy. *Kokesh* addressed a statute of limitations issue under 28 U.S.C. § 2462, which provides a five-year statute of limitations for any "action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise." The case focused on whether a $34.9 million disgorgement judgment entered in an SEC enforcement action was a "penalty," such that the statute of limitations barred the recovery of $29.9 million in disgorgement for violations that occurred outside the limitations period. *See id.* at 1641. Below, the district court sided with the SEC that the statute of limitations did not apply because disgorgement was supposedly not a "penalty;" the U.S. Court of Appeals for the Tenth Circuit affirmed, finding that disgorgement was neither a "penalty" nor a "forfeiture." *Id.*

In reversing the lower courts and holding that disgorgement was a "penalty," the Supreme Court first looked to the definition of "penalty": "punishment, whether corporal or pecuniary, imposed and enforced by the State, for a crime or offense against its laws." *Id.* at 1642 (quoting *Huntington v. Attrill*, 146 U.S. 657, 667, 13 S.Ct. 224, 36 L.Ed. 1123 (1892)). This definition, the Court said, gives rise to two principles: (1) "whether a sanction represents a penalty turns in part on 'whether the wrong sought to be redressed is a wrong to the public, or a wrong to the individual,'" and (2) "a pecuniary sanction operates as a penalty only if it is sought 'for the purpose of punishment, and to deter others from offending in like manner'—as opposed to compensating a victim for his loss." *Id.* (citing *Huntington*, 146 U.S. at 668). In concluding that SEC disgorgement "bears all the hallmarks of a penalty," *id.* at 1644, the Court emphasized that SEC disgorgement is imposed as a consequence of violating "public laws," (*id.* at 1643, citing *Meeker v. Lehigh Valley R. Co.*, 236 U.S. 412, 35 S.Ct. 328, 59 L.Ed. 644 (1915)), and that the SEC acts "in the public interest" in seeking disgorgement. *Id.* Next, the Court explained that SEC disgorgement is largely imposed for punitive purposes —"not to compensate"—and that "the primary purpose of disgorgement orders is to deter violations of the securities laws by depriving violators of their ill-gotten gains." *Id.* at 1643–44 (internal quotation omitted).

In rejecting the SEC's primary argument that "SEC disgorgement is not punitive but 'remedial' in that it 'lessens the effects of a violation' by 'restoring the status quo,'' the Court explained first that it was not clear, at least in the context of SEC enforcement actions, that disgorgement "simply returns the defendant to the place he would have occupied had he not broken the law." *Id.* at 1644. The Court explained that defendants can be forced to disgorge amounts exceeding the defendants' own profits, such as in insider trading cases: "[i]n such cases, disgorgement does not simply restore the status quo; it leaves the defendant worse off. The justification for this practice … demonstrates that disgorgement in this context is a punitive, rather than a remedial, sanction." *Id.* at 1645. The Court further emphasized that while disgorgement can, and often does, serve "compensatory goals in some cases," this fact alone is not dispositive, as "sanctions frequently serve more than one purpose." *Id.* The Court's observation that disgorged funds may serve at least *some* compensatory purpose without negating the "punitive, rather than remedial" nature of disgorgement is an important point.

The *Kokesh* Ruling May Shift the Focus in "Loss" and Disgorgement Insurability Disputes

The insurability of SEC disgorgement was recently front and center in *J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 51 N.Y.S.3d 369 (N.Y. Sup. Ct. 2017), as amended, (N.Y. Sup. Ct. Aug. 7, 2017), where the *Kokesh* decision is playing a role in the latest appeal of that action. In *J.P. Morgan*, Bear Stearns agreed to pay "a total of $250 million, of which $160 million was labeled 'disgorgement' and $90 million was a penalty," in connection with the SEC's investigation and allegations of "possible violations of federal securities law in connection with their alleged facilitation of late trading and deceptive market timing by certain customers involved in buying and selling shares in various mutual funds." *Id.* at 372. Bear Stearns sought indemnity for the SEC settlement from its professional liability insurers and filed suit seeking a declaration that the insurers were obligated to indemnify it for the "*non-penalty* portion of the SEC settlement." *Id.* The insurers had denied coverage and moved to dismiss on the grounds that, *inter alia*, the settlement constituted disgorgement of ill-gotten gains which are not insurable as a matter of public policy and did not constitute insurable "Loss" under the policies—making *Level 3*- type arguments. 21 N.Y.3d at 332. The trial court denied the insurers' motion to dismiss, and the Appellate Division reversed, holding the disgorgement payment was not an insurable "Loss" and that recoupment was precluded as a matter of public policy. Ultimately, the New York Court of Appeals reinstated the trial court's denial of the insurers' motion to dismiss, agreeing that "it was unable to conclude, on the basis of the SEC order alone, that the $160 million disgorgement payment was 'specifically linked' to *Bear Stearns'* improperly acquired funds, as opposed to profits that flowed to its *customers*." *Id.* at 333 (emphasis added). That circumstance, the Court of Appeals explained, was different from cases where SEC disgorgement is "conclusively linked … to improperly acquired funds in the hands of the insured," which "directly implicate[s] the policy rationale for precluding indemnity for disgorgement—to prevent unjust enrichment of the insured by allowing it to, in effect, retain the ill-gotten gains by transferring the loss to its carrier." *Id.* at 337.

On remand, the trial court granted Bear Stearns' motion for summary judgment dismissing the insurers' defense that the disgorgement payment is uninsurable, finding dispositive that "the SEC order does not establish that the … payment, although labeled disgorgement, was predicated on profits that Bear Stearns improperly acquired," noting that Bear Stearns presented evidence "to demonstrate that the settlement payment it made to the SEC actually represents the gains of its customers, rather than its own gains." 51 N.Y.S.3d at 374. The Supreme Court issued its ruling in *Kokesh* roughly six weeks later, and the insurers then filed a motion for leave to renew their motion to dismiss arguing that *Kokesh* firmly established the disgorgement payment was a "penalty" that did not constitute insurable "Loss," and that public policy barred coverage. The trial court, however, advised the insurers that they will need to take up the impact of the *Kokesh* ruling with the New York appellate courts. Considering that Bear Stearns did not even seek coverage in the first instance for the $90 million "penalty" portion of its SEC settlement, and that *Kokesh* highlighted instances where defendants are made to disgorge more than they personally may have gained as being supportive of the fundamentally punitive nature of disgorgement, the *Kokesh* decision will play a central role in the latest appeal of *J.P. Morgan*.

Takeaways

First, as *J.P. Morgan* and the above cases reaffirm, the labels parties attach to claims, relief, and settlements, while often relevant, are not dispositive when considering issues of insurable versus uninsurable "Loss." Rather, it is necessary to undertake a fact-specific inquiry and to understand the actual nature of the claims and relief at issue. *Kokesh* also illustrates that a disgorgement payment may be punitive in nature even if it shares compensatory elements; the inquiry is not “all or nothing.” Second, *Kokesh* allows insurers to emphasize “penalty”-based arguments concerning the “Loss” insurability analysis and related public policy arguments. Insurers should now consider whether *Kokesh* provides an additional or stronger defense to coverage by focusing on the punitive nature of disgorgement. Third, while broader implications of *Kokesh* remain to be seen, the decision provides a useful framework beyond the SEC disgorgement setting for evaluating whether disgorgement or other relief constitutes an uninsurable “penalty.” In this regard, it is worth bearing in mind the Court’s observation that while disgorgement can, and often does, serve “compensatory goals,” this fact alone is not dispositive given that “sanctions frequently serve more than one purpose.” 137 S. Ct. at 1645. Fourth, *Kokesh* could especially impact Regulatory Claims coverage, including coverage for SEC enforcement actions – since the available remedies for such actions are largely limited to penalties and injunctions– which could limit coverage to defense costs unless specifically included and not against the public policy of governing state law.

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