To Be Argued By:
STEVEN E. OBUS
Time Requested: 15 Minutes

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Court of Appeals

STATE OF NEW YORK

J.P. MORGAN SECURITIES INC., J.P. MORGAN CLEARING CORP., and THE BEAR STEARNS COMPANIES LLC,

Plaintiffs-Appellants,

—against—

VIGILANT INSURANCE COMPANY, THE TRAVELERS INDEMNITY COMPANY, FEDERAL INSURANCE COMPANY,

Defendants,

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURG, PA., LIBERTY MUTUAL INSURANCE COMPANY, CERTAIN UNDERWRITERS AT LLOYD'S, LONDON, and AMERICAN ALTERNATIVE INSURANCE CORPORATION,

Defendants-Respondents.

BRIEF FOR PLAINTIFFS-APPELLANTS

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DISCLOSURE STATEMENT PURSUANT TO 22 N.Y.C.R.R. 500.1(F)

J.P. Morgan Securities LLC, f/k/a J.P. Morgan Securities Inc. is owned by J.P. Morgan Broker-Dealer Holdings Inc., which is owned by JPMorgan Chase Holdings LLC, which is owned by JPMorgan Chase & Co. Its only subsidiaries or affiliates are J.P. Morgan Prime Inc., J.P. Morgan Putters/Drivers, Series 5034 Trust, and Nine Point Energy Holdings, Inc. "Subsidiary" is defined as a legal entity in which JPMorgan Chase & Co. owns a diluted equity interest of at least 50% of total equity. "Affiliate" is defined as a legal entity in which JPMorgan Chase & Co. owns a diluted equity interest of at least 25% but less than 50% of total equity.

J.P. Morgan Clearing Corp. has been merged into J.P. Morgan Securities LLC and has no owners, subsidiaries or affiliates independent of those of J.P. Morgan Securities LLC.

The Bear Stearns Companies LLC is owned by JPMorgan Chase Holdings LLC, which is owned by JPMorgan Chase & Co. The Bear Stearns Companies LLC has the following subsidiaries and affiliates:

Access Fund II, L.P.

Access Fund III, L.P.

Access Fund IV, L.P.

Access Fund V, L.P.

Access Fund VI, L.P.

Access Fund VII, L.P.

Bear Growth Capital Partners, LP

Bear Stearns Access Fund II Management LLC

Bear Stearns Access Fund III Management LLC

Bear Stearns Access Fund Management LLC

Bear Stearns Alternative Assets International Limited

Bear Stearns Asset Backed Securities I LLC

Bear Stearns Asset Backed Securities, Inc.

Bear Stearns Asset Management Inc.

Bear Stearns Capital Markets Inc.

Bear Stearns Equity Holdings Inc.

Bear Stearns FOF Asset Management LLC

Bear Stearns FOF II Asset Management LLC

Bear Stearns Global Securitisation Limited

Bear Stearns High-Grade Structured Credit Strategies (Overseas) Ltd.

Bear Stearns High-Grade Structured Credit Strategies (Overseas) Yen Unit Trust

Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage (Overseas) Ltd.

Bear Stearns High-Grade Structured Credit Strategies Master Fund Ltd.

Bear Stearns Holdings Limited

Bear Stearns International Trading Limited

Bear Stearns Investment Products Inc.

Bear Stearns MB 2000-2001 Pre-Fund, LLC

Bear Stearns MB Manager III, Inc.

Bear Stearns Merchant GP II, LLC

Bear Stearns Merchant GP III, LLC

Bear Stearns Private Opportunity Ventures Management LLC

Bear Stearns Secured Investors Inc.

Bear Stearns Structured Products Inc.

Bear Stearns UK Holdings Limited

Bear Stearns Ventures Management LLC

Bear UK Mortgages Limited

Belmont Asset Based Lending Ltd.

BGCP GP, LLC

BGCP Group, LP

BSAM Capital Corp.

BSAM Private Equity Holdings, Inc.

BSAM Private Equity Solutions, Inc.

BSCGP Inc.

CGC GP II, LLC

CGC GP, LLC

Constellation Venture Capital II, L.P.

Constellation Venture Capital Offshore II, L.P.

Constellation Ventures (BVI), Inc.

CVC II Partners LLC

eCAST Settlement Corporation

EMC Mortgage LLC

EMC Mortgage SFJV 2005, LLC

Gregory Properties Inc.

Intermediary Servicing Limited

IPC Advisors II, L.P.

IPC/NYCG LLC

J.P. Morgan Mansart Management Limited

Max Recovery Canada Company

Max Recovery Limited

MB Group BGCP, LP

MBI Co-Invest GP LLC

MBI Co-Invest SLP LLC

Plymouth Park Tax Services LLC

Principal Guaranteed Investors Inc.

Private Equity Opportunity Fund, L.P.

Private Equity Opportunity Fund II, L.P.

Private Opportunity Ventures, L.P.

PSERS Fee Income, L.P.

Rooftop Funding Limited

Rooftop Holdings Limited

SACO I Inc.

Structured Asset Mortgage Investments II Inc.

The BSC Employee Fund II, L.P.

The BSC Employee Fund III, L.P.

The BSC Employee Fund IV, L.P.

The BSC Employee Fund V, L.P.

The BSC Employee Fund VI, L.P.

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Plaintiffs-Appellants J.P. Morgan Securities LLC, f/k/a J.P. Morgan Securities Inc., J.P. Morgan Clearing Corp., and The Bear Stearns Companies LLC (collectively, "Bear Stearns") respectfully submit this brief in support of their appeal from (i) the judgment of the Supreme Court, New York County entered on September 23, 2019 (the "Judgment," R.28-30) dismissing Bear Stearns' Amended Complaint as to Defendants National Union Fire Insurance Company of Pittsburgh, Pa. ("National Union"), Liberty Mutual Insurance Company ("Liberty Mutual"), Certain Underwriters at Lloyd's, London ("Underwriters"), and American Alternative Insurance Corporation ("AAIC") (collectively, "Respondents") and severing the remaining claims in the Amended Complaint as to Defendants Vigilant Insurance Company ("Vigilant"), The Travelers Indemnity Company ("Travelers"), and Federal Insurance Company ("Federal"), and (ii) the decision and order of the Appellate Division, First Department, dated September 20, 2018 (the "Decision," R.5-21) that necessarily affected the Judgment.[1]

PRELIMINARY STATEMENT

In 2013, in this case, this Court held that a "disgorgement" payment that Bear Stearns made to settle claims by the Securities Exchange Commission ("SEC") that Bear Stearns had violated the securities laws is insurable under New York law, and is a covered "Loss" under Respondents' insurance policies, to the

[1] Respondents and the remaining Defendants are referred to as "Insurers."

extent the payment represented gains obtained by Bear Stearns' customers rather than by Bear Stearns itself. *See J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 21 N.Y.3d 324, 334-38 (2013). After Bear Stearns established that very factual predicate and obtained a judgment (R.480-86), the Appellate Division nonetheless erroneously held in the Decision, based on an inapposite intervening federal decision, *Kokesh v. SEC*, 137 S. Ct. 1635 (2017), that this Court's rulings should not be followed. However, *Kokesh* addressed only the narrow question of how to treat a disgorgement payment for purposes of a federal statute of limitations in a securities enforcement action. The Appellate Division improperly relied on that decision to hold, under materially different New York insurance law, that Bear Stearns' payment was an uninsurable penalty and therefore excluded from coverage under Respondents' policies. (R.12-14.)

As shown in Point I, the Appellate Division failed to recognize the crucial differences between this case and *Kokesh*, and therefore wrongly concluded it was free to set aside this Court's binding precedent as to the insurability of disgorgement payments under New York law. Specifically, the Decision contradicts the New York insurance law rule from *Zurich Insurance Co. v. Shearson Lehman Hutton*, 84 N.Y.2d 309, 316-17 (1994), which held that a dual-purpose remedy – one that has "both punitive and compensatory elements," like the disgorgement payment at issue here – is insurable. That rule, applied by this Court in 2013, is still the law in New York, and *Kokesh* did not change it.

Indeed, in *Kokesh*, the Supreme Court did not address questions of insurability. Rather, *Kokesh* addressed federal statutes of limitations and held that the five-year limitations period for penalty claims by the SEC should also apply to SEC disgorgement claims, because SEC disgorgement deters violations of the securities laws. *Kokesh* also expressly acknowledged that the SEC regularly seeks disgorgement of third party gains, and that SEC disgorgement may be used to compensate investors.

Kokesh thus has no bearing on New York insurance law, the well-settled holding of *Zurich*, or this Court's holding in this case as to the insurability of Bear Stearns' disgorgement payment. That payment represented the gains to certain investors and was required to be used, and was used, to compensate other injured investors, and offset any Bear Stearns' liability to those investors. Accordingly, it was an error for the First Department to reverse based on *Kokesh*.

As shown in Point II, the Appellate Division also erred in holding that Bear Stearns' disgorgement payment must be excluded from the definition of "Loss" under the terms of the insurance policies at issue. In so holding, the Appellate Division erroneously failed to apply (or even mention) rules of contract construction and insurance law that are well-settled in New York, including that coverage should be consistent with the reasonable expectation of the insured; that each provision is given a distinct meaning; and that ambiguities are construed against the insurer and in favor of coverage.

The Appellate Division thus ignored that the SEC consent order that imposed the disgorgement payment at issue specifically designated it as "disgorgement" and distinguished that payment from a separate payment expressly designated as a penalty. This distinction was not merely a label: the SEC and Bear Stearns agreed that, unlike the disgorgement payment, the penalty would be treated as a penalty for tax purposes; Bear Stearns could not use the penalty to offset damages that may be owed to civil plaintiffs; and Bear Stearns could not seek insurance coverage for the penalty.

These provisions differentiating the remedies in the consent order were consistent with how the terms "penalty" and "disgorgement" are and were commonly used and understood. Indeed, when Insurers sold the policies to Bear Stearns in 2000, and, for that matter, in 2006 when Bear Stearns settled with the SEC, no court had ever held, or even suggested, that disgorgement was a penalty. The entire notion that the disgorgement payment was a penalty outside the definition of "Loss" did not occur to Insurers themselves until after *Kokesh*, which shows that it is completely unrooted in ordinary usage and inappropriate for construction of the insurance policies here. The Decision is thus contrary to the principle that insurance policies should be construed in light of the law in effect when the policies were sold, or, at latest, when the Loss was incurred, not on changes in the law that occurred years later.

As shown in Point III, the Appellate Division's *Kokesh* rationale did not in any event support its sweeping reversal of the original judgment in favor of Bear Stearns. That judgment included an award of coverage for a separate $14 million settlement payment Bear Stearns made to settle class actions by mutual fund investors. Nothing in *Kokesh* changed the insurability of damages payments Bear Stearns made to settle private claims by investors.

As addressed in Point IV, Insurers (including Respondents) advanced various arguments below that the Appellate Division did not reach, but that they may now attempt to raise as alternate grounds to affirm, as they did in 2013. Each of those alternative arguments fails for the reasons stated by the IAS Court. First, Bear Stearns demonstrated beyond genuine dispute that the $140 million for which it seeks insurance coverage was based on customer gains, rather than its own. Second, as this Court has already held, the "personal profit" exclusion in Insurers' policies does not apply because Bear Stearns' $140 million disgorgement payment did not consist of any of its own profits. Third, Insurers failed to raise a genuine issue of material fact regarding the reasonableness of Bear Stearns' settlements with the SEC and the investor plaintiffs. As the IAS Court recognized, the SEC settlement was reasonable given the substantial risk that Bear Stearns would have liability for the SEC's disgorgement demand for $520 million, more than triple the ultimate settlement amount. The class action settlement, which was a much smaller amount because Bear Stearns was able to use the disgorgement payment to offset liability to investors, was also correctly found to be reasonable in light of Bear Stearns' potential exposure there. Fourth, Insurers' argument that coverage is barred by public policy because Bear Stearns' liability stemmed from intentionally harmful acts fails because there is no evidence that Bear Stearns acted for the purpose of inflicting harm, as New York law requires. Fifth, two Respondents – Underwriters and AAIC – failed to overcome Bear Stearns' showing that a "prior knowledge" exclusion (which is present only in those Insurers' policies) could not apply because no Bear Stearns officer with relevant responsibility knew of the alleged violations of the securities laws at the time they sold their policies to Bear Stearns. Finally, the IAS Court correctly awarded Bear Stearns prejudgment interest accruing from Insurers' repudiation of coverage.

QUESTIONS PRESENTED

The Decision raises the following questions:

1. Whether the Appellate Division improperly overruled this Court's prior decision in this case, which held that a disgorgement payment in the amount of third party gains that was expressly required to be used to

compensate injured persons, and was so used, is insurable under New York law and public policy.

2. Whether, after *Kokesh*, such a settlement payment continues to constitute an insurable "Loss" under the applicable insurance policies, as this Court held in this case.
3. Assuming that the 2017 *Kokesh* decision did prospectively change the meaning of the term "penalty" in New York law-governed insurance contracts, whether the Appellate Division should nonetheless have applied the law in effect in 2000 when the parties entered into those contracts, which law was still in effect in 2006 when Bear Stearns entered into the SEC settlement and made the disgorgement payment at issue.
4. Whether the Appellate Division erred in relying on *Kokesh* to reverse the judgment in favor of Bear Stearns in its entirety, when that judgment included $14 million Insurers owed to indemnify Bear Stearns for a settlement with an investor class that sought damages, not disgorgement, and none of Insurers' other arguments against coverage had merit.

STATEMENT OF JURISDICTION

The Court has jurisdiction to review this appeal pursuant to CPLR 5602(a)(1)(ii). The Judgment is final as to Respondents, and the Decision necessarily affected the Judgment.

First, the Judgment is final as to Respondents because it resolves all claims against them. None of the Respondents pled any counterclaims or cross-claims in their answers (R.170-226, 227-55, 288-314, 345-77), and the Judgment (R.28-30) dismisses each of them from the case.

Second, the Decision "necessarily affect[ed]" the Judgment. *See* CPLR 5602(a)(1)(ii). In the Decision, the Appellate Division held that even if Bear Stearns' payment did in fact represent third party gains, it was uninsurable, and was not a Loss under the insurance policies. (R.12-14.) As the IAS Court's subsequent order directing entry of the Judgment recited (R.25), the Decision thereby rendered Bear Stearns unable to recover damages sufficient to penetrate to the upper excess layers of its coverage program (which would implicate Respondents' higher-level excess insurance policies).

The Appellate Division made its holding "on the law." (R.21.) The issues herein are preserved for this Court's review. Bear Stearns prevailed on them before the IAS Court (R.399-434, 473-79, 600-43) and addressed them throughout its brief to the Appellate Division.

STATEMENT OF THE FACTS

The material facts are set forth in full in Bear Stearns' statement of undisputed facts (R.1066-1089) and not genuinely disputed in Insurers' responding statement (R.2695-2741).

The Mutual Fund Investigations

Beginning in September 2003, various regulatory agencies, including the SEC, began investigating allegations that Bear Stearns improperly facilitated late trading and deceptive market timing by certain hedge funds and other investors – which were Bear Stearns' customers – in mutual funds. (R.1069 ¶¶ 11-12; R.1287-1472.) During the course of the investigation, Bear Stearns was sued by mutual fund investors in numerous class actions (the "Civil Actions") involving similar allegations. (R.1473-1525.) The SEC's investigation was resolved as to Bear Stearns on March 16, 2006, when the SEC and Bear Stearns entered into a consent order (the "SEC Order"), under which Bear Stearns agreed to pay $160 million as disgorgement (of which $140 million represented gains by Bear Stearns' customers and for which it sought insurance coverage) and $90 million as a penalty. (R.1560-1603.) The SEC made allegations in the SEC Order, which it called "findings," but Bear Stearns did not admit or deny the "findings," and consented to the order "[s]olely for the purpose of these proceedings." (R.1562-63.) Bear Stearns also settled with the New York Stock Exchange ("NYSE"), in an agreement (the "NYSE Decision") that required the same payments. (R.1635-1679.)

Undisputed evidence of how the settlement with the SEC was reached is contained in the Affirmations and deposition testimony of Lewis Liman, Bear Stearns' lead counsel. (R. 1090-1136; R.9053-9142.) The undisputed record evidence confirms that the $140 million disgorgement payment for which Bear Stearns seeks insurance coverage was based on a calculation of gains to Bear Stearns' customers. (R.1072-74 ¶¶ 26-38; R.1077-78 ¶¶ 50-52.)

Bear Stearns' Own Revenues of $16.9 Million

At the request of the SEC, Bear Stearns calculated that its own revenues from handling the transactions at issue amounted to $16.9 million. (R.1072-73 ¶¶ 26-33; R.1095-96; R.1845-85; R.1889-1912; R.2586-87; R.2596; R.2613.) This calculation became the basis for the $20 million Bear Stearns revenue component of the disgorgement payment under the SEC settlement. (R.1095-98 ¶¶ 3-6, 10; R.9135-42.) The SEC staff did not question Bear Stearns' calculation of its own gains either by asserting that the calculation understated those gains or by contending that it should have included revenues from the handling of non-mutual fund transactions. (R.1096; R.1890; R.1914; R.2591-99; R.2607-08.)

Bear Stearns' Customers' $140 Million Gains

At the SEC staff's request, Bear Stearns estimated the gains of its customers using two different methodologies that the SEC staff specified: first, a "Delta NAV" analysis, based on the difference between the hedge fund customer's net asset value on the day of a late trade or market timing trade and on the next day; and second, an estimation of customer gains based on the purchase and sales prices for the same transactions. (R.1077-78 ¶¶ 50-56; R.1097; R.1743; R.1753-54; R.1915-62; R.2588-90; R.2593; R.2625; R.2633.) The calculations yielded customer gain estimates of $519 million and $306 million, respectively. (R.1078 ¶¶ 55-56; R.1097; R.1743; R.1915-62; R.2633.)

Based on the Bear Stearns $519 million Delta NAV customer gain estimate, the SEC staff demanded that Bear Stearns pay $720 million: $520 million in customer gains and a $200 million penalty. (R.1079 ¶¶ 58-59; R.1097-98; R.1975; R.2022-23.) In response, Bear Stearns proposed what it contended was a more appropriate means to measure customer gains – a "fair value" analysis, which estimated customer gains of $140 million. (R.1079 ¶ 61; R.1098; R.2042-51.) This analysis compared executed trade prices with the estimated "fair value" of the fund shares at the time of the trades based on futures index prices. (*Id.*)

June 2005 Settlement Negotiations

On June 24, 2005, two days after Bear Stearns presented the SEC staff with its $140 million fair value estimate of customer gains, the SEC staff informed Bear that it was prepared to recommend a settlement consisting of $90 million as a penalty and $160 million as disgorgement. (R.1080 ¶ 65; R.1091; R.1098; R.9137.) The SEC staff expressly stated to Bear Stearns that $140 million of the proposed disgorgement amount was based on Bear Stearns' fair value analysis of customer gains. (R.1080-81 ¶¶ 64-67; R.1091-92; R.1098; R.2604; R.2606; R.9137.) Contemporaneous notes confirm that the $160 million number consisted of the $140 million for the fair value estimate of customer gain estimate plus $20 million reflecting Bear Stearns' estimated revenues. (*Id.*)

Bear Stearns agreed to this proposed settlement by submitting its final offer of settlement in March 2006, and the SEC accepted and entered the SEC Order reflecting the settlement terms on March 16, 2006. (R.1081; R.1560-1603.) The SEC Order provided for the entire $250 million (which consisted, as agreed, of $160 million paid as disgorgement and $90 million paid as a penalty) to be paid into a Fair Fund for distribution to injured mutual fund customers. (R.1598-1600.) The SEC Order references "hundreds of millions of dollars in profits" to Bear Stearns' customers, but says nothing at all about profits to Bear Stearns. (R.1564 ¶ 5.) It further provided that the penalty, but not the $160 million in disgorgement, would be treated as a penalty "for all purposes, including all tax purposes." (R.1600.) In addition, to "preserve the deterrent effect" of the penalty, the order provided that Bear Stearns would not be permitted to offset the penalty against any civil liability, but did not contain any similar limitation as to the disgorgement payment. (*Id.*)

<u>The Settlement Payments and Insurers' Repudiation</u>

Bear Stearns paid the $250 million settlement amount on April 4, 2006. (R.1081 ¶ 70; R.1680-82.) Because the $140 million that Bear Stearns paid to the SEC based on third party profits was distributed to civil plaintiffs and the SEC agreed that Bear Stearns could offset that disgorgement amount against potential civil liability, Bear Stearns was able to settle the Civil Actions for only $14 million, which it paid on June 10, 2010. (R.1085 ¶ 86; R.1086 ¶ 92; R.2234; R.2255; R.2609.) Insurers refused to indemnify Bear Stearns for either of these payments, or to reimburse Bear Stearns for any of its covered defense costs. (R.1084-86; R.1330-34; R.206; R.243; R.276; R.304; R.335; R.365-66.) As the Appellate Division concluded in a previous decision in this case, Insurers' "unreasonable delay in dealing with plaintiffs' claims under the insurance contracts, consistently stated position that the various regulatory investigations and civil actions concerning plaintiffs' alleged late trading and market-timing transactions did not constitute claims under the contracts, and insistence that in any event disgorgement payments such as those demanded by the regulators were not insurable as a matter of law constitute[d] a denial of liability under the contracts that justifie[d] plaintiffs' settlement of those claims without defendants' consent." *J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 151 A.D.3d 632, 633 (1st Dep't 2017) (concluding that Insurers "repudiat[ed]" coverage).)

The Insurance Policies

The primary policy of insurance at issue in this action was issued by Vigilant. (R.1066 ¶ 1; R.1150-66 (the "Vigilant Policy").) All of the other Insurers issued excess policies that follow form to the Vigilant Policy. (R.1067-68 ¶¶ 4-6; R.1167-1286.) Under the Vigilant Policy, Insurers agreed to "pay on behalf of the Insured all Loss which the Insured shall become legally obligated to pay as a result of any Claim or Claims first made against the Insured and reported in writing to the Insurer during the Policy Period for any Wrongful Act of the Insured." (R.1068 ¶ 7; R.1152.)

As defined in the Vigilant Policy, "Loss" includes "compensatory damages, multiplied damages, punitive damages where insurable by law, judgments, settlements, costs, charges and expenses or other sums the Insured shall legally become obligated to pay as damages resulting from any Claim," as well as "costs, charges and expenses or other damages incurred in connection with any investigation by any governmental body or self-regulatory organization."

(R.1152.) Fines and "penalties imposed by law" are excluded, as are payments that are uninsurable under applicable law. (*Id.*) "Claim" includes civil actions and regulatory investigations. (R.1153.)

This Coverage Action

Bear Stearns commenced this action in 2009 seeking reimbursement of $140 million paid to the SEC on account of the gains of third parties, $14 million paid to settle the related civil class action, and its defense costs for the above matters. Insurers moved to dismiss, contending that the payment Bear Stearns made to the SEC was uninsurable disgorgement and barred by the Profit Exclusion in the Vigilant Policy, among other arguments. The IAS Court denied that motion, which denial was overturned by the Appellate Division, but reinstated by this Court. *J.P. Morgan*, 21 N.Y.3d at 338.

Insurers then answered. (R.170-377.) Bear Stearns prevailed on a series of motions for partial summary judgment, establishing, among other things, that there is no genuine dispute that the $140 million payment at issue did in fact reflect the amount of customer gains rather than its own; that Bear Stearns' settlement payments to the SEC and the Class Action plaintiffs were reasonable; that Bear Stearns did not act with intent to harm investors; and that the exclusions Insurers relied on in their policies did not apply.[2] When *Kokesh* was decided, Insurers moved to renew. The IAS Court denied the motion, recognizing that *Kokesh* is a federal statute of limitations decision that did not change New York insurance coverage law. (R.602.) On August 14, 2017, the IAS Court entered judgment for Bear Stearns in the aggregate amount of $144 million, plus $142 million in prejudgment interest, and directed further proceedings to address Bear Stearns' additional claims against excess Insurers Liberty Mutual, Underwriters and AAIC to determine the amount of its reimbursable defense costs. (R.480-86.)[3]

The Decision and the Judgment

Insurers appealed and the Appellate Division reversed. (R.21.) It held that under *Kokesh*, SEC disgorgement is a "penalty," both for the purpose of determining whether the payment was a "Loss" under the Vigilant Policy and for determining "whether public policy bars insurance companies from indemnifying insureds paying SEC disgorgement." (R.12-14.) The Appellate Division maintained that it was not bound by this Court's 2013 decision because (1) that

[2] *See J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 126 A.D.3d 76 (1st Dep't 2015) (dismissing dishonest acts exclusion defense); *J.P. Morgan*, 151 A.D.3d at 633 (holding Bear Stearns was not required to seek Insurers' consent to settle, due to their repudiation); *J.P. Morgan Sec. Inc. v. Vigilant Ins. Co.*, 57 Misc. 3d 171 (Sup. Ct. N.Y. Cty. 2017) (R.399-434) (dismissing remaining defenses).

[3] The judgment included the underlying $140 million from the SEC settlement and $14 million from the Civil Action settlement, less a $10 million retention under the Vigilant Policy.

decision supposedly dealt only with "the public policy issue," and (2) *Kokesh* was a "change of law" warranting departure from the law of the case – the "missing precedent" this Court found lacking for denying coverage. (R.15-17.) The Appellate Division's *Kokesh*-based holding did not, however, resolve all of the coverage issues that the IAS Court had addressed on summary judgment; for example, it did not take issue with the IAS Court's determination that Bear Stearns was entitled to coverage for the Civil Action settlement, which is not even alleged to constitute disgorgement. Nevertheless, rather than modify the IAS Court's decision, the Appellate Division reversed it in its entirety. Bear Stearns timely moved for reargument or, in the alternative, for leave to appeal to this Court, and Insurers (also recognizing the incongruity between the grounds the Appellate Division stated and the sweeping reversal in its decretal) cross moved to clarify the Decision. The Appellate Division denied the motions. (R.22.)

On August 16, 2019, in accordance with the Decision, the IAS Court entered an order vacating the August 17, 2017 judgment in favor of Bear Stearns (R.23-27), and on September 23, 2019 entered the Judgment (R.28-30) in favor of Respondents. The order also severed Bear Stearns' claims against Vigilant, Federal, and Travelers from its claims against Respondents, creating finality as to Respondents. (*Id.*)

Bear Stearns then timely moved this Court for leave to appeal, which was granted. (R.2-4.)

ARGUMENT

I. THE DECISION SHOULD BE REVERSED BECAUSE IT CONTRADICTS THIS COURT'S PRIOR HOLDING IN THIS CASE AND IMPROPERLY ALTERS NEW YORK LAW.

A. Disgorgement of Third Party Gains Is Insurable under New York Law as a Dual-Purpose Remedy.

This Court has already held that Bear Stearns' disgorgement payment is insurable as a matter of New York law, consistent with public policy, to the extent it reflected third-party gains and was used to compensate injured investors. *J.P. Morgan*, 21 N.Y.3d at 334-38. The Court reached that conclusion despite Insurers' argument that disgorgement intrinsically serves a "punitive" or "deterrent" purpose (*e.g.*, R.2308-10), recognizing that disgorgement may also have other, compensatory purposes. This ruling was consistent with this Court's precedent in *Zurich*, 84 N.Y.2d at 316-17, which set forth the long-standing rule under New York insurance law that a remedy is insurable if it has "both punitive and compensatory elements."

This Court's decision confirmed that insurability does not depend on how a remedy is "labeled" or whether it has a deterrent effect. *See J.P. Morgan*, 21 N.Y.3d at 334-36. Rather, this Court recognized that, at least where a payment represents the gains of third parties (as opposed to the insured's own allegedly ill-gotten gains), and the payment has a compensatory or remedial element, it is insurable. *See id.*; *Zurich*, 84 N.Y.2d at 316-17; *see also Messersmith v. Am. Fid. Co.*, 232 N.Y. 161, 164 (1921).

This Court also rejected Insurers' policy argument that disgorgement should be uninsurable for the same policy reason punitive damages are uninsurable, which is to preserve its deterrent effect. (R.2308, 2325.) The Court properly recognized that cases cited by Insurers holding that public policy bars coverage for punitive damages in order to punish and deter misconduct are inapposite because those cases do not involve the dual-purpose remedy at issue here; the sole purpose of the remedies in those cases was to punish rather than compensate the injured party. *See J.P. Morgan*, 21 N.Y.3d at 334-35; *cf. Biondi v. Beekman Hill House Apt. Corp.*, 94 N.Y.2d 659, 664 (2000); *Home Ins. Co. v. Am. Home Prods. Corp.*, 75 N.Y.2d 196, 200 (1990). Here, the SEC Order expressly provides that the disgorgement payment is to be used to compensate injured parties and permits it to be used to offset civil liabilities to investors. (R.1598-1600.) Accordingly, this Court found no basis on which to override the strong public policy to enforce contracts, including insurance contracts, as written. *J.P. Morgan*, 21 N.Y.3d at 334 (citing, *inter alia*, *White v. Continental Cas. Co.*, 9 N.Y.3d 264, 267 (2007)).

That should have been the end of "deterrence"-based public policy arguments in this case. *See People v. Greenberg*, 27 N.Y.3d 490, 496 (2016) (rejecting attempts to relitigate issues previously raised before the Court). Insurers nonetheless cited exactly the same *Biondi* and *Home* cases to the Appellate Division and argued once again that disgorgement, like punitive damages, should be uninsurable because it is deterrent, regardless of whether it is also compensatory in particular cases. The Appellate Division, however, improperly accepted that analysis, not even mentioning *Zurich*. (R.14.) The resulting Decision was a patent violation of the principle that this Court's decisions bind the lower courts, *see, e.g.*, *Telaro v. Telaro*, 25 N.Y.2d 433, 437-38 (1969), and should be reversed.

B. *Kokesh* Does Not Undermine This Court's Determination That Bear Stearns' Disgorgement Payment Is Insurable.

Kokesh did not change, or even address, any of the fundamental New York law principles that underlay this Court's holding as to the insurability of Bear Stearns' payment. Therefore, *Kokesh* did not provide any basis for the Appellate Division to set aside the law of the case, as enunciated by this Court, as to the insurability of the disgorgement payment, or to ignore well-settled New York law set forth in *Zurich*.

In *Kokesh*, the task before the Supreme Court was a narrow one – to determine the federal limitations period for disgorgement claims by the SEC. The statute at issue, 28 U.S.C. § 2462, set a five-year limitations period for, *inter alia*, "penalty" claims, while "no limitations period applie[s]" in purely equitable actions. 137 S. Ct. at 1641. In that context, the Supreme Court assigned disgorgement actions to the penal category subject to the five-year limitations period, explaining that a "civil sanction that cannot fairly be said *solely* to serve a remedial purpose, but rather can only be explained as also serving either retributive or deterrent purposes, is punishment, as we have come to understand the term." *Id.* at 1645 (emphasis in original; citation omitted). Numerous court decisions have already rejected attempts to expand the reach of *Kokesh* beyond the specific question it decided, and have held that even for other purposes under federal law, SEC disgorgement should not be deemed a penalty.[4] This Court too should not expand *Kokesh* beyond its limited holding.

What is relevant from *Kokesh* is that the Supreme Court recognized that, in addition to having a deterrent purpose, many disgorgement payments to the SEC

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[4] Indeed, the SEC continues to successfully take the position that disgorgement payments are not necessarily penal for purposes other than the statute of limitations. *See, e.g.*, *SEC v. de Maison*, 2019 WL 4127328, at *1 (2d Cir. Aug. 30, 2019) (rejecting argument that "*Kokesh* must be read as holding that disgorgement in the securities enforcement context is always a penalty"); *see also SEC v. Jammin Java Corp.*, 2017 WL 4286180, at *3-4 (C.D. Cal. Sept. 14, 2017), *aff'd*, 773 F. App'x 354 (9th Cir. 2019); *SEC v. Ahmed*, 2018 WL 4266081, at *5 (D. Conn. Sept. 6, 2018); *SEC v. Present*, 2018 WL 1701972, at *2 (D. Mass. Mar. 20, 2018); *SEC v. Revolutions Med. Corp.*, 2018 WL 2057357, at *3 (N.D. Ga. Mar. 16, 2018); *SEC v. Sample*, 2017 WL 5569873, at *2 (N.D. Tex. Nov. 20, 2017); *SEC v. Brooks*, 2017 WL 3315137 (S.D. Fla. Aug. 3, 2017). In *SEC v. Liu*, 754 F. App'x 505, 509 (9th Cir. 2018), the court rejected the contention that under *Kokesh*, the SEC may no longer seek disgorgement based on an argument that *Kokesh* had held that disgorgement is penal for all purposes, and therefore beyond the SEC's equitable power. *Liu* is under review by the Supreme Court; oral argument was held on March 3, 2020.

can be remedial in that they "serve[] compensatory goals." *Id.*[5] The Supreme Court's analysis is thus entirely consistent with this Court's prior holding that, to the extent it reflects third-party investor gains, the disgorgement payment at issue here is insurable as a dual-purpose remedy. Indeed, the *only* relevance of *Kokesh* to this case is its recognition that, as this Court previously held, SEC disgorgement payments can be compensatory and can apply to funds received by third parties.

In misapplying *Kokesh*, the Appellate Division failed to recognize the material difference between the federal limitations issue that the Supreme Court was addressing and the New York law – and public policy – at issue here. Under the different, well-settled standard of New York insurance law, *see J.P. Morgan* and *Zurich*, if a remedy has *any* compensatory element, it is insurable. That is the case here. Bear Stearns' disgorgement payment is insurable under New York

[5] Virtually every remedy has a deterrent purpose. *See, e.g.*, *In re Del-Val Fin. Corp. Sec. Litig.*, 868 F. Supp. 547, 558 (S.D.N.Y. 1994) (deterrence a purpose of compensatory damages under the securities laws). That does not render every such remedy a "penalty" for insurance purposes. If promoting deterrence were a sufficient public policy reason to override insurance contracts, practically all liability insurance would be nullified. This Court has observed, however, that the presence of penal and/or regulatory deterrents is a good reason *not* to use the law of insurance coverage as a means to create additional deterrence for the regulated conduct, with resulting forfeitures by insureds. *See New England Mut. Life Ins. Co. v. Caruso*, 73 N.Y.2d 74, 82 (1989); *see also Pub. Serv. Mut. Ins. Co. v. Goldfarb*, 53 N.Y.2d 392, 399 (1981) ("The mere fact that an act may have penal consequences does not necessarily mean that insurance coverage for civil liability arising from the same act is precluded by public policy.").

insurance law, whether or not it had any deterrent purpose, because it was compensatory and not intended *solely* to punish or deter. The payment was calculated based on the gains of mutual fund shareholders at the expense of other investors and the settlement expressly required it to be used to compensate those harmed investors.

The Appellate Division erroneously contended that, because it made Bear Stearns "worse off," having to disgorge customer gains made the payment "more, not less, of a penalty." (R.19.) That suggestion has it exactly backwards. The fact that a remedy leaves the insured worse off is precisely what makes it an insurable Loss. As this Court explained in 2013, a traditional justification for disallowing coverage for disgorgement of the insured's own ill-gotten gains is that disgorgement merely restores the status quo, so the insured has not suffered a "loss." *See J.P. Morgan*, 21 N.Y.3d at 336. But this Court correctly found that, in contrast to restoring the status quo, disgorgement of third party gains is insurable precisely because the insured actually suffers a loss in that circumstance. *See id.*

In sum, *Kokesh* did not alter the nature of the disgorgement remedy itself, but merely the classification of the remedy for federal statute of limitations purposes. Consequently, there is no basis to alter this Court's holding that Bear Stearns' payment is insurable to the extent it reflected the gains of third parties and was required to be used to compensate investors. The record created following this

Court's decision amply confirmed that factual predicate. Treating Bear Stearns' payment as solely penal, despite the fact that it was calculated based on third party gains and the express condition that it be used for compensatory purposes, is unwarranted under *Kokesh*, and irreconcilable with this Court's decisions in this case and in *Zurich.*

II. BEAR STEARNS' LOSS ARISING FROM ITS DISGORGEMENT PAYMENT IS INSURED UNDER THE POLICIES.

In addition to misapplying *Kokesh* to impose a new public policy limitation on insurability, the Appellate Division also disregarded this Court's governing 2013 decision, and significantly and erroneously upset settled New York contract law, when it held that, as a matter of contractual interpretation, the disgorgement payment was not a "Loss" as defined in Insurers' policies. (R.12-14.)

Losses are defined in the policies as, among other things, "settlements" and "expenses" due to a "Claim," and "costs . . . incurred in connection with" a regulatory investigation. (R.1152.) The payment Bear Stearns made to the SEC fits within both definitions. Indeed, the Court noted that "Insurers do not earnestly dispute that the claims fall within the policy's definition of Loss." *J.P. Morgan*, 21 N.Y.3d at 333. Insurers argued below that the Appellate Division should not follow this Court's decision because this Court focused on their public policy arguments and did not further address whether the claims fall within the definition of "Loss." But that is wrong. Insurers raised the "Loss" issue before this Court, even if not "earnestly."[6] This Court necessarily rejected their "Loss" arguments (or deemed them abandoned) when it remanded for proceedings to determine whether the payment was on account of third party gains. The Appellate Division nonetheless revisited the "Loss" issue and concluded that, under *Kokesh*, disgorgement is now a "penalty" and therefore within the policy exclusion from "Loss" for "fines or penalties imposed by law." (R.12-14; R.1152.) That conclusion was erroneous for multiple reasons.

A. The Conclusion That the Disgorgement Payment Was a Penalty and Not a Loss Violates New York Contract and Insurance Law.

The Appellate Division's holding that Bear Stearns' payment was a penalty and not a "Loss" under the policies was contrary to New York insurance law as well as numerous New York canons of contract construction. It was reversible error for the Appellate Division to ignore these canons in the decision.

First, coverage under an insurance policy should be determined "consistent with the reasonable expectation of the average insured." *In re Viking Pump, Inc.*, 27 N.Y.3d 244, 257 (2016) (citation omitted). Bear Stearns' reasonable expectation was that an errors and omissions policy would cover settlement of a

[6] Insurers contended that their "Policies only cover 'Loss' and define that term to include only amounts paid 'as damages'" (R.2288), and that Bear Stearns' payment was not damages because "the SEC's statutory authority is restricted to penalties and equitable relief (which includes disgorgement) and does not include the authority to seek compensatory damages" (R.2298; *see also* R.2384).

claim for third party disgorgement paid to a regulator where that policy expressly covers the cost of defending and settling regulatory investigations. (R.1152-53.) After all – aside from uninsurable penalties and disgorgement of one's own gains – third party disgorgement was the only monetary remedy that the SEC, which is the main regulator of broker-dealers, could obtain. *See* 15 U.S.C. §§ 77t, 78u (delimiting SEC remedies); *Thomas J. Lipton, Inc. v. Liberty Mut. Ins. Co.*, 34 N.Y.2d 356, 361 (1974) (rejecting reading that would exclude "what, as a practical matter, would usually be some of the largest foreseeable elements" covered). It was error for the Appellate Division to ignore this canon and cut out the heart of the coverage Bear Stearns bargained for.

Second, because a "consent decree [like the SEC Order] 'is in the nature of a contract,'" it must be "interpret[ed] in light of its plain language." *Callahan v. Carey*, 12 N.Y.3d 496, 502 (2009) (citation omitted) (rejecting construction of consent order that failed to give effect to all its terms).[7] Moreover, contracts should be construed to give each provision independent effect. *Viking Pump*, 27 N.Y.3d at 257. On its face, the SEC Order treated the disgorgement payment at issue differently from the separately imposed "penalty" of $90 million, making

[7] As the Supreme Court has observed, "it is the agreement of the parties, rather than the force of the law upon which the complaint was originally based, that creates the obligations embodied in a consent decree." *Local No. 93, Int'l Ass'n of Firefighters, AFL-CIO C.L.C. v. City of Cleveland*, 478 U.S. 501, 522 (1986).

clear that the disgorgement payment was not intended to also constitute a penalty. (R.1600.) The Appellate Division erred in failing to give effect to these distinct terms of the SEC Order. *See Viking Pump*, 27 N.Y.3d at 257; *Callahan*, 12 N.Y.3d at 502; *see also Navigators Ins. Co. v. Sterling Infosystems, Inc.*, 145 A.D.3d 630, 631 (1st Dep't 2016) (under statute that provided separately for penalties, court refused to construe statutory damages as a penalty).

Specifically, the SEC Order provided that, unlike the disgorgement payment, the "amounts ordered to be paid as civil money *penalties* pursuant to this Order shall be treated as *penalties* paid to the government for all purposes, including all tax purposes." (R.1600 (emphasis added).) Further, to "preserve the deterrent effect of the civil *penalty*," Bear Stearns agreed in the SEC Order that it "shall not, in any Related Investor Action, benefit from any offset or reduction of any investor's claim by the amount of any Fair Fund distribution to such investor in this proceeding that is proportionately attributable" to the penalty. (*Id.*) Bear Stearns also agreed that, in contrast to the disgorgement payment, it would not seek insurance coverage for the civil penalty. (R.9223.) The clear distinction between the disgorgement payment and the penalty payment was fundamental to the settlement and thus built into the remedial paragraphs of the SEC Order.

Finally, any ambiguities in an insurance policy should be construed against the insurer and in favor of coverage. *Viking Pump,* 27 N.Y.3d at 257-58; *see also*

McGroarty v. Great Am. Ins. Co., 36 N.Y.2d 358, 364 (1975) ("a word employed by an insurer in the contract . . . should be given the construction most favorable to the insured"). This Court has recognized that whether a provision is ambiguous depends on the context in which it is used, and also that a term in an insurance policy "can, of course, be ambiguous in one context and not another." *Cont'l Cas. Co. v. Rapid-American Corp.*, 80 N.Y.2d 640, 652-53 (1993). As the Supreme Court has observed, "'[p]enalty' is a term of varying and uncertain meaning." *Life & Cas. Ins. Co. v. McCray*, 291 U.S. 566, 574 (1934); *see also Borden v. 405 East 55th Street Associates, L.P.*, 24 N.Y.3d 382, 396 (2014) (the "determination of whether a certain provision constitutes a penalty may vary depending on the context") (citation omitted). Insurers themselves did not take the position that disgorgement was a penalty in this case, or any other litigated case known to Bear Stearns, until *Kokesh* was decided in 2017.[8] Inasmuch as the test for ambiguity is whether there is a "reasonable basis for a difference of opinion," *Viking Pump*, 27 N.Y.3d at 258 (citation omitted), Insurers' own failure to contend during claims handling or at any other time before the decision in *Kokesh* that the disgorgement

[8] Disgorgement has historically been regarded as an equitable remedy. *See, e.g.*, *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1474 (2d Cir. 1996) (disgorgement an equitable remedy). Insurers cited *First Jersey* to this Court on the first appeal. (R.2292.)

payment was a penalty is powerful confirmation that Bear Stearns had a more than reasonable basis to disagree with Insurers' recently minted position.

At the very minimum, the policies, which do not define "penalty," are ambiguous in the context of a settlement payment not denominated as – indeed, differentiated from – a separate civil penalty and required to be used for compensatory purposes. Because any such ambiguity should be resolved in favor of the insured, *Viking Pump*, 27 N.Y.3d at 257-58, the Appellate Division erred in holding that the settlement payment was a penalty under the policies.

B. Coverage Should Be Determined Based on the Law That Was in Effect at the Time Bear Stearns Entered into Its Contracts with Insurers and the SEC.

The Decision is paradoxical: it says that *Kokesh* is "a change of law" (R.16), yet it applies the new law to interpret an eighteen-year-old insurance contract and a twelve-year-old settlement. Thus, the Decision fails to take into account settled New York law that coverage should be determined based upon the law at the time the parties entered into their insurance contract, not on any new law created many years later, and certainly not the law as amended after the liability was incurred.

Like any contract, an insurance policy should be enforced in accordance with "accepted law in New York at the time the policy was issued." *New England Mutual*, 73 N.Y.2d at 82. Because the SEC Order is also a contract, it, too, incorporates "the law in force at the time the agreement is entered into . . . ."

Dolman v. U.S. Tr. Co., 2 N.Y.2d 110, 116 (1956). Accordingly, in *Zurich,* this Court found the liability to be insurable because the award included a compensatory element under the law prevailing at the time of the verdict, even though the law had changed after the verdict to eliminate the compensatory element. *Zurich*, 84 N.Y.2d at 316-17 & 316 n.3. *See also Hartford Accident & Indemnity Co. v. Village of Hempstead*, 48 N.Y.2d 218, 225 & n.10 (1979) (holding that a statutory modification affecting coverage could not be enforced against an insurer retroactively).

The definition of "Loss" in Insurers' policies excluded "penalties imposed by law." (R.1152.) But the applicable law is the law pursuant to which the parties entered into the insurance contracts in 2000, *see New England Mutual*, 73 N.Y.2d at 82, or, at latest, when the parties entered into the SEC Order in 2006, *see Zurich*, 84 N.Y.2d at 116-17; there is no material difference here, as *Kokesh* was decided long after 2006. Thus, even if the Appellate Division had construed *Kokesh* correctly as a change in the law that could alter the meaning of an insurance contract or settlement agreement, New York law is clear that such a change can only apply prospectively. Here, pre-*Kokesh* law applies and nothing changes this Court's prior conclusion that the $140 million paid as disgorgement of third party gains was a Loss within coverage.

III. THE APPELLATE DIVISION ERRED BY REVERSING THE AWARD OF COVERAGE FOR THE SEPARATE CLASS ACTION SETTLEMENT.

The Appellate Division also erred when, based solely on its *Kokesh* analysis, it reversed the 2017 judgment in favor of Bear Stearns in its entirety. (R.21.) One component of Bear Stearns' Loss (and hence the damages Insurers owed) was the $14 million Bear Stearns paid to settle the Civil Actions. (R.1085 ¶ 86; R.1086 ¶ 92; R.2234; R.2255; R.2609.) Of course, the investors who brought those actions sought damages, not SEC disgorgement. (R.1479-1525.) Therefore, even if the Appellate Division were correct that *Kokesh* required that third party disgorgement be treated as an uninsurable penalty, nothing in *Kokesh*, or in the Appellate Division's analysis, supports reversing the judgment as to Insurers' obligation to indemnify Bear Stearns for the Civil Action settlement payment.

IV. INSURERS' OTHER DEFENSES ARE WITHOUT MERIT.

Insurers raised several other contentions below that the Appellate Division did not reach but which Respondents may choose to raise again on this appeal. Each of those defenses is unavailing for the reasons given by the IAS Court. Accordingly, to leave no doubt that the August 2017 judgment in its favor should be reinstated in its entirety, Bear Stearns addresses each of those issues here.

A. Insurers Failed to Raise a Genuine Issue of Material Fact Rebutting Bear Stearns' Showing That the Disgorgement Payment Consisted of Third Party Gains Required to Be Used to Compensate Investors.

On Bear Stearns' motion for summary judgment, the IAS Court determined that Insurers had failed to raise a genuine issue of material fact in response to Bear Stearns' showing that $140 million of its payment to the SEC reflected third party gains. (R.406-14.) In other words, under the rules of decision this Court set out in 2013, Bear Stearns proved its case. Insurers argued to the Appellate Division (and in opposition to Bear Stearns' motion for leave to appeal to this Court) that Bear Stearns had not shown that the $140 million in fact reflected customer gains. To the contrary, the IAS Court's determination is supported by the uncontradicted evidence of the calculations the SEC required Bear Stearns to perform; uncontradicted expert testimony replicating the key calculation that the SEC ultimately accepted; and the uncontradicted testimony of Bear Stearns' counsel who negotiated with the SEC on behalf of Bear Stearns as to the basis for the third party disgorgement payment (R.1093-99), corroborated by his contemporaneous notes. Insurers, who are opposing coverage for a settlement payment made after their coverage "repudiation," *J.P. Morgan*, 151 A.D.3d at 633, had the ultimate burden to "demonstrate that the loss compromised by the insured was not within policy coverage." *Servidone Constr. Corp. v. Sec. Ins. Co.*, 64 N.Y.2d 419, 425 (1985); *see also Pepsico, Inc. v. Continental Cas. Co.*, 640 F. Supp. 656, 662

(S.D.N.Y. 1986) (carrier opposing coverage for settlement bore burden of proof to identify amounts not covered). They presented no competent evidence in response to the evidence Bear Stearns submitted, on which the IAS Court relied.

As described in detail at pages 10-12, above, the SEC required Bear Stearns to perform a revenue calculation, which the SEC accepted, that showed that Bear Stearns received $16.9 million from processing transactions of market timing and late trading customers. (R.1095-96; R.1889-1912; R.2588-93; R.2596-99; R.2607-08; R.2617-23.) Bear Stearns then calculated customer gains using two methods requested by the SEC, followed by a third, "fair value" calculation showing $140 million in customer gains. (R.1098; R.2042-51.) This calculation became the basis for the settlement. Following Bear Stearns' tender to the SEC of its calculations in support of the $140 million figure, the SEC confirmed to Bear Stearns' counsel that its proposed settlement consisted of $140 million based on Bear Stearns' customers' gains, plus $20 million reflecting Bear Stearns' own gains and a $90 million penalty. (R.1092; R.1098; R.2604; R.2606; R.9137-42.) Insurers have failed to controvert that uniform evidence as to the basis for the $140 million settlement payment with any contrary evidence: they do not contend that the parties agreed in the SEC Order, or anywhere else, to a different basis for the $140 million settlement payment.

Unable to present any evidence of a different basis for the $140 million payment, Insurers improperly attempted below to brush Mr. Liman's testimony aside as "hearsay." However, hearsay "exists only when an out-of-court statement is introduced for the truth of the matter asserted in that statement, not when such testimony is introduced merely to demonstrate that the statement was made." *Oberle v. Caracappa*, 133 A.D.2d 202, 203 (2d Dep't 1987) (citing *Matter of Bergstein v. Bd. of Educ.*, 34 N.Y.2d 318, 324 (1974)); *see also* Richard T. Farrell, *Prince, Richardson on Evidence* § 8-101 (11th ed. 2008). Thus, evidence of what one party demanded in a negotiation and the other party accepted is not hearsay. Here, Mr. Liman's testimony is admissible to establish that the SEC insisted on payment of $140 million to resolve its claim that Bear Stearns was responsible for its *customers'* gains, and that Bear Stearns acceded to that demand. *See, e.g.*, *Smokes 'n' Sweets, Inc. v. W. Lake Assocs.*, 227 A.D.2d 757, 759 (3d Dep't 1996) (evidence of negotiations preceding agreement relevant to its construction); *Twin City Fire Ins. Co. v. Country Mut. Ins. Co.*, 23 F.3d 1175, 1182-83 (7th Cir. 1994) (Posner, C.J.) (offers and demands made in settlement negotiations are verbal acts and evidence of them is not hearsay); *see also People v. Giordano*, 50 A.D.3d 467, 468 (1st Dep't 2008) (evidence of price seller demanded for merchandise is not hearsay). Mr. Liman's core testimony is that the "SEC staff advised us that it was willing to recommend a settlement for a payment of $250 million, consisting of a

$90 million penalty and $160 million to be paid as disgorgement . . . . based on the $140 million fair value customer gain estimate and $20 million to reflect Bear Stearns' gain . . . ." (R.1098 ¶ 10.) That is direct evidence of what the SEC demanded and what Bear Stearns agreed to pay and it is admissible for that purpose. It is not hearsay.

Moreover, the revenue calculations themselves show that the $140 million represented third party gains, and those calculations are plainly admissible. The evidence is undisputed that Bear Stearns created those revenue calculations for the SEC and transmitted them. (R.1072-78 ¶¶ 26-52; R.1093-99; R.1845-63; R.1865; R.1870-79; R.1887-1962; R.2042-51.) And the evidence is undisputed that the calculations were correct. Michael Quinn, an expert economist, replicated the calculations, confirming that the data compiled by Bear Stearns and submitted to the SEC did in fact yield the $140 million total. (R.1737-62.) Thus, all the evidence of the amounts calculated and the surrounding communications show that the $140 million represented customer gains.[9] In sum, the IAS Court correctly

[9] Having no evidence that the $140 million payment was anything other than a payment reflecting third party gains, Insurers relied instead on testimony by their expert, Eric Zitzewitz, who contended that if the SEC had counted all revenues Bear Stearns obtained from customers allegedly involved in late trading or deceptive market timing – including not only fees for clearing mutual fund trades, but also for clearing other kinds of trades in other kinds of securities, and including revenues from correspondent broker dealers other than the ones the SEC identified as the subject of the proposed charges – the SEC could have arrived at a disgorgement figure of $350 million based on Bear Stearns' revenues. That

determined based on the record evidence that Bear Stearns had established beyond genuine dispute that the $140 million consisted of third party gains. (R.406-14.)

B. The Profit Exclusion Does Not Bar Coverage.

1. Under This Court's 2013 Decision, the Profit Exclusion Does Not Apply to Losses Consisting of Disgorgement of Third Party Gains.

Insurers argued below that coverage is barred by the personal profit or advantage exclusion in the Vigilant Policy (the "Profit Exclusion"), and hence all the excess policies, which follow form to it. The Profit Exclusion provides that the Vigilant Policy "shall not apply to any Claim(s) made against the Insured(s) . . . based upon or arising out of the Insured gaining in fact any personal profit or advantage to which the Insured was not legally entitled, including but not limited to any actual or alleged commingling of funds or accounts." (R.1154-55.) This Court rejected Insurers' reliance on the Profit Exclusion in 2013 for essentially the same reason that it rejected Insurers' disgorgement contentions, holding that "[b]ecause Bear Stearns alleges, and the SEC order does not conclusively refute, that its misconduct profited others, not itself, this exclusion does not defeat

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contention is wholly irrelevant since, under New York law, experts may not base their opinions on speculation about what might have happened but did not. *See, e.g.*, *Cassano v. Hagstrom*, 5 N.Y.2d 643, 646 (1959). In any event, the evidence is uncontroverted that the fair value analysis was one way to calculate gains to third parties, and produced the $140 million that was incorporated into the SEC Order.

coverage under CPLR 3211." *J.P. Morgan*, 21 N.Y.3d at 337. Just as with the disgorgement issue, here too, the summary judgment record fully confirmed Bear Stearns' allegations that it paid $140 million as disgorgement of third party gains, which were determined in a separate calculation from the one that determined that Bear Stearns' own gains were $16.9 million. (R.1095-98.) Gains by others are not gains to Bear Stearns and therefore do not trigger the Profit Exclusion. *Pereira v. Cogan*, 2006 WL 1982789, at *6 (S.D.N.Y. July 12, 2006); *Am. Century Servs. Corp. v. Am. Int'l Specialty Lines Ins. Co.*, 2002 WL 1879947 (S.D.N.Y. Aug. 14, 2002).

As described in Point IV.A, above, Insurers, who had the burden of proof to support application of the Profit Exclusion, presented no evidence showing that the $140 million payment reflected a gain to Bear Stearns. Thus, as the IAS Court correctly held (R.418), the Loss for which Bear Stearns seeks indemnification cannot be deemed to have resulted from a Claim based upon any personal profit or advantage to Bear Stearns to which it was not entitled.

2. Insurers' Arguments in Support of Applying the Profit Exclusion Are Contrary to Basic Principles of New York Insurance Law.

Although the record is uncontroverted that the settlement payment was based on gains to Bear Stearns' customers, Insurers nonetheless argued below that the Profit Exclusion applies here because it should apply whenever the insured obtains *any* benefit related to the conduct alleged in the underlying claim. They made exactly the same argument to this Court in the prior appeal, contending that because Bear Stearns acknowledged that $16.9 million of the disgorgement payment was based on its own revenues, it had a "profit or advantage" triggering the Profit Exclusion. (R.2333.) This Court rejected that argument when it held that Bear Stearns' allegations stated a claim. *J.P. Morgan*, 21 N.Y.3d at 337. There is no reason to reconsider that holding.

Moreover, even if the issue had not already been decided, Bear Stearns would prevail under elementary principles of New York insurance law. New York law construes exclusions strictly against the insurer. *See, e.g.*, *Pioneer Tower Owners Ass'n v. State Farm Fire & Cas. Co.*, 12 N.Y.3d 302, 307 (2009) (citation omitted) (exclusions must use "clear and unmistakable language"). Any ambiguity in the language of an exclusion must be "resolved against the insurer." *Belt Painting Corp. v. TIG Ins. Co.*, 100 N.Y.2d 377, 383 (2003) (citation omitted) (insurer must establish that the exclusion "is subject to no other reasonable interpretation, and applies in the particular case"). Of course, insurers bear the burden of proof to establish that their exclusions apply. *Seaboard Sur. Co. v. Gillette Co.*, 64 N.Y.2d 304, 311 (1984).

The construction Insurers advocated would erroneously expand the Profit Exclusion so far as to wipe out virtually all coverage under the Vigilant Policy because there is always some benefit or else the conduct would not occur. As a judge of this Court commented on the Profit Exclusion at oral argument in 2013, Insurers' contention begs the question of what policyholders are "paying their premiums for." (R.2386.) And as one federal district court correctly observed:

> Almost all securities fraud complaints will allege that the defendants did what they did in order to benefit themselves in some way. If such an allegation were sufficient to invoke [the insurance exclusion], the broad coverage for "Securities Claims" provided by the National Union policy would be rendered valueless by this exclusion.

Alstrin v. St. Paul Mercury Ins. Co., 179 F. Supp. 2d 376, 400 (D. Del. 2002).

Courts have recognized that provisions similar to the Profit Exclusion are not triggered whenever a claim alleges some wrongful activity by the insured resulting in some gain by it; rather, receipt of the alleged gain by the insured must be the *basis* for the underlying payment for which it asserts an insurance claim. *See, e.g.*, *id.* at 400; *Federal Insurance Co. v. Sheldon (In re Donald Sheldon & Co.)*, 186 B.R. 364, 369 (S.D.N.Y. 1995) (because the "alleged personal profits to" the insureds "were not the basis of the liability for which recovery was sought," the exclusion did not apply).[10]

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[10] *See also Wintermute v. Kans. Bankers Sur. Co.*, 630 F.3d 1063, 1073 (8th Cir. 2011) ("Missing from the facts stated in the indictment is an allegation that Wintermute received a personal gain to which she was not legally entitled," so exclusion did not apply); *Perdue Farms, Inc. v. Travelers Cas. & Sur. Co. of Am.*, 448 F.3d 252, 256 n.3 (4th Cir. 2006) (exclusion did not apply because underlying claim under ERISA "proscribe[d] specified conduct, not profit"); *OneBeacon Am. Ins. Co. v. City of Zion, Ill.*, 119 F. Supp. 3d 821, 836 (N.D. Ill. 2015) (exclusion

Here, the Profit Exclusion does not apply because Bear Stearns' own gains were not the basis of the SEC's underlying claim for the $140 million. In the "Violations" section (R.1591-92 ¶¶ 179-83) of the SEC Order, the SEC alleged violations of Securities Act § 17(a), Exchange Act §§ 10(b), 15(c), and 17(a), and Investment Company Act § 22(c). None of those statutes requires proof that the respondent obtained profits or advantages to which it was not entitled. *See, e.g.*, *In re Mut. Funds Inv. Litig.*, 384 F. Supp. 2d 845, 855 (D. Md. 2005) (elements of 10b-5 claim in investor action against Bear Stearns; obtaining a profit or advantage not an element). Accordingly, the SEC did not allege gains to Bear Stearns when it laid out the elements of its case in the Violations section. (R.1591-92.) Whether or not Bear Stearns had any such gains was immaterial to the SEC's theories for their claims. This in itself disposes of Insurers' defense based on the Profit Exclusion.

C. Insurers Failed to Raise a Genuine Issue of Material Fact Regarding the Reasonableness of the Settlements.

The IAS Court granted Bear Stearns summary judgment and dismissed Insurers' defenses challenging the reasonableness of Bear Stearns' settlements with the SEC and the Civil Action plaintiffs. (R.422-25.) This Court should reject any

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did not apply because underlying complaint did not allege that insureds personally profited from illegal conduct).

challenge to this conclusion because the undisputed evidence shows that both amounts were reasonable.

An indemnitor that receives notice of a claim and wrongly refuses to pay "will be bound by any reasonable good faith settlement the indemnitee might thereafter make." *Deutsche Bank Trust Co. of Ams. v. Tri-Links Inv. Trust*, 74 A.D.3d 32, 39 (1st Dep't 2010) (citation omitted); *see also Servidone*, 64 N.Y.2d at 424 ("an insurer cannot by virtue of its own breach escape liability for the reasonable settlement of a covered risk"). To avoid summary judgment, the indemnitor (or insurer) has the burden to prove "that there was no possibility that litigating the case to the end would result in a judgment against [the indemnitee/insured] in an amount greater than the settlement." *Deutsche Bank*, 74 A.D.3d at 43; *see also Pepsico*, 640 F. Supp. at 662 (insurer had the burden to establish settlement amounts were not covered). Insurers did not even attempt to meet their burden. Indeed, the evidence establishing the reasonableness of Bear Stearns' settlements of the regulatory investigation and of the Civil Action was both overwhelming and completely undisputed.

There can be no doubt that the amount of the disgorgement payment to the SEC was reasonable. First, the size of the potential liability was at least triple the amount of the settlement. As a compromise to avoid greater risk to Bear Stearns at trial, the SEC had demanded $720 million, of which $520 million would have been payable as disgorgement. (R.1078-79 ¶¶ 57, 58; R.1097-98; R.1975; R.2022-23.) The $520 million component of the SEC's demand was based on an analysis of the gains of Bear Stearns' customers using a method, Delta NAV, that the SEC had successfully used in other litigated cases. (R.1077-78 ¶¶ 52-55; R.1097; R.1753-54; R.1915-62; R.2633.) Obtaining such a substantial discount from the amount at risk is powerful proof of reasonableness. *See, e.g.*, *Clarostat Mfg. Co. v. Travelers Indem. Co.*, 115 A.D.2d 386, 388-89 (1st Dep't 1985) (granting summary judgment on reasonableness to insured that obtained 45 percent reduction in exposure).

Second, making a payment with no guarantee that it will be reimbursed by insurance is in itself evidence the payment amount was reasonable. *See, e.g.*, *Taco Bell Corp. v. Cont'l Cas. Co.*, 388 F.3d 1069, 1075-76 (7th Cir. 2004); *Danaher Corp. v. Travelers Indem. Co.*, 2015 WL 409525, at *15 (S.D.N.Y. Jan. 16, 2015). Here, Insurers had repudiated coverage – they even denied that the SEC investigation constituted a "Claim" against Bear Stearns under their policies. *See J.P. Morgan*, 151 A.D.3d at 633. At the time the payment was made by Bear Stearns, it was clear that Bear Stearns would have to fund the payment itself and then continue to bear the entire cost of the settlement unless and until it could pry payment out of Insurers' grip.

Third, apart from the size of the exposure, the risk of liability was substantial. The SEC contended it was able to require disgorgement of third party gains; Insurers' own 2013 brief to this Court includes a sampling of the case law the SEC could have cited to support its contention. (R.2292-94.) The SEC also had the statutory authority to pursue a theory of aider and abettor liability. *See* 15 U.S.C. § 78t(e). On the specific question of how the securities laws apply to allegations of facilitating late trading and deceptive market timing, a federal court had ruled that allegations similar to those in the SEC Order stated an investor claim against Bear Stearns, *see In re Mut. Funds Inv. Litig.*, 384 F. Supp. 2d at 862, requiring proof only of recklessness, *id.* at 865. As applied to the SEC's own claims, there was a substantial risk that the SEC would prevail if the matter went to trial; former SEC Chairman Harvey Pitt opined that it probably would prevail. (R.3867-70.) Further compounding the risk of liability, the trial would have been before an SEC administrative law judge and could have involved evidence obtained by the SEC from third parties in a process with little transparency to Bear Stearns.

Faced with these risks, it was reasonable for Bear Stearns to settle the investigation for $250 million, of which only $140 million – just 27% of the SEC's initial disgorgement demand – is the subject of Bear Stearns' insurance claim. (R.1079-81 ¶¶ 58, 67; R.1097-98; R.1975; R.2022-23.) Bear Stearns also obtained the right to use the disgorgement payment, which was distributed to investors, to offset its liabilities to investors in the Civil Actions. (R.1085-86; R.1598-1660.) As the IAS Court held, based on the risk and magnitude of the exposure (as discussed above), this was more than sufficient to establish that the SEC settlement was reasonable. (R.424.)

As to the Civil Action, the evidence was also undisputed that the amount paid in settlement was reasonable. Based on essentially the same allegations as the SEC had made, the plaintiffs had survived a motion to dismiss. *In re Mut. Funds Inv. Litig.*, 384 F. Supp. 2d at 862. They contended that even after receiving an offset for the amount of the settlement with the SEC and NYSE, Bear Stearns could be required to pay at least $100 million in damages. (R.1085-86 ¶¶ 85-92; R.2234.) Expert testimony in this action, which Bear Stearns proffered and Insurers did not rebut, confirmed that Bear Stearns' exposure "was likely well in excess" of the $14 million it paid. (R.1759.) And, of course, if it had not settled, it would have continued to incur legal expenses, which Insurers refused to pay.

D. Insurers Also Cannot Rely on the Public Policy Exception Because They Failed to Raise a Genuine Issue of Material Fact Regarding Intent to Harm.

The IAS Court properly rejected Insurers' contention that public policy bars coverage because Bear Stearns supposedly acted with intent to harm. (R.419-21.) To prevail, Insurers would have had to demonstrate that Bear Stearns knew and intended that its employees' alleged facilitation of its customers' transactions would directly and immediately harm particular investors – not merely that they allegedly acted without regard to the likelihood of such harm. Because Insurers did not meet that standard, this Court should reject any challenge to the IAS Court's conclusion.

1. Insurers Had the Burden to Prove That Bear Stearns Acted with the Purpose of Injuring Investors.

New York's public policy is to enforce contracts as written. *J.P. Morgan*, 21 N.Y.3d at 334. Accordingly, as this Court stated in this case, 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." *Id.* at 335 (citing *Goldfarb*, 53 N.Y.2d at 399 and rejecting Insurers' contention that public policy barred coverage based on the findings in the SEC Order). The party seeking to avoid a contractual obligation based on public policy bears the burden of proof. *See, e.g.*, *JMD Holding Corp. v. Cong. Fin. Corp.*, 4 N.Y.3d 373, 379-80 (2005); *Schultz v. Boy Scouts of Am., Inc.*, 65 N.Y.2d 189, 202 (1985); *Brown v. Two Exchange Plaza Partners*, 146 A.D.2d 129, 139 (1st Dep't 1989), *aff'd*, 76 N.Y.2d 172 (1990); CPLR 3018.

In addition to this Court's decision in this case, many more New York cases confirm that, in order to overcome the paramount New York public policy of enforcing contracts as written, the burden was on Insurers to prove that an insured acted *for the purpose* of causing injury – as opposed to acting without regard to whether certain conduct, engaged in for another purpose, may, or even was likely to, result in injury. *See, e.g.*, *Town of Massena v. Healthcare Underwriters Mut. Ins. Co.*, 98 N.Y.2d 435, 445 (2002) (reckless conduct insufficient to trigger public policy bar on coverage for acts with intent to harm); *Slayko v. Sec. Mut. Ins. Co.*, 98 N.Y.2d 289, 293 (2002) (reckless shooting insufficient to trigger intentional act exclusion); *Goldfarb*, 53 N.Y.2d at 399 (coverage for dentist's criminal sexual abuse of patient during treatment not barred as intentionally harmful); *Baldinger v. Consol. Mut. Ins. Co.*, 15 A.D.2d 526 (2d Dep't 1961) (injury caused by shoving the underlying plaintiff was not intentional), *aff'd*, 11 N.Y.2d 1026 (1962). As discussed in the next section, there is no evidence in the record that any Bear Stearns employee had such an intent. *A fortiori*, there is no evidence that Bear Stearns itself, or its management, intended to harm investors.[11]

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[11] Moreover, coverage is available even when an individual employee of an Insured intends to cause harm, where the harm is not intended from the perspective of the insured entity. *See, e.g.*, *Essex Ins. Co. v. Zwick*, 27 A.D.3d 1092, 1092 (4th Dep't 2006). On issues of intent, the "dispositive question" is what the insured's "executives knew, when they knew it, and what conclusions they drew from their knowledge." *Olin Corp. v. Ins. Co. of N. Am.*, 762 F. Supp. 548, 564 (S.D.N.Y. 1991), *aff'd*, 966 F.2d 718 (2d Cir. 1992). Insurers presented no evidence that any executive of Bear Stearns had any intent to harm.

2. The Undisputed Evidence Demonstrated That Bear Stearns Did Not Act with Intent to Harm Investors.

To meet its initial summary judgment burden, Bear Stearns proffered testimony by its senior managers and others demonstrating that company policy and procedures were designed to prevent legal violations, block any unwanted market timing, and avoid harm to investors. (*E.g.*, R.1087-88; R.2650-51; R.2655; R.2657; R.2660-66; R.2668; R.2670; R.2678; R.2681-83; R.2686.) Insurers were thereupon obliged to adduce competent evidence of Bear Stearns' purported intent to harm, but they failed to do so. They sought to rely instead on the unproven allegations in the SEC Order, which the SEC referred to as "findings," and the nearly-identical NYSE Decision, and other hearsay. That evidence was both incompetent and insufficient. Bear Stearns did not admit the SEC's "findings." (R.1562.) Thus, they are no more than allegations that were not adjudicated. As the court held in *Borst v. Bovis Lend Lease LMB, Inc.*, 102 A.D.3d 519, 520 (1st Dep't 2013), statements in a non-prosecution agreement are "inadmissible as proof of liability." Statements in a consent order are no different. *See J.P. Morgan*, 126 A.D.3d at 83. In short, unadmitted findings in an agency consent decree, like allegations in a complaint, are inadmissible to prove the conduct alleged by the agency.

In addition, the unadmitted "findings" in the SEC Order and NYSE Decision would also be inadmissible as proof of liability because they are statements made in settlement negotiations. *See* CPLR 4547.[12] Such agency settlement agreements are routinely stricken as evidence because they do not establish any facts. *See, e.g.*, *Lipsky v. Commonwealth United Corp.*, 551 F.2d 887, 893 (2d Cir. 1976) ("a consent judgment between a federal agency and a private corporation which is not the result of an actual adjudication" cannot "be used as evidence in subsequent litigation between that corporation and another party"); *In re Platinum & Palladium Commodities Litig.*, 828 F. Supp. 2d 588, 593-94 (S.D.N.Y. 2011) (same).

Insurers also relied on press releases in which the SEC and NYSE criticized Bear Stearns immediately after the settlement. (R.3503, R.3505, R.3510.) But the press releases did not even allege that any Bear Stearns employee acted for the purpose of inflicting harm. Moreover, such press releases are not in any case admissible under the public records exception to hearsay because they meet none of the requirements of CPLR 4520, which applies only where "a public officer is required or authorized, by special provision of law, to make a certificate or an

[12] Courts applying the federal rule on which CPLR 4547 was modeled have repeatedly ruled averments in agency consent orders inadmissible for that reason. *See, e.g.*, *In re Blech Sec. Litig.*, 2003 WL 1610775, at *11 (S.D.N.Y. Mar. 26, 2003); *N.J. Turnpike Auth. v. PPG Indus., Inc.*, 16 F. Supp. 2d 460, 473-74 (D.N.J. 1998), *aff'd*, 197 F.3d 96 (3d Cir. 1999).

affidavit to a fact ascertained . . . in the course of his official duty, and to file or deposit it in a public office of the state . . . ."

Further, the "evidence" proffered by Insurers merely referred to acts taken for the purpose of obtaining profits, and does not imply, much less establish, any act taken for the purpose of harming any investor. As this IAS Court aptly noted, under this Court's precedents, "even one whose intentional acts cause unintended injury may be indemnified," and Insurers proffered no evidence of acts taken with intent to harm. (R.420, citing *Town of Massena* and *Goldfarb*.)

E. The Knowledge Exclusion Does Not Apply.

The top-layer Underwriters and AAIC Policies contain an exclusion (the "Knowledge Exclusion") that does not appear in the other Insurers' policies, for Claims certain officers of the insured could reasonably have foreseen at the time the Policies were purchased in March 2000, more than three years before any of the Claims at issue here were asserted. (R.6207.) The IAS Court properly dismissed the defense based on this Exclusion because Insurers presented no evidence that any Bear Stearns officer, under any definition of that term, had such knowledge at the relevant time. (R.425-32.)

1. Underwriters and AAIC Had the Burden to Prove Each Element of the Exclusion.

The Knowledge Exclusion provides that "Underwriters shall not be liable to make any payment for Loss in connection with any Claim made against the

Assured … for any alleged Wrongful Act(s) committed prior" to March 21, 2000, "if any officer of the Assured, at such date, knew or could have reasonably foreseen that such Wrongful Act(s) could lead to a Claim." (R.1264.) Thus, Underwriters and AAIC had to establish that (1) an "officer" of Bear Stearns (2) knew before March 21, 2000 (3) of "such Wrongful Act(s)," *i.e.*, the specific Wrongful Act(s), and that they were Wrongful, (4) for which a Claim was later made against Bear Stearns, and (5) the officer knew or could reasonably have foreseen before March 21, 2000 that those specific Wrongful Act(s) could lead to a Claim.

Courts construing similarly-worded exclusions have held that insurers have the burden to prove that the relevant person whose knowledge triggers the exclusion (here, an "officer") had both actual knowledge before the policy period of the specific conduct triggering the exclusion, and an objective basis at that time to anticipate a Claim based on such knowledge. *See Exec. Risk Indem. Inc. v. Pepper Hamilton LLP*, 13 N.Y.3d 313, 322 (2009); *see also United Nat'l Ins. Co. v. Granoff, Walker & Forlenza, P.C.*, 598 F. Supp. 2d 540, 549 (S.D.N.Y. 2009).[13]

[13] Although *Pepper Hamilton* was decided under Pennsylvania law, courts have applied a similar analysis under New York law. *See CPA Mut. Ins. Co. of Am. Risk Retention Grp. v. Weiss & Co.*, 80 A.D.3d 431, 431 (1st Dep't 2011) (requiring proof of subjective knowledge of relevant facts combined with objective basis to anticipate Claim).

2. "Officer" in the Exclusion Means Top Managers, Not Thousands of Rank-and-File Employees.

In addition to the particular requirements that exclusions be construed narrowly and that any ambiguity be resolved in favor of coverage, all insurance policy terms must be construed in light of the "reasonable expectation of the average insured." *Viking Pump*, 27 N.Y.3d at 257 (citation omitted). The application of the Knowledge Exclusion turns entirely on the knowledge of an insured's "officer," but that term is not defined anywhere in the exclusion (R.6207) or elsewhere in the policy. Underwriters and AAIC adamantly contended that it applied to anyone with a title categorized as an "officer" position in Bear Stearns' by-laws, although the evidence showed that this amounted to several thousand employees and about 40 percent of Bear Stearns' entire workforce. (R.6156 ¶ 31; R.6174; R.6180.) In ordinary usage, however, an "officer" is a person in a senior position of "trust, authority, or command." *Merriam-Webster Collegiate Dictionary* (11th ed. 2009). Contrary to Insurers' assertion, a reasonable insured would not expect that an exclusion limited to knowledge of potential claims by "officers" would extend to such an enormous group.

The securities laws are also clear that true officers enjoy that status because of the information they have, not their titles. *See C.R.A. Realty Corp. v. Crotty*, 878 F.2d 562, 566 (2d Cir. 1989) ("vice president" not an officer under the securities laws because he lacked access to inside information); *Merrill Lynch,* *Pierce, Fenner & Smith, Inc. v. Livingston*, 566 F.2d 1119, 1122 (9th Cir. 1978) (same); *see also Aleynikov v. Goldman Sachs Grp., Inc.*, 765 F.3d 350, 363-65 (3d Cir. 2014) (title not dispositive, especially in light of "title inflation" in the financial services industry).

The evidence is not genuinely disputed that at Bear Stearns, only a handful of top managers, such as the President and CEO, had sufficient authority to be considered officers within the meaning of the Knowledge Exclusion. Such authority did not trickle down to the literally thousands of people with titles such as "vice president," "associate director," "managing director" and "senior managing director." The only personnel with "officer" titles elected by the Boards of the Bear Stearns companies were senior management such as the President and CEO. (R.6173-74 ¶ 4.) The other Bear Stearns personnel who were deposed unanimously testified that only the CEO and his peers were regarded as officers, in contrast to the thousands of employees with titles referred to in the by-laws as "officer" titles, but lacking actual executive authority. (R.6156-58 ¶¶ 31-40; R.6174; R.6180; R.6372; R.6392; R.6472; R.6523-24; R.6536; R.6558; R.6637; R.6640; R.6643-44.) Accordingly, only the knowledge of members of Bear Stearns' senior management bears on the applicability of the Knowledge Exclusion, and none of them had the requisite knowledge.

3. Underwriters and AAIC Failed to Meet Their Burden to Show That a Bear Stearns Officer Knew by March 21, 2000 of the Alleged Wrongful Acts at Issue or That They Could Lead to a Claim.

Underwriters and AAIC failed to meet their burden for multiple reasons. First, to attempt to meet their burden that an "officer" within the meaning of the policy possessed the knowledge required by the Knowledge Exclusion, Underwriters and AAIC relied mainly on the SEC's unproven "findings" in the SEC Order. That reliance was misplaced here just as it was in the case of the intent to harm defense: *i.e.*, because the "findings" were mere allegations that were neither admitted (R.1562) nor adjudicated.[14]

Second, as the IAS Court properly concluded (R.430), even taking the SEC unadmitted "findings" as true, Underwriters and AAIC did not meet their burden to demonstrate that any Bear Stearns officer actually knew of any act of late trading or deceptive market timing by its customers at the time the policies were issued. For one thing, Underwriters and AAIC simply failed to identify any Board-elected officer with the relevant knowledge. Additionally, even if the knowledge possessed by associate directors and managing directors were relevant, Underwriters and AAIC still did not identify anyone with actual knowledge of late trading or deceptive market timing before March 21, 2000.

[14] *See* Point IV.D, above.

Third, Underwriters and AAIC failed to produce evidence demonstrating that an officer who possessed knowledge of market timing had an objective basis to anticipate a Claim based on market timing before March 21, 2000. *See Pepper Hamilton*, 13 N.Y.3d at 322.[15] They relied on the repeated assertion below that certain brokers were aware of "complaints" by mutual fund customers who wanted Bear Stearns to do a better job inhibiting market timing by investors in those funds that did not permit it. But if the knowledge that customers sometimes request better service established that an insured had a reasonable basis to expect a Claim – even where, as here, such mutual fund customers never sued, or even threatened suit – then the Knowledge Exclusion would apply to nearly every Claim. No case, and nothing in the language of the Knowledge Exclusion, permits reliance on such routine customer requests for this purpose.

Moreover, even if a Bear Stearns officer had known before March 21, 2000 of the conduct regarding market timing that the SEC later deemed unlawful, such an officer could not have anticipated the subsequent Claim. The indisputable

[15] Much less did Underwriters and AAIC demonstrate that any Bear Stearns officer involved in the decision to obtain coverage had such knowledge. Claims-made policies, like the policies here, cover prior acts, including known wrongful acts, by design. (R.6607-09.) The rationale for the Knowledge Exclusion is to prevent policyholders from obtaining such coverage when they already expect a claim (*id.*), a scenario not at all implicated here. Underwriters and AAIC made no attempt to argue that Bear Stearns obtained coverage from them because it anticipated increased exposure due to market timing.

evidence is that no regulatory investigation or civil action regarding market timing had ever been commenced against any broker-dealer or anyone else before September 2003. *SEC v. Pentagon Capital Mgmt. PLC*, 844 F. Supp. 2d 377, 392 (S.D.N.Y. 2012), *aff'd in part, vacated in part*, 725 F.3d 279 (2d Cir. 2013). Indeed, even after 2000, the very "definition of market timing was still evolving," and the "SEC issued no guidelines as to which fund provisions it might seek to enforce." *Id.* at 414-15. The SEC admitted to the Government Accounting Office that it did not regulate market timing before September 2003. GAO-05-313, *Mutual Fund Trading Abuses: Lessons Can Be Learned from SEC Not Having Detected Violations at an Earlier Stage*, Apr. 2005, at 10. To apply the Knowledge Exclusion in these circumstances – where no Claim was made or even threatened until more than three years after March 21, 2000 – is totally unprecedented and would undercut prior acts coverage.

In sum, Underwriters and AAIC did not meet their burden to show that an "officer" of Bear Stearns had the requisite knowledge at any time before the SEC commenced its investigation, much less before March 21, 2000.

F. The Award of Prejudgment Interest Was Proper.

The IAS Court properly awarded Bear Stearns prejudgment interest, accruing beginning in 2006, when Bear Stearns made its payment to the SEC. (R.473-79.) The award was mandated by CPLR 5001 because all Insurers had repudiated coverage by that time. They acted together as a unified insurance tower in response to a single large covered loss that exceeded the attachment point of each of their policies. They denied coverage collectively, compelling Bear Stearns to pay for the SEC settlement out of its own pocket and bring this action, causing Bear Stearns to lose and Insurers to profit from the time value of money for more than twelve years, and counting. That was a breach entitling Bear Stearns to interest under the statute.

Under CPLR 5001(a), an award of prejudgment interest is mandatory where a sum is awarded "because of a breach of performance of a contract . . . ." CPLR 5001(a). Here, Insurers breached their insurance contracts prior to the date of Bear Stearns' Loss by: (i) unreasonably delaying their response to the claims, (ii) improperly denying that the regulatory actions constituted a Claim under their policies, and (iii) continuing to insist that the disgorgement payment here was uninsurable as a matter of law. *J.P. Morgan*, 151 A.D.3d at 633 (concluding that Insurers "repudiate[ed]" coverage). Given those findings, an award of prejudgment interest was mandatory to fully compensate Bear Stearns for the loss of use of the insurance proceeds – proceeds that Insurers were instead undeservedly able to keep and use themselves. *Aurecchione v. N.Y. State Div. of Human Rights,* 98 N.Y.2d 21, 27 (2002); *Love v. State*, 78 N.Y.2d 540, 545 (1991); *see also Olin Corp. v. OneBeacon Am. Ins. Co.,* 864 F.3d 130, 152 (2d Cir. 2017)

("It is not the intention of [the statute] that an insurer could deny coverage for years in the face of reasonable demands and then, once it is adjudicated liable, avoid paying any prejudgment interest").

Respondents argued below that prejudgment interest is not payable because their policies were not triggered absent exhaustion of the underlying policies by actual payment by the underlying Insurers. That is, they contend that, although any one of them would be liable for prejudgment interest if it alone denied coverage, all of them are relieved of that liability because they repudiated coverage in unison. But none of their policies contains language providing that the only way to exhaust underlying coverage is by payment by the underlying Insurers. As the Second Circuit has observed, such a construction would be unduly "burdensome to the insured" (which is deprived of coverage based on factors beyond its control, such as the underlying carrier's insolvency or repudiation) and of "no rational advantage to the insurer" (which objectively has no interest in whether the underlying payment is made by the underlying carrier or the insured). *Zeig v. Mass. Bonding & Inc. Co.*, 23 F.2d 665, 666 (2d Cir. 1928). Courts therefore avoid such construction unless the policy language requires it with absolute clarity. *Id.*; *see also Pereira*, 2006 WL 1982789, at *6. None of Respondents' policies contain such language. (R.1239; R.1248; R.1259; R.1280).

Moreover, Respondents' argument fundamentally misconceives the scope and purpose of the prejudgment interest requirement. Under CPLR 5001(a), Insurers are obligated to pay prejudgment interest for loss "*because of* a breach of performance of a contract . . . ." (Emphasis added.) What matters is that, because of a contract breach, the defendant retained the use of funds that would have been paid to the plaintiff but for the breach. *See, e.g.*, *Aurecchione*, 98 N.Y.2d at 27.[16] Here, that breach occurred and therefore, prejudgment interest applied.

[16] If the Court accepted Respondents' contention that they were excused from paying interest from the date of Bear Stearns' Loss because of Vigilant's wrongful failure to pay, then Bear Stearns would be entitled to recover such interest from Vigilant both under CPLR 5001, because Bear Stearns was deprived of payments by Respondents "because of" Vigilant's breach, and, alternatively, as consequential damages. *Bi-Economy Mkt., Inc. v. Harleysville Ins. Co. of N.Y.*, 10 N.Y.3d 187, 195-96 (2008).

CONCLUSION

For all of the foregoing reasons, the Decision should be reversed and the judgment in favor of Bear Stearns should be reinstated.

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