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EDWARD J. KIRK
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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,

(*Caption continued on inside cover*)

BRIEF FOR DEFENDANTS-RESPONDENTS CERTAIN UNDERWRITERS AT LLOYD'S, LONDON AND AMERICAN ALTERNATIVE INSURANCE CORPORATION

KRISTI S. NOLLEY
R. PATRICK BEDELL
LINDSEY D. DEAN
BATESCAREY LLP
191 North Wacker Drive, Suite 2400
Chicago, Illinois 60606
Telephone: (312) 762-3100
Facsimile: (312) 762-3200

WILLIAM BALLAINE
LANDMAN CORSI BALLAINE
& FORD P.C.
120 Broadway, 13th Floor
New York, New York 10271
Telephone: (212) 238-4800
Facsimile: (212) 238-4848

Attorneys for Defendant-Respondent American Alternative Insurance Corporation

EDWARD J. KIRK
GABRIELA RICHEIMER
SCOTT SCHWARTZ
CLYDE & CO US LLP
The Chrysler Building
405 Lexington Avenue
New York, New York 10174
Telephone: (212) 710-3900
Facsimile: (212) 710-3950

Attorneys for Defendant-Respondent Certain Underwriters at Lloyd's, London

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

Defendants-Respondents.

DISCLOSURE STATEMENT PURSUANT TO RULE 500.1(F)

The Defendant-Respondent denominated as "Certain Underwriters at Lloyd's, London" includes Syndicates 1241, 1007, 435, 2488, 456 1211, 861 and 1209, which together subscribe to 80% of Excess Professional Liability Insurance Policy No. 501/FF00AC4B (the "Lloyd's Excess Policy"). Pursuant to the applicable claims scheme, the claim at issue in the litigation is handled by leading Lloyd's underwriter Syndicate 1241 on behalf of Syndicates 1241 and 1007 and Syndicate 435. The 2002 years of account for Syndicates 1241 and 1007 are reinsured by Syndicate 2008, which is managed by StarStone Underwriting Limited, of which Enstar Group Limited is the ultimate parent. Syndicate 435 is managed by Faraday Underwriting Limited, which is wholly-owned by Faraday Holdings Limited. Berkshire Hathaway Inc. is the ultimate parent of Faraday Holdings Limited. Syndicate 2488 is managed by Chubb Underwriting Agencies Limited, of which Chubb Limited is the ultimate parent. Syndicate 456 is managed by Limit Underwriting Limited, of which QBE Insurance Group Limited is the ultimate parent. Syndicate 1211 is managed by Travelers Syndicate Management Limited, of which Travelers Companies Inc. is the ultimate parent. Syndicates 861 and 1209 are managed by XL London Market Limited, which is wholly-owned by XL London Market Services Ltd. AXA S.A. is the ultimate parent of XL London Market Services Ltd.

American Alternative Insurance Corporation is a wholly owned subsidiary of Munich Reinsurance America Inc., which is itself a wholly owned subsidiary of the Munich Re Group/Münchener Rückversicherungs (Munich Re). Munich Re is a German corporation, which issues shares that are traded only on the Deutsche Boerse [German Stock Exchange] ("DAX").

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Respondents Certain Underwriters at Lloyd's, London ("Lloyd's") and American Alternative Insurance Corporation ("AAIC", and together with Lloyd's, "Underwriters") submit this brief in opposition to the opening brief submitted by Appellants (collectively, "Bear") in support of their appeal of an order issued by the Supreme Court Appellate Division, First Department (the "Appellate Division") entirely dismissing Bear's claims against Underwriters and the other respondents. Specifically, this brief responds to the arguments at pages 49-55 of Bear's brief regarding the Prior Knowledge Exclusion in Underwriters' policies. Underwriters further join and incorporate the opposition brief of Vigilant Insurance Company and Federal Insurance Company (together, "Chubb").

PRELIMINARY STATEMENT

Bear urges this Court to overturn the Appellate Division's holding that Bear cannot turn to its insurers for reimbursement of the substantial penalties it agreed to pay the government for the brazenly illegal and deceptive market timing/late trading scheme perpetrated by numerous Bear officers beginning in 1999. For all the reasons stated in Chubb's opposition brief, the Appellate Division's ruling should be affirmed because it fully comports with this Court's law and the plain language of Bear's insurance policies precluding coverage for the penalties imposed on Bear in the final orders from the United States Securities and Exchange Commission and New York Stock Exchange.

Bear's brief also raised an issue not reached by the Appellate Division—the application of the "Prior Knowledge Exclusion" in Underwriters' excess policies as a separate and independent bar to coverage. This policy provision expressly precludes coverage for claims arising from "wrongful acts" committed before March 21, 2000 where, as here, "any officer" of Bear knew or could have reasonably foreseen that those wrongful acts could lead to a claim. Bear insists here (as it did below): (i) that the term "any officer" should be construed so narrowly as to comprise *only* four top officers in what was at the time one of the largest banks in the world, and (ii) that this Court should ignore the overwhelming evidence adduced in the trial court showing that multiple Bear officers—as *Bear itself* defined the term—participated directly in late trading and market timing practices *known* to violate federal securities laws.

The Appellate Division correctly reversed the trial court for its misreading of the insurance policies for all the reasons discussed in Chubb's opposition brief. The Prior Knowledge Exclusion is, as noted, an alternative reason why Bear cannot seek coverage from Underwriters. As Underwriters' high-excess policies "follow form" to and apply excess of the limits of the underlying policies, affirming the Appellate Division's sound holding would render the Prior Knowledge Exclusion issue moot. If the Court should reach this separate issue, however, the Court could remit to the Appellate Division for initial de novo

review, or affirm as to Underwriters on this alternative ground, as discussed in this brief and argued to the Appellate Division below.

COUNTERSTATEMENT OF QUESTIONS PRESENTED

1. Does the plain meaning of the term "any officer" in the Prior Knowledge Exclusion include only the top four officers as Bear contends, or rather any individual qualifying as an officer of the company as defined in Bears' own corporate by-laws and other documents?

2. Based on the overwhelming and undisputed record evidence, did at least one Bear officer know or reasonably could have foreseen prior to March 21, 2000 that Bear's deceptive market timing and illegal trading practices could lead to a Claim and, therefore, the Prior Knowledge Exclusion applies?

With respect to all other issues presented in this appeal, Underwriters incorporate herein by reference the Questions Presented in Chubb's brief.

STATEMENT OF THE CASE[1]

A. Procedural History Relevant to the Prior Knowledge Exclusion Issue

This coverage dispute arises from an investigation commenced in 2003 by the United States Securities and Exchange Commission (the "SEC") and New York Stock Exchange ("NYSE") into Bear's role in the illegal late trading and

[1] Underwriters incorporate by reference the factual statement in Chubb's brief and reiterate here the key points relevant to the separate Prior Knowledge Exclusion issue.

deceptive market timing of mutual fund shares in violation of federal securities laws. R.[2] 6158 (¶ 41). In 2006, the SEC entered a final order against Bear finding that, from 1999 to 2003, Bear willfully violated securities laws by engaging in and facilitating unlawful late trading and deceptive market timing trading that generated "hundreds of millions of dollars" in profits at the expense of innocent mutual fund investors (the "SEC Order"). R. 6243 (¶5); R. 6158-59 (¶¶41-44). The SEC's willfulness finding was critical—the SEC found that the underlying misconduct was perpetrated by numerous senior officers of the company justifying significant sanctions against Bear. *See* R. 6270-71 (¶¶ 179-184). The SEC Order thus required Bear to pay "disgorgement" of $160 million and a further $90 million civil penalty. R. 6279. The NYSE issued a parallel order. R. 6322.

As reflected in the SEC's detailed findings and confirmed in discovery, Bear's illegal trading practices were well underway in and before March 2000 when it obtained the Excess Policies from Underwriters and AAIC.[3] The Lloyd's Excess Policy and the AAIC Excess Policy provided combined limits of $50 million excess of $150 million in underlying insurance and a $10 million self-

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[2] All references to "R." refer to the Record on Appeal.

[3] The Excess Policies are Excess Professional Liability Insurance Policy No. 501/FF00AC4B (the "Lloyd's Excess Policy") and Commercial Excess Professional Liability Policy No. 01-A2-PX-0000019-00 (the "AAIC Excess Policy", and together with the Lloyd's Excess Policy, the "Excess Policies").

insured retention. In general, the Excess Policies follow form to the terms and conditions of the underlying policies, including primary Policy No. 7023-22-82 (the "Primary Policy") issued by Vigilant Insurance Company. R. 4144; 4091. As relevant to this brief, the Excess Policies included the express additional limitation referred to herein as the "Prior Knowledge Exclusion" (discussed further below).

In 2009, Bear sued Underwriters and its other insurance carriers seeking coverage for its $160 million disgorgement payment, $14 million that it paid to settle related civil actions, and legal fees and costs that it claims to have incurred in defense of the regulatory investigations and civil actions. R. 90 (¶ 14). Subsequently, Bear revised its claim to seek only $140 million of the $160 million disgorgement payment, in addition to the other amounts. R. 133 (¶ 25). In support of its claim for coverage for those amounts, Bear relied explicitly on the SEC Order, which Bear repeatedly referenced in its Amended Complaint in this action, just as it has done on appeal. R. 126-169.

In the trial court, the parties cross-moved for summary judgment, and the court granted summary judgment to Bear with respect to the Prior Knowledge Exclusion and other issues. On appeal, the Appellate Division reversed the trial court and instructed it to enter judgment in favor of the defendants on the basis that the payments to the SEC for which Bear sought coverage under the Policies represented an uncovered penalty. As a result, the Appellate Division did not

address the issue of the Prior Knowledge Exclusion because it ruled in favor of Underwriters on other grounds. Recognizing that the Prior Knowledge Exclusion represents an alternative ground for affirming the Appellate Division's opinion, Bear included its arguments regarding the exclusion at pages 49-55 of its opening brief.

B. Bear Officers' Knowledge of Illegal Conduct Pre-Dating March 21, 2000

Endorsement No. 2 to the Lloyd's Excess Policy (the "Prior Knowledge Exclusion") provides that:

> Underwriters shall not be liable to make any payment for **Loss** in connection with any **Claim** made against the **Assured**:
>
> * * *
>
> 2. (i) for any alleged **Wrongful Act(s)** committed prior 12:01 a.m. Local Standard Time on 21st March, 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**; or
>
> (ii) any other **Wrongful Act** whenever occurring, which, together with a known **Wrongful Act** as set forth in 2(i) above, would constitute **Interrelated Wrongful Acts**.

R. 4160.

"Officer" is not defined in the Excess Policies or underlying Primary Policy. But Bear's corporate by-laws during the relevant period from 1999-2000 provided that:

> The Board shall elect a Chairman of the Board of Directors, a Chief Executive Officer, a President, a Chief Operating Officer, a Chief Financial Officer, a Secretary, a Treasurer and a Controller, and may elect or appoint one or more Senior Managing Directors, Managing Directors, Associate Directors, Vice Presidents and such other officers … as the Board may determine. …

R. 4180; R. 4213-14. In addition, Bear maintained an "Officers' Committee," operating under authority of the Board of Directors, which confirmed the appointment of many "individuals serving as officers in the operations and administration areas" of Bear. R. 4259; 4238-4274 (Exhibits 5-9).

Bear's by-laws, Responses to Interrogatories and Requests for Admissions, internal "New Officers" lists and Wells Submissions to the SEC all confirmed that the following individuals who served as Managing Directors, Associate Directors, Vice Presidents and other senior positions—and who were involved in or aware of Bear's illegal trading schemes as of March 21, 2000—were officers of Bear during the relevant time period:

Officer	Title/Position	Evidence
Maximo James Acosta	Managing Director	R. 4285 (Response 10)
Raymond Aronson	Senior Managing Director & Compliance Officer	R. 4286 (Response 13); R. 45605 (Response 11)

Officer	Title/Position	Evidence
Jeffrey Bernstein	Senior Managing Director and Co-Head of Operations/ Member of Board of Directors (“Board”) and Internal Audit Committee	R. 4287-89 (Responses 16, 20); R. 4264; R. 5797-98
Jimmy Cayne	President & CEO	R. 4290-91 (Responses 25, 26)
Anthony Coloprisco	Associate Director	R. 4292 (Response 31)
Phil Connor	Vice President	R. 4293 (Response 34)
Steven Dantus	Senior Managing Director	R. 4295 (Response 40)
James DelVecchio	Associate Director/ Head of Mutual Fund Operations Department (“MFOD”)	R. 4296 (Response 44); R. 4512 (Response 21)
Vincent Dicks	Senior Managing Director/ Private Client Services (“PCS”) Division Administrative Head	R. 4298-99 (Response 50); R. 4500 (Response 3)
Timothy Fitzpatrick	Vice President	R. 4258
Jack Foley	Vice President	R. 4301 (Response 57)
Bruce Geismar	Senior Managing Director/ Co-Head of Operations/ Board Member	R. 4264; R. 5797-98; R. 4305 (Response 68)
Stephen Harasek	Managing Director/ MFOD’s Head Supervisor	R. 4239 ; R. 4512 (Response 21)
Mark Hurant	Managing Director	R. 4308 (Response 79)
Richard Lindsey	Senior Managing Director/ Co-President/ Board Member	R. 4311 (Responses 86-88)

Officer	Title/Position	Evidence
Michael Minikes	Senior Managing Director/ Co-President / Board Member	R. 4264; R. 4313 (Responses 92, 93)
Peter Murphy	Senior Managing Director	R. 42517
Christopher Welsh	Managing Director	R. 4211-22 (Response 119)

See also generally R. 4527-28 (Response 3 (identifying individuals aware of Bear Stearns facilitating or Bear Stearns clients engaging in market timing)).

The facts known to these and other of Bear's officers as of March 21, 2000 confirm that the Prior Knowledge Exclusion precludes coverage under the Excess Policies.

1. Bear's Illegal Late Trading Prior to March 21, 2000

Late trading is a *per se* violation of the forward pricing rule and Rule 22c-1 of the Investment Company Act of 1940. R. 4998 (¶¶ 180, 182). By at least 1999, multiple Bear officers knew of, engaged in or facilitated illegal late trading. For example, former broker Adam Feil from Bear's PCS Division confirmed that, before March 21, 2000, Managing Director Mark Hurant knowingly permitted a client, Chronos Asset Management, Inc. ("Chronos"), to improperly cancel trades the next business morning in violation of the forward pricing rule. R. 5452-5453. Feil further confirmed that Hurant received calls from Chronos about certain trades and directed another PCS broker Robert Conway to cancel the trades the next day. R. 5511-14. In addition, by February 2000, James DelVecchio, head of the MFOD

at Bear, knew that individuals he supervised within the MFOD were cancelling trades for known market timers after the 4:00 pm EST cut-off. R. 5492.[4]

Not only did Bear facilitate late trading, it touted its ability to do so as a marketing tool to attract additional business. In late-1998, Bear promised a prospective clearing client, Empire Financial Group ("Empire"), that it would be able to accept late trades while protecting Empire's identity from mutual funds. R. 4979 (¶¶ 63-64); R. 5022-28. On or about January 7, 1999, Bear entered into a clearing relationship with Empire. R. 4979 (¶ 65); R. 5530. True to its word, Bear granted Empire access to its routing system, and Managing Director Jimmy Acosta "explicitly granted" Empire the ability to trade "based on post-4:00 pm trading decisions." R. 5024; *see also* R. 4990 (¶ 67); R. 4522-28; R. 5515-31; R. 5533.

2. Bear's Deceptive Market Timing Prior to March 21, 2000

Market timing done in conjunction with false and misleading statements is securities fraud. R. 4710 (p. 54). In 1999, Bear started receiving thousands of complaints from various mutual funds directing Bear to stop clearing market timing trades because it was harming the funds and investors. R. 4974 (¶ 29), 4994 (¶156); R. 9285- 9287(Section F).

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[4] Bear Stearns cleared trades through the MFOD, which the SEC described as "the department within [Bear Stearns] that was responsible for all mutual fund clearing" for customers of PCS brokers, prime brokerage customers such as hedge funds and for customers of its correspondence firms/introducing brokers. R. 4969 (SEC Order ¶3).

Bear then established the "timing desk" in the MFOD. R. 4973 (¶ 23). As head of the MFOD, James DelVecchio supervised the timing desk employees. R. 5043-49 (pp. 68-72, 97, and 106), 5057 (p. 114); R. 5084-85. Although purportedly created to manage the increasing flow of market timing trades it cleared, Bear used the timing desk to assist its customers in evading blocks and restrictions imposed by mutual funds and to market its ability to facilitate improper trading. R. 4969-70 (¶¶1, 2 and 4), 4973 (¶¶ 24 and 25), 4974-75 (¶ 33), and 4984 (¶79).

Bear's supposed processes to protect against market timing were ineffective by design. R. 4984-86 (¶¶ 89, 93); R. 5280-81; R. 5282-84; R. 5285-86. Beginning in 1999, Bear maintained a list of known market timers trading on its clearing platform (ostensibly to address customer concerns), yet during the relevant period it knowingly cleared over 53,000 trades for market timing accounts on the "closed for timing" list, each averaging over $1.5 million and totaling over $83 billion in value. R. 9287 (p. 14).

3. Customer Complaints Against Bear About Harmful Market Timing

From 1999 to 2003, numerous Bear officers, including Aronson, Bernstein, DelVecchio, Foley, Fitzpatrick, Harasek, Hurant, Lindsey, Minikes, Murphy and Welsh, received or became aware of voluminous and repeated complaints from mutual funds requesting that Bear stop harmful market timing trading activity by

its own PCS brokers, Empire and other traders that cleared through the firm. R. 7370-7374; R. 8308-10; R. 8311-18.

On January 13, 2000, for example, during a meeting of Broker-Dealer Services Staff, Senior Managing Director Peter Murphy informed managing Director Christopher Welsh and others that "Senior Management is paying close attention to the mutual fund timers." R. 5619-21; R. 5627. Murphy further explained that senior management, including Lindsey and Minikes, were aware of the mutual funds' "*complaints* because it was widely discussed and the mutual funds were important clients of the firm." R. 5627 (emphasis added). The following day, Acosta, Aronson, Lindsey, Minikes and other Bear officers received a copy of the meeting minutes. R. 5620.

In May 2000, during an Operations Committee meeting attended by Senior Managing Director and Co-President Richard Lindsey and other officers, Senior Managing Director Jeffrey Bernstein reported that "*over the last year* we have been contacted by approximately 15 mutual fund families to restrict specific customers, who are engaging in market-timing activity from investing in their respective funds." R. 5631 (emphasis added). In his Wells Submission to the SEC, Bernstein acknowledged that Managing Director and Assistant Cashier Stephen Harasek and Senior Managing Director and Cashier Phil Lanz alerted him to "the problem of market timing activity at Bear in the Summer of 1999" and

"escalate[d] issues to the appropriate parties" within Bear prior to March 21, 2000. R. 5805.

Between August 20, 1999 and May 4, 2001, one mutual fund company (American Century) sent numerous complaints to DelVecchio requesting that Bear block market timing in its fund. R. 8322-8356, 11225-11226. Nevertheless, Bear continued to clear market timing trades in American Century's fund, and did not add it to the "closed for timing list" until May 8, 2001. R. 5599-5601.

Similarly, during 1999, another mutual fund company (Fidelity) complained to Bear repeatedly about market timing by Hurant and other known timers, and notified the MFOD and its head, DelVecchio, that it expected compliance with its market timing policy. R. 5676-5679, 10618-10621. DelVecchio, however, did not add Fidelity to the "closed for timing" list until much later, in February 2001. R. 5695, 10636.

During 1999, DelVecchio received numerous complaints from Scudder Kemper Investments ("Scudder") about market timing in its fund and reported this to more senior officers, including Vice President Jack Foley and Managing Director Stephen Harasek. R. 5735-5772; 10678-10715. Despite his knowledge of Scudder's complaints and Harasek's repeated reassurances to Scudder, DelVecchio delayed in adding Scudder to the "closed for timing" list until late 2000. R. 8450.

4. Bear's Deceptive Use of Multiple Account Numbers and Representative Numbers

Despite numerous and repeated complaints from mutual funds before March 2000—as well as the (false) assurances made by Bear officers to the mutual funds about stopping the harmful activity—Bear continued to facilitate market timing by providing known market timers with deceptive devices, such as multiple account and/or registered representative ("RR") numbers, to disguise their identities from the complaining mutual funds. R. 4969-79 (¶¶ 2, 4), 4996-97 (¶¶ 171, 175). *See also* R. 5026.

Specifically, by at least 1999, Bear officers, including DelVecchio, Acosta and Aronson, knew that market timers used multiple account numbers to evade detection by mutual funds. R. 4993-94 (¶ ¶ 150-154); R. 5540-45. For example, during July and August 1999, Phil Connor, Vice President and Relationship Manager within Bear's Global Clearing Services ("GCS"), with the knowledge of Managing Director Acosta and others within Bear, helped create several non-sequential accounts for Jemmini Offshore Ltd. ("Jemmini"), an Empire customer, to allow Jemmini to market time while avoiding detection by mutual funds. R. 4993-94 (¶¶ 150-154); R. 10486-90.

In addition, by email dated December 10, 1999, DelVecchio explained to Vice President Jack Foley that a mutual fund (Putnam) was rejecting Empire's trades and did "not want them timing," but Empire was planning to "set up new

A/C's [account numbers] and time small amounts of Putnam." R. 4993 (¶ 151); R. 5547. In response, Foley advised DelVecchio, Senior Managing Director and Compliance Officer Raymond Aronson, and Vice President Tim Fitzpatrick that Empire was negatively impacting Bear's relationship with Putnam and that he had warned Empire that Bear "[cannot] accept any new orders but [Empire] does a tremendous amount of timing." *Id*. Foley advised Aronson that Empire is "an example of one of our Correspondents hurting Bear relationship" and sought his advice regarding how to respond. R. 4993 (¶ 151); R. 5547. These emails were forwarded to Senior Managing Director Peter Murphy and Managing Director Stephen Harasek. R. 4993 (¶ 151); R. 5547.

Two days later, on December 16, 1999, DelVecchio forwarded to Foley a complaint from Scudder regarding Empire's market timing. The same day, Foley forwarded the email to Aronson, Fitzpatrick and Murphy. R. 5549-50. On December 17, 1999, Acosta, Aronson, Lindsey, Minikes, Murphy and Welsh received an internal report about Empire, explaining that Empire was a notorious market timer and that several mutual funds, including Putnam and Scudder, had asked that Empire not trade their funds due to "the impact it has on the Funds NAV." R. 4993 (¶ 150); R. 5551-53. On January 1, 2000, Welsh forwarded a copy of the internal report on Empire to DelVecchio, Fitzpatrick and Murphy and

suggested that they meet to "discuss market timers [with reference to the Empire report] … and our policies." R. 5554-60.

On January 5, 2000, DelVecchio received an email from Scudder reiterating a prior complaint. Scudder advised that the trader simply transferred from one fund to another through use of another account, and stated that it "does not seem to be an acceptable way to alleviate timers." R. 5753.

The mutual fund complaints and internal correspondence establish that, by at least December 1999, Bear officers understood that Empire was engaging in unwanted market timing that not only harmed mutual funds, but also attempted to deceive them by using multiple account numbers. Nevertheless, Bear continued to facilitate the harmful trading and, through at least June 2001, deceived mutual funds by creating additional non-sequential account numbers for Empire and its other customers. R. 4993-94 (¶¶ 152-155, 157-158); R. 9287 (p. 14).

Furthermore, by at least 1999, Managing Director Mark Hurant and other PCS brokers were using multiple RR numbers to deceive mutual funds about the source of their customers' market timing trades and to avoid blocks implemented by the mutual funds. For example, on December 21, 1999, Senior Managing Director Vincent Dicks approved a new RR number for PCS broker Adam Feil to allow him to trade in a mutual fund on behalf of Hurant—who the mutual fund had identified as a market timer. R. 4997 (¶ 176); R. 5561-68. Once the new RR

number was issued (*i.e.*, No. RC7), Feil used it to trade mutual funds that had previously complained about improper timing. R. 5569-70.

On January 4, 2000 and March 13, 2000, Dicks approved additional RR numbers for Hurant (*i.e.*, Nos. RC8 and RE9). R. 5566-67. Despite a clear directive from American Century funds in August 1999 that Bear deny Hurant "any and all abilities to purchase" its funds, Hurant continued to time American Century funds with Bear senior management's knowledge until at least February 2001. R. 5572, 10571; R. 5561-68.

Beginning by at least January 1999 and through the relevant period, senior management, including Dicks, Senior Managing Director and Chief Executive Officer of PCS Steve Dantus and Chief Executive Officer James Cayne, looked for ways to assist Hurant's market timing activities (i.e., making him "aware of our internal mutual fund supermarket") and tracked his profitability. R. 4641-42; R. 4643-45; R. 4647; R. 4512-73 (Response 22).

5. Bear's Prior Involvement with SEC Enforcement Provided a Basis for its Officers to Know Its Conduct Could Lead to a Claim

Bear cannot reasonably dispute that in 1999 and 2000, its officers knew that regulators could bring an action or investigation against the company if it facilitated improper trading and failed to address customer complaints—because the SEC already had done so. R. 4616, 4621.

In August 1999, Bear agreed to pay $35 million in civil penalties and restitution to customers for willfully aiding and abetting fraud by an introducing broker, A.R. Baron (the "A.R. Baron Order"). R. 4660-81. From 1999 through 2000, an independent consultant retained pursuant to the A.R. Baron Order, Robert M. Bushman, Esq., interviewed and worked closely with Bear's senior management, including Aronson, Lindsey and Murphy, to review and revise Bear's procedures for its clearing business. R. 4666-68; R. 4704-05; R. 4608.

In November 1999, a Bear committee created to oversee relationships with introducing firms clearing through Bear began meeting. R. 4818; R. 4614-15, 4617-18. The committee included managers Lindsey, Minikes, Mark Lehman and Bruce Geismar. Several other Bear officers, including Aronson and Murphy, routinely attended these meetings. R. 4818-19, 4828; 4933. The committee recognized that "the quantity of customer complaints can be an important indicator of serious concerns with introducing firms." R. 4837, 4847-48; R. 4931-14.

Counsel for the independent consultant, Morris Simkin Esq., prepared an expert report in this matter detailing the many reasons why Bear's officers had or should have had a keen awareness, before March 21, 2000, that their deceptive or fraudulent conduct, and/or the failure to implement controls for addressing customer complaints, could lead to a regulatory investigation or lawsuit—just like it did with A.R. Baron. R. 4701, 4707.

ARGUMENT

As a "sophisticated business entity," Bear is bound to the plain terms of the contract it entered into freely with Underwriters. *Vigilant Ins. Co. v. Bear Companies, Inc.,* 10 N.Y.3d 170, 178 (2008). Here, Bear agreed as part of its contracts with Underwriters to a Prior Knowledge Exclusion, which bars coverage when the following statements are true:

1) The purported Loss is in connection with a Claim made against Bear for an alleged Wrongful Act committed before March 21, 2000, or any Interrelated Wrongful Acts occurring at any time.

Bear admits the first point is true.[5]

2) "*Any officer*" of Bear knew of such alleged Wrongful Act(s) as of March 21, 2000.

Bear asks this Court to expunge "*any* officer" from the Excess Policies and re-write the agreed upon terms to say "only a handful of top management such as the President and CEO." (Bear Br. at 51.)

3) The officer knew or could have reasonably foreseen that such alleged Wrongful Act(s) could lead to a Claim.

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[5] Bear Stearns admitted in its Amended Complaint that the Claim involves Wrongful Acts committed prior to March 21, 2000 and Interrelated Wrongful Acts committed after that date. R. 126-169 (¶¶ 50, 52, 55, 73, 80, 93, 130, 140-141, 149); R. 5849-51. Accordingly, there is no dispute between the parties as to the first element of the Prior Knowledge Exclusion.

Bear urges the Court to accept Bear's "head in the sand" subjective approach (Bear Br. at 54) instead of this Court's precedent adopting an objective "reasonable insured" approach to assessing prior knowledge.

Bear's arguments are contrary to the Excess Polices, the overwhelming evidence and this Court's precedent and should be rejected.

A. "Any Officer" Means What It Says

Ignoring its own contemporaneous corporate documents and procedures, Bear argues that "*any* officer" of Bear in fact means *only* a "handful of top managers such as the President and CEO," because such individuals are the only employees of Bear in positions of "trust, authority, or command" and were elected by the Boards of Bear companies. (Bear Br. at 51-52.) Bear's arguments contradict the plain language of the Excess Policies, all objective evidence of its understanding of the term "officer" and this Court's law.

1. This Court Should Reject Bear's Attempt to Re-Write Unambiguous Language in the Excess Policies

To begin with, New York law recognizes as a "fundamental, neutral precept of contract interpretation" that "agreements are construed in accord with the parties' intent." *Greenfield v. Philles Records, Inc.*, 98 N.Y.2d 562, 569 (2002) ("[A] written agreement that is complete, clear and unambiguous on its face must be enforced according to the plain meaning of its terms"). This principle holds equally true for insurance policies. As such, "insurance contracts, like other

agreements, will ordinarily be enforced as written" and based on the plain and ordinary meaning of their terms. *J.P. Morgan*, 21 N.Y.3d at 333; se*e also White v. Continental Cas. Co.*, 9 N.Y.3d 264, 267 (2007) ("As with any contract, unambiguous provisions of an insurance contract must be given their plain and ordinary meaning"). Where an insurance policy on its face expresses the plain intent of the parties, "courts should refrain from rewriting the agreement." *Govt. Emp. Ins. Co. v. Kligler*, 42 N.Y.2d 863, 864 (1977).

Bear's cries of "ambiguity" (which the trial court wrongly accepted) are specious. By definition, insureds like Bear "who are of sufficient sophistication to be in the market for this brand of insurance" (i.e., financial institution professional liability insurance) are not easily "misled" even by policy language that might otherwise have the "potential to confuse a layman." *In re Ambassador Grp., Inc. Litig.,* 738 F. Supp. 57, 63 (E.D.N.Y. 1990). *See also Loblaw, Inc. v. Employers' Liability Assur. Corp.*, 85 A.D.2d 880, 881 (4th Dep't 1981) (considering purpose of disputed policy provision in the context of entire policy and rejecting sophisticated insured's argument for ambiguity). Where, as here, the Insureds are "sophisticated business [people]" "[t]he plain meaning of the policy language is not measured … by the understanding of a layperson, but by the understanding of a person engaged in the insured's course of business." *Moshiko, Inc. v. Sieger & Smith Inc.,* 137 A.D.2d 170, 175-76 (1st Dep't 1988), *aff'd* 72 N.Y.2d 945 (1988).

Courts in New York and elsewhere have applied "the ordinary definition of 'any' as the *maximum or whole*" when examining an insured's attempt to create ambiguity in a prior knowledge exclusion. *See Colony Ins. Co. v. Kuehn*, No., 2012 WL 4472038, at *4-5 (D. Nev. Sept. 25, 2012) (emphasis added) (citing, among other cases, *Murphy v. Allied World Assur. Co. (U.S.), Inc.*, 370 Fed. Appx. 193, 194 (2nd Cir. 2010)). New York courts routinely have recognized the term "any" in prior knowledge exclusions of insurance policies to be purposefully broad, and found that "any" insured's knowledge can be imputed to the company or even to innocent insureds and insurance coverage for known wrongful acts is "not part of the coverage provided for the premium paid." *Gluck v. Exec. Risk Indem., Inc.*, 680 F. Supp. 2d 406, 418 (E.D.N.Y. 2010). *Cf. Shapiro v. Am. Home Assur. Co.*, 584 F. Supp. 1245, 1253 (D. Mass. 1984) (explaining that purpose of prior knowledge question in application was to broadly exclude coverage for all directors and officers with knowledge of pre-policy wrongful acts because of the joint and several nature of directors and officers liability, and finding the insured's contrary interpretation unreasonable because it "would provide inadequate protection to the interest of the insurer").

Interpreting "any" to mean "only" and inserting the titles of only specific management appointed by the Board would rewrite the policy to favor the policyholder, contrary to the plain and ordinary meaning of the agreed to terms of

the Prior Knowledge Exclusion. *See Kligler*, 42 N.Y.2d at 864 ("[W]here the provisions of the policy are clear and unambiguous, they must be given their plain and ordinary meaning, and courts should refrain from rewriting the agreement."); *In re Ambassador*, 738 F. Supp. at 63 ("'[I]t is not the function of the court to rewrite insurance policies so as to provide coverage which the court might have considered more equitable.'") (*quoting Cornellier v. Am. Cas. Co.*, 389 F.2d 641, 644 (2d Cir. 1968)).

Bear's interpretation of "any officer" also is inconsistent with the other policy provisions. The underlying Primary Policy defines "Insured" to include "*any* persons who were… officers." (Emphasis added.) Had the parties intended to limit the terms of the Excess Policies as Bear contends, they would have drafted the policy provisions to state that only Bear's top four officers qualify as officers. Instead, the parties agreed in the Policy that the Prior Knowledge Exclusion would apply where "any officer of the Assured" had knowledge of alleged Wrongful Acts. R. 7014-19. The "Assured", Bear, was a sophisticated business entity that knew when it entered into the Excess Policies how many individuals held officer designations and who would fall within the "any officer" language of the Prior Knowledge Exclusion.

2. The Term “Any Officer” Refers to Any Employee Who Bear Deemed to be an Officer

As noted above, Bear’s By-Laws, New Officer Lists and other internal documents defined “officer” to include, among others, Secretary, Treasurer, Senior Managing Directors, Managing Directors, Associate Directors and Vice Presidents. R. 4180; R. 4213-14. There is no genuine dispute that, during the relevant period, individuals in those positions were officers and had relevant knowledge of the wrongful acts leading to the SEC and NYSE investigations and other Claims.

For example, the SEC Order describes the wrongful conduct of certain Bear officers. Bear confirmed the identity of these individuals, who were described but not named in the SEC Order, including: (i) Associate Director DelVecchio - “MFOD Head”; (ii) Senior Managing Director Dicks - “PCS Administrative Head”; (iii) Vice President Connor - “ Relationship Manager”; (iv) Senior Managing Director Murphy - “head of broker-dealer services for [Global Clearing Services]”; (v) Managing Director Harasek -”MFOD Head’s supervisor”; and (vi) Senior Managing Director Aronson - “counsel.” R. 4285-4318 (Responses: 9, 13, 16, 31, 34, 40, 44, 51, 54, 67, 75, 79, 86-88, 91-93, 96-97); R. 4499-4517 (Responses: 1, 6, 11, 13, 14, 21, 25); R. 4527-28 (Response 3). These individuals were “officers” as defined in Bear’s By-Laws, R. 4180; R. 4213-14, confirmed in Bear’s Responses to Interrogatories and Requests for Admissions, R.4285-4314 (Responses: 9, 13, 16, 31, 34, 40, 44, 51, 54, 67, 75, 79, 86-88, 91-93, 96-97); R.

45326-4544 (Responses: 1, 6, 11, 13, 14, 21, 25); R. 4487 (Response 3)), and reflected in Bear's "New Officers" lists. R. 4238-4273 (Exhibits 5-8). Further, DelVecchio, Murphy and others either represented or testified in the underlying proceedings that they were officers of Bear. R. 4569 (p. 197); R. 4580-81 (pp. 5, 38).

As discussed above, prior to 1999, Acosta, Aronson, Bernstein, DelVecchio, Fitzpatrick, Harasek, Hurant, Minikes, Murphy and Welsh were "appoint[ed] as officers" of Bear and during the relevant time "serv[ed] as officers in the operations and administration areas" of Bear. R. 4238-4274 (Exhibits 5-9). Moreover, these individuals had significant supervisory and management responsibilities within Bear. Bear, itself, referred to Senior Managing Directors Steven Dantus, Dicks, Bruce Geismar, Jeffrey Bernstein, Murphy and Raymond Aronson as the "heads" of departments. R. 6153-6155 (¶¶16, 22, 24, 26-28), 6162 (¶ 63).The SEC, for its part, described DelVecchio, Dicks, Dantus and Harasek as "very senior people" and "executives" "at the highest levels of the firm." R. 5024-25. In addition, DelVecchio and Harasek each signed agreements with mutual funds on behalf of Bear and were able to bind the company. R. 7312-14; R. 6018-20. Accordingly, there can be no reasonable dispute as to any material fact that each of the individuals discussed in the SEC Order and above in connection with the Prior Knowledge Exclusion were "officers" of Bear.

Bear seeks to avoid this plain-meaning interpretation by citing three cases in which the courts considered whether a person was an officer where the relevant by-laws were ambiguous as to who was an officer, or interpreted specific SEC guidance to determine who was liable under section 16(b) of the Securities and Exchange Act of 1934. (*See* Bear Br. at 51-52 *(citing Aleynikov v. Goldman Sachs Grp., Inc.*, 765 F.3d 350, 363-65 (3d Cir. 2014) (interpreting ambiguous definition of officer in by-laws); *C.R.A. Realty Corp. v. Crotty*, 878 F.2d 562, 565(2d Cir. 1989) (noting that Section 16(b) of the securities laws applies to those with access to confidential information, regardless of whether they were officers of the company); *Merrill Lynch, Pierce Fenner & Smith, Inc. v. Livingston*, 566 F.2d 1119, 1121 (9th Cir. 1978) (same).) In fact, the *Aleynikov* court specifically noted that the standard definition of "officer" does not require the individual to be elected or appointed, as Bear now contends. *Aleynikov*, 765 F.3d at 361 ("We therefore conclude that the election or appointment requirement cannot properly be considered a part of the ordinary, dictionary definition of officer.").

Even if holding a duly appointed title of "officer" in the relevant time period was insufficient to deem an individual to be an "officer" of Bear under the Prior Knowledge Exclusion, the record showed that the individuals at Bear with knowledge of the improper trading practices had significant supervisory and management responsibilities in positions of "trust authority or command" and

clearly meet the dictionary definition of "officer" suggested by Bear. (Bear Br. at 51.) Indeed, the nature of the SEC's charges confirms that the individuals identified in the SEC Order were officers and had significant supervisory and management responsibilities. The SEC determined that Bear "willfully" violated anti-fraud provisions of federal securities laws. R. 7709-7710. For each violation, the SEC had to establish intent at the corporate level by showing the knowledge and conduct of senior management. *See SEC v. Durgarian*, 477 F. Supp. 2d 342, 353, 357 (D. Mass. 2007); *SEC v. PIMCO Advisors Fund Mgmt. LLC*, 341 F. Supp. 2d 454, 470 (S.D.N.Y. 2004) ("Scienter of the corporate entity is ascertained through the mental state of its management."). Beginning no later than 1999, as the SEC found, Bear's senior management knew of the late trading and market timing activities and violations by the corporate entities. The SEC specifically rejected Bear's argument in its Wells Submission that senior management had no knowledge of late trading and deceptive market timing during the period 1999-2003. R. 4969-70.

Bear acknowledges that its by-laws referred to additional employees with titles such as "vice president," "associate director," "managing director" and "senior managing director" as officers. (Bear Br. at 51.) It is unreasonable to suggest that the term "any officer" in the Prior Knowledge Exclusion does not

include individuals that Bear itself deemed to be "officers" of the company—as did the SEC when it penalized the company for willfully committing securities fraud.

3. New York Courts Consider Extrinsic Evidence to Resolve Ambiguity in a Contract

In order to support its interpretation of the term "any officer" to actually mean "a small subset of officers," Bear argues that exclusions must be construed "narrowly and that any ambiguity be resolved in favor of coverage," also known as the doctrine of *contra proferentem*. (Bear Brief at 51.) However, New York courts are "reluctant, except 'as a matter of last resort'" to apply the rule construing ambiguous contract terms against the drafter and have held that the doctrine of *contra proferentem* is "generally inappropriate" where, as here, "both parties are sophisticated." *DaPuzzo v. Globalvest Mgmt. Co.*, 263 F. Supp.2d 714, 729 (S.D.N.Y. 2003) (quoting *Int'l Multifoods Corp. v. Commercial Un. Ins. Co.*, 309 F.3d 76, 88 n.7 (2d Cir. 2002)); s*ee also Cummins, Inc. v. Atl. Mut. Ins. Co.*, 56 A.D.3d 288 (1st Dep't 2008) (refusing to apply *contra proferentem* where parties had equal bargaining power); *Westchester Fire Ins. Co. v. MCI Commc'ns Corp.*, 74 A.D.3d 551 (1st Dep't 2010) (*contra proferentem* was "inapplicable to this sophisticated policyholder"); *United States Fire Ins. Co. v. Gen. Reinsurance Corp.*, 949 F.2d 569, 574 (2d Cir. 1991). Where the relevant extrinsic evidence is disputed, New York courts do not apply the rule of *contra proferentem* to

ambiguities in the insurance policy, but instead "the resolution of the ambiguity is for the trier of fact." *State v. Home Indem. Co.*, 66 N.Y.2d 669 (1985).[6]

Further, as the existence of extrinsic evidence may enable the fact finder to resolve the ambiguity in the contract, "courts should not resort to *contra proferentem* until after consideration of extrinsic evidence to determine the parties' intent." *M. Fortunoff Corp. v. Peerless Ins. Co.*, 432 F.3d 127, 142 (2d Cir. 2005) (internal quotation marks and citation omitted); *see also Int'l Multifoods*, 309 F.3d at 88 n.7 (same). Only when "the tendered extrinsic evidence . . . will not resolve the equivocality of the language of the contract," should the court employ *contra proferentem*. *State v. Home Indem. Co.*, 486 N.E.2d at 829.[7]

Here, the contemporaneous extrinsic evidence confirms Underwriters' position, whereas the only evidence relied on by Bear before the trial court and Appellate Division was limited to its own post hoc, self-serving deposition testimony in this case. If the Court were to find the Prior Knowledge Exclusion

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6 *See also Fed. Ins. Co. v. Am. Home Assur. Co.*, 639 F.3d 557, 567 (2d Cir. 2011) ("under New York law, contract claims are generally not subject to summary judgment if the resolution of a dispute turns on the meaning of an ambiguous term or phrase"); *Ocean Partners, LLC v. North River Ins. Co.*, 546 F. Supp.2d 101, 105 (S.D.N.Y. 2008) (refusing to grant summary judgment after finding ambiguity in term used in policy exclusion).

7 *See also Morgan Stanley Grp. Inc. v. New England Ins. Co.*, 225 F.3d 270, 276 (2d Cir. 2000) (finding that a court may apply other rules of contract construction, including *contra proferentem*, only when "extrinsic evidence does not yield a conclusive answer as to the parties' intent"); *Schering Corp. v. Home Ins. Co.*, 712 F.2d 4, 10 n.2 (2d Cir. 1983) ("The trial court erroneously invoked this doctrine because *contra proferentem* is used only as a matter of last resort, after all aids to construction have been employed but have failed to resolve the ambiguities in the written instrument" (italics in original)).

ambiguous, then at the very least Underwriters would be entitled to a trial to resolve the factual dispute as to the meaning of "any officer."

B. Underwriters Met Their Burden to Show that the Prior Knowledge Exclusion Applies to Bear's Claim

Bear also contends that, regardless of the definition of officer, Underwriters failed to meet their burden to show that any officer of Bear knew by March 21, 2000 of the Wrongful Acts or that they could lead to a claim. This is entirely belied by the record. In view of the findings of the SEC Order and NYSE Decision and the evidentiary record confirming those findings, there can be no genuine issue of any material fact that on or before March 21, 2000 at least one—and in fact more than one—of Bear's officers could have reasonably foreseen that the alleged Wrongful Acts could lead to a Claim.

1. New York Courts Apply a Mixed "Subjective/Objective" Test to Evaluate the Knowledge of Bear Stearns Officers

New York courts apply a mixed subjective/objective standard to exclusions similar to the Prior Knowledge Exclusion to determine whether an insured could have reasonably foreseen that a claim could arise from Wrongful Acts committed before a cutoff date. *See Executive Risk Indem. Inc. v. Pepper Hamilton LLP*, 13 N.Y.3d 313, 322-23 (2009) (applying Pensylvania law); *see also Liberty Ins. Underwriters, Inc. v. Corpina Piergrossi Overzat & Klar LLP*, 78 A.D.3d 602, 604-05 (1st Dep't 2010) (applying test from *Pepper Hamilton*).

In applying this test, courts evaluate whether "a reasonable [officer] in possession of such facts would have a basis to believe that the insured might expect such facts to be the basis of a claim against the insured." *Pepper Hamilton*, 13 N.Y.3d at 322 [internal citations and quotations omitted]; *see also Coregis Ins. Co. v. Baratta Fenerty, Ltd.*, 264 F.3d 302, 306-07 (3d Cir. 2001) (holding insured was aware of the client's dissatisfaction and thus could have reasonably foreseen a claim); *XL Specialty v. Agoglia*, 2009 WL 1227485 at *8 (S.D.N.Y. Apr. 30, 2009)(finding "the appropriate line of inquiry is whether a reasonable person would understand that, given the facts and circumstances, there may be grounds for a claim to be made under the Policy").

The mixed subjective/objective test does not require that an officer actually form an expectation that a claim will result, but only that an officer could have reasonably foreseen that a Claim could be made. *See Pepper Hamilton*, 13 N.Y.3d at 322. Thus, an officer's subjective belief that a claim would not be brought, that they would not get caught, or as to the likelihood of success of a claim, is not relevant to the analysis. *See Coregis Ins. Co. v. Lewis, Johs, Avallone and Kaufman, LLP*, 2006 WL 2135782, at *13 (E.D.N.Y. July 28, 2006) (finding that subjective knowledge as to whether client would in fact make a malpractice claim was not relevant to the court's analysis of the objective prong of the prior knowledge exclusion). Even a low probability of a claim triggers the Prior

Knowledge Exclusion. *See Westport Ins. Corp. v. Goldberger & Dubin, P.C.*, 255 Fed. Appx. 593, 594 (2d Cir. 2007).

2. The Court Can Consider the SEC Order and NYSE Decision

Bear filed this lawsuit demanding that Underwriters (and the other defendants) cover the bulk of a $160 million disgorgement payment to the SEC. The basis for that settlement payment was set forth in the SEC Order. Yet, Bear argues that Underwriters cannot rely on the findings of the SEC Order in this litigation. (Bear Br. 47, 53.) In other words, Bear argues that the SEC Order was relevant and admissible to find coverage for the Claim, but not to consider whether the Prior Knowledge Exclusion applies to limit coverage for the same Claim.

The basis of an insured's settlement with the SEC—as this Court has recognized repeatedly—is found in the related SEC Order. *See, e.g., Vigilant Ins. Co. v. Credit Suisse First Boston Corp.*, 10 A.D.3d 528, 528-29 (1st Dep't 2004); *Vigilant Ins. Co. v. Bear Cos.*, 34 A.D.3d 300, (1st Dep't 2006), *rev'd on other grounds,* 10 N.Y.3d 170, 178 (2008); *Millenium Partners L.P. v. Select Ins. Co.*, 24 Misc. 3d 212, 217-18 (N.Y. Sup. Ct. 2009), *aff'd* 68 A.D.3d 420 (1st Dep't 2009).

Indeed, this Court *in this case* has already acknowledged that coverage should be determined based on the findings in the SEC Order. Referring to the insurers' earlier dismissal motions, this Court deemed the allegations in Bear's complaint to be true, except where "conclusively refuted by the *relevant*

documentary evidence, in this case, *the SEC order*." *See J.P. Morgan Sec. Inc. v. Vigilant Ins. Co*., 21 N.Y.3d 324, 336 (2013) (emphasis added). Bear's position that this Court should exclude the SEC Order from its analysis of whether the Prior Knowledge Exclusion applies simply cannot be squared with this Court's prior authority and recognition that the SEC Order is relevant and admissible.

3. Multiple Bear Officers Participated in and "Knew" of the Illegal Late Trading and Deceptive Market Timing Practices

When the term "any officer" in the Prior Knowledge Exclusion is construed properly to include individuals who served as officers of the company as defined in Bear's By-Laws, there can be no reasonable dispute that on and before March 21, 2000, multiple Bear officers knew of alleged Wrongful Acts committed prior to that date.

The SEC Order, corroborated by the evidentiary record in this case, shows as a matter of undisputed fact that, during the period 1999 to 2003, Bear's senior management, including, among others, individuals described as the "head of broker dealer services", the "MFOD Head", the "MFOD Head's supervisor," "senior managers" and individuals at the "highest levels" of Bear, knew of and condoned Bear's facilitation of and participation in illegal late trading and deceptive market timing. R. 4992 (¶ 138), (4993 (¶¶150-52), 4997-98 (¶¶ 175-183). In view of

these findings, there is no reasonable dispute of fact that officers of Bear knew of the alleged Wrongful Acts as of March 21, 2000.

The findings of the SEC Order and NYSE Decision, as well as the evidence obtained in the underlying actions and this matter confirm that, prior to March 21, 2000, Bear officers knew of the alleged Wrongful Acts by Bear and its clearing customers. As outlined above, before March 21, 2000, one or more Bear officers knew of, facilitated and/or engaged in deceptive market timing activity by providing multiple account and RR numbers to PCS brokers, correspondent brokers and other clients seeking to evade trading blocks by mutual funds. Moreover, by at least March 21, 2000, Acosta, DelVecchio and Hurant knew of, facilitated or engaged in illegal late trading activities. *See* Statement of the Case B.1, *supra*.

4. The Prior Knowledge Exclusion Applies Because Bear's Officers Reasonably Could Have Foreseen that the Illegal Trading Practices Could Lead to a Claim

Having established that multiple Bear officers knew of the deceptive market timing and illegal late trading before March 21, 2000, the next question under the Prior Knowledge Exclusion is whether an officer knew or could reasonably have foreseen that such trading practices could lead to a Claim.

A reasonable officer could expect that Wrongful Acts could lead to a Claim where, as here, the officer knew of, engaged in or facilitated conduct in violation of

securities laws, rules and regulations, as well as mutual fund prospectuses, and knew that mutual funds had complained that their investors were being harmed by the conduct. As discussed in Statement of the Case Section B.2 above, months before the March 21, 2000 prior knowledge date, numerous Bear officers actively assisted and/or engaged in illegal late trading activities. They were also aware of the repeated complaints by several mutual fund clients before March 21, 2000, as well as Bear's efforts to assist its clients in disguising their identities to continue deceptive market timing despite representations made to the mutual funds that it would stop such activity. Moreover, during this same period, the officers knew of the contemporaneous A.R. Baron Order and ongoing review by an independent consultant into similar practices that had resulted in an SEC action. R. 4707 (pp. 42-44).

Under similar circumstances where an insured participated in, aided a fraudulent scheme or was aware of a breach of professional duty, courts have found that the insured would manifestly have reason to know that Wrongful Acts could lead to a Claim and granted summary judgment in favor of the insurers regarding the applicability of similar prior knowledge exclusions. For example, in *XL Specialty Ins. Co. v. Agoglia*, the court concluded that "[a] reasonable person who had devised and executed a scheme to create hundreds of millions in phony receivables to cover losses, and then used client funds to revolve the receivables to

hide its true nature, would manifestly have reason to know that a claim might occur." 2009 WL 1227485, at *8. In *Coregis Ins. Co. v. Baratta & Fenerty, Ltd.*, the Third Circuit reasoned that "a breach of professional duty and a basis for a claim are … 'two peas in a pod,'" and therefore a breach of a professional duty may establish a basis for a claim. 264 F.3d at 307, fn. 3.

In *Pepper Hamilton*, this Court found that given the insured law firm's role in the wrongful conduct of the client and the insured attorney's "close involvement" with the client, "a reasonable attorney with the law firm defendants' knowledge should have anticipated the possibility of a lawsuit, particularly when millions of dollars may have been lost from activities of which they were aware." 13 N.Y.3d at 322. Similarly, in view of Bear's role in clearing substantial numbers of illegal late trades and facilitating deceptive market timing, its close involvement with "known market timers" such as Empire and its PCS brokers, its receipt of hundreds of complaints by mutual funds and its efforts to disguise the identities of timers to allow them to continue improper trading, an officer could have reasonably foreseen a Claim.

In *CPA Mut. Ins. Co. v. Weiss & Co.*, the First Department affirmed the grant of summary judgment to an insurer on the basis of a prior knowledge exclusion, finding that the insured had knowledge of facts prior to the relevant date pertaining to a fraudulent scheme undertaken by its clients which implicated the

insured. 80 A.D.3d 431 (1st Dep't 2011). The First Department held that, given that evidence, it was "unreasonable for defendants to have failed to foresee that these facts might form the basis of a claim against them." *Id.* The First Department further held that the insureds' "subjective belief they were not facing a claim in connection with the fraud committed by their clients … would not have warranted a different result" because "[t]he record shows that such belief would not have been reasonable under the circumstances." *Id.* at 432. Similarly, Bear officers knew prior to March 21, 2000 that its clients were engaging in a fraudulent scheme that implicated Bear, and therefore could have reasonably foreseen a Claim.

In *Schlather, Stumbar, Parks & Salk, LLP v. One Beacon Ins. Co.*, the court considered the professional rules governing the insureds' business in its analysis of a prior knowledge exclusion. 2011 WL 6756971 (N.D.N.Y. Dec. 22, 2011). The court recognized that the professional rules of conduct provide guidance on what is expected of a reasonable insured. *Id.* at 9, n. 7. Further, the court found that letters received from a client put the insured on notice of the client's concerns about potential violations of their rights, as well as the client's unhappiness with the insured's service to the client. *Id.* at 9, n. 6. Ultimately, the court found the objective prong satisfied because a "reasonable [insured] with knowledge of the [facts] might expect a claim to arise because the [insured's] alleged conduct falls

below the minimum level of professional conduct expected of attorneys, and [the client] had alleged a violation of her rights as a client." *Id.* at 10. Equally, a reasonable officer with the training, experience and registrations of the Bear officers, and knowledge of the illicit trading and numerous complaints by mutual funds, could have reasonably foreseen that a Claim could be made.

5. The Lack of Prior SEC Enforcement does not Negate the Prior Knowledge Exclusion

Bear argues that, before March 21, 2000, its officers could not have reasonably anticipated a Claim because, "no regulatory investigation or civil action regarding market timing had ever been commenced against any broker-dealer or anyone else before September 2003" and the SEC was still determining "which fund provisions it might seek to enforce," such that no Bear officer would have believed a claim would be made, and that the application of the Prior Knowledge exclusion in such a case would be "totally unprecedented." (Bear Br. at 55.) However, an officer's subjective belief that a Claim would not be brought, that they would not get caught, or as to the likelihood of success of a Claim, is irrelevant. *See Quanta Lines Ins. Co. v. Investors Capital Corp.*, 2009 WL 4884096 at *16 (S.D.N.Y. Dec. 17, 2009), *aff'd*, 2010 WL 4608763 (2d. Cir. 2010) (finding that an insured's denial of knowledge based on "grounds of ignorance of the law, oversight, psychological difficulties, or other personal reasons is immaterial" to analysis of the objective prong); *Coregis Ins. Co. v. Lewis, Johs,*

Avallone, Aviles and Kaufman, LLP, 2006 WL 2135782, at *10, *13 (holding insured's subjective beliefs regarding whether the potential claimant would file suit irrelevant); *see also CPA Mut*., 80 A.D.3d at 432. Rather, the Prior Knowledge Exclusion applies if any officer could have reasonably foreseen that a Claim *could* be made, regardless of whether he or she believed that Bear would ultimately be found liable. *See Pepper Hamilton*, 13 N.Y.3d at 322 (2009); *Coregis Ins.*, 2006 WL 2135782 at *13.

What is more, here, in 1999 Bear already was in the SEC's cross-hairs for similar behavior in connection with the A.R. Baron matter. In at least three conference calls, the SEC indicated to Bear's counsel that the A.R. Baron matter was relevant to the charges that the SEC was considering against Bear.[8] In fact, during its investigation of the illegal mutual fund trading, the SEC expressed "frustration … because at the same time Bear was negotiating the [A.R. Baron] Order, it was receiving numerous complaints from mutual funds." R. 5844-47.

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[8] *See* R. 6067(Nov. 4, 2004 memo regarding Wells Discussion during which the SEC advised counsel for Bear Stearns that "[Baron] 'heavily colors' their judgments and 'forms the background' on the charges. Bachenheimer said that this was 'particularly troubling' to the SEC because the 'backbone of [A.R.] Baron' is an increase in compliance and oversight."); R. 6062 (July 30, 2004 memo regarding telephone conference with the SEC advised counsel for Bear Stearns that it was rethinking its position as to whether to pursue charges relating to A.R. Baron); R. 5844-47 (June 8, 2004 memo regarding discussion during which the SEC expressed frustration regarding the fact that the conduct took place during the AR Baron independent consultant's review of practices at Bear Stearns). All of these memos were submitted by Bear Stearns in support of its summary judgment motion and thus any objections should be deemed waived. *See* R. 1713-16; R. 1864-1868; R. 1880-1885 (Exhibits 31, 40, 44 to Jonathan Siegelaub Affirmation).

Given their knowledge of the alleged Wrongful Acts prior to March 21, 2000, reasonable officers with the registrations, training and experience of the Bear officers would believe that the Wrongful Acts could lead to a Claim. *See* R. 4701, 4707.

The A.R. Baron Order and contemporaneous onsite review by the independent consultant remove any doubt that a reasonable officer with the knowledge of the Bear officers prior to March 21, 2000 could have foreseen that the alleged Wrongful Acts could give rise to a Claim. The SEC made clear in the A.R. Baron Order that Bear could be held liable for fraud where it participated in or obtained knowledge of a client's fraudulent conduct, and that aiding and abetting liability and causing another's violations of securities laws was a basis for a regulatory enforcement action. As its Chief Financial Officer and director Samuel Molinaro testified, Bear could not turn a blind eye to the activities of its clients. R. 5855 (p. 101).

The evidence that prior to March 21, 2000 Bear's officers were aware of and participated in a fraudulent trading scheme overwhelmingly supported summary judgment in Underwriters' favor. At a minimum, the evidence raised a disputed issue of fact that justified the reversal of the trial court's grant of summary judgment.

6. Bear Reasonably Could Expect a Claim Based on Complaints from Mutual Funds Regarding Market Timing

In its Brief, Bear argues that Underwriters improperly rely on Bear's officers' knowledge 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." (Bear Br. at 54.) Bear characterizes these complaints as "routine customer requests" that did not include a threat to sue and therefore could not trigger the Prior Knowledge Exclusion. (Bear Br. at 54.) Rather than merely make "requests for better service," however, the mutual funds repeatedly complained of unwanted market timing, advised that the trading harmed investors and violated the funds' prospectuses and agreements, and demanded that Bear stop the trading. R. 4974 (¶29); R.4994 (¶156); R. 9285- 9287(Section F). The evidence shows, moreover, that before March 21, 2000, in the face of numerous complaints from mutual funds and requests that it stop clearing market timing trades, Bear continued to facilitate market timing and provided known and notorious timers with deceptive devices to allow them to continue their unwanted and harmful trading in those funds. R. 4969-79 (¶¶ 2, 4), 4996-97 (¶¶ 171, 175). Moreover, Bear established the MFOD's "timing desk" in 1999 purportedly to manage the increasing flow of market timing trades cleared through BSSC. In reality, Bear used the timing desk to assist its customers in evading blocks and

restrictions imposed by mutual funds and to market its ability to facilitate improper trading. R. 6242-43 (¶¶ 1, 2, 4,); 6246-48 (¶¶ 24-25, 33).

The Prior Knowledge Exclusion applies if any officer as of March 21, 2000 could have reasonably foreseen that any alleged Wrongful Acts could lead to a civil proceeding, governmental or regulatory investigation into possible violations, or a written demand (i.e., a "Claim") in the future. It does not require that an officer knew before March 21, 2000 that a Claim had been made or that a customer had threatened litigation. *See Pepper Hamilton LLP*, 13 N.Y.3d at 322-23. Accordingly, Bear's arguments that its officers could not have reasonably foreseen that numerous Wrongful Acts could lead to a Claim have no support in the record, the policy language or applicable law.

CONCLUSION

For all of the reasons stated above, the Prior Knowledge Exclusion provides an alternative basis to uphold the Appellate Division's Order reversing the Trial Court and granting judgment as to Underwriters in addition to its well-reasoned legal conclusions. In the alternative, the matter should be remanded for further consideration by the Appellate Division, which did not reach the Prior Knowledge Exclusion issue in its opinion.

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EDWARD J. KIRK
GABRIELA RICHEIMER
SCOTT SCHWARTZ
CLYDE & CO US LLP
The Chrysler Building
405 Lexington Avenue
New York, New York 10174
(212) 710-3900
edward.kirk@clydeco.us
gabriela.richeimer@clydeco.us
scott.schwartz@clydeco.us

Attorneys for Defendant-Respondent Certain Underwriters at Lloyd's, London

KRISTI S. NOLLEY
R. PATRICK BEDELL
BATESCAREY LLP
191 North Wacker Drive, Suite 2400
Chicago, Illinois 60606
(312) 762-3100
knolley@batescarey.com
rbedell@batescarey.com

WILLIAM BALLAINE
LANDMAN CORSI BALLAINE
& FORD P.C.
120 Broadway, 27th Floor
New York, New York 10271
(212) 238-4800
wballaine@lcbf.com

Attorneys for Defendant-Appellant American Alternative Insurance Corporation

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