COURT OF APPEALS

STATE OF NEW YORK

J.P. MORGAN, ET AL.,
Appellants,

-against-

VIGILANT INSURANCE COMPANY, ET AL., NO. 61
Respondents.

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20 Eagle Street
Albany, New York
October 6, 2021

Before:

CHIEF JUDGE JANET DIFIORE
ASSOCIATE JUDGE JENNY RIVERA
ASSOCIATE JUDGE EUGENE M. FAHEY
ASSOCIATE JUDGE MICHAEL J. GARCIA
ASSOCIATE JUDGE ROWAN D. WILSON
ASSOCIATE JUDGE MADELINE SINGAS
ASSOCIATE JUDGE ANTHONY CANNATARO

Appearances:

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CHIEF JUDGE DIFIORE: Good afternoon, everyone. Please be seated. Judge Rivera is participating remotely today.

And the first we will hear is appeal number 61, J.P. Morgan Securities v. Vigilant Insurance Company.

Counsel?

MR. OBUS: Thank you, Your Honor. May it please the court. I am Steven Obus of Proskauer Rose, appearing on behalf of the plaintiff-appellants, J.P. Morgan entities, which are the successors to the Bear Stearns entities that are the insureds in this case.

If I may, I'd like to reserve three minutes of my time.

CHIEF JUDGE DIFIORE: Three, sir?

MR. OBUS: Yes.

CHIEF JUDGE DIFIORE: You may.

MR. OBUS: Thank you. Your Honors, we're seeking insurance coverage for a disgorgement payment that Bear Stearns made to settle an SEC investigation fifteen years ago now, and also for the settlement payment it made to resolve a civil class action and the associated very substantial defense costs that were associated with both matters.

When we were last before this court, this court reversed an order of the Appellate Division that had

dismissed our complaint on the erroneous premise that a disgorgement payment could never be insurable, no matter whether it reflected Bear Stearns' own return of gains or the return of the third-party's gains that they had made at the expense of other investors.

The court said the label doesn't matter, and it did matter which of those two alternatives it was, and if Bear Stearns could establish that the 140 million at issue reflected third-party gains at the expense of others, then there was not a problem of insurability.

The court did so in the face of the insured's vigorous insistence that a disgorgement remedy could never be insurable, regardless of whose gains were reflected, because it was punitive in nature. The court did not accept that proposition. Instead, it pointed out that the only remedy that is prohibited, as a matter of public policy, from insurance coverage, is punitive damages, and then only, as illustrated in the Zurich case, when the remedy is solely, purely punitive, it does not have any compensatory element. And of course this payment is virtually exclusively compensatory payment, so it would not come within that standard.

The court also noted that the Appellate Division had completely overlooked our class action settlement claim.

JUDGE GARCIA: Counsel, I'm familiar with our prior case, but going to this - - - this case here, let's look at the contract, right, and the word "penalty". So what in the record is there to indicate what the parties intended to exclude by "penalty"?

MR. OBUS: Well, there is certainly nothing in the record that bears on what the parties negotiated in terms of that word. It was just in the contract, and therefore, under generally accepted rules, it should be construed in the manner most favorable to insurance coverage.

JUDGE GARCIA: But it has to get a reasonable interpretation, right?

MR. OBUS: Well, as we've pointed out in our papers, I mean, there are more than a half dozen reasons why this payment is not a penalty. New York courts have repeatedly said that a payment that is no more than necessary to make an injured party whole is not a penalty. It's done that often in private litigation, but in the Harvardsky case, for example, the Appellate Division, with whom we disagree on many matters, got it exactly right - - -

JUDGE GARCIA: Can you recover - - -

MR. OBUS: - - - when it said that even a criminal - - -

JUDGE GARCIA: Could you recover from the mutual funds, from the wrongdoers here, for the amount that you're - - - you have to disgorge of their profits?

MR. OBUS: No. We certainly didn't seek to do that. I hadn't thought about whether - - - whether there would be - - -

JUDGE GARCIA: So you mean - - -

MR. OBUS: - - - a basis for doing it. We were - - - we were accused by the SEC of recklessly allowing other people to do things that they shouldn't have done, and - - -

JUDGE GARCIA: Because it seems like you're just being held liable for third-party gains which, what is that but a penalty? I mean, it's not your own liability, certainly. You didn't make the money.

MR. OBUS: Well, it is, I think, much more analogous to ordinary damages. We're being held liable for allegedly doing something or failing to do something that caused injury, and so we - - - we are one of the parties that was held responsible.

The SEC did go after a variety of the - - - of the traders who paid much smaller amounts, I might add, than - - - than Bear Stearns did. But the SEC was holding a large number of people responsible.

JUDGE WILSON: Did the SEC make a - - - over

here; sorry - - - make a conspiracy-like allegation in its complaint?

MR. OBUS: It did not. I mean, it alleged that what Bear Stearns did, they said it was knowing or reckless and that it - - - most of this was done in the context of entrusting machines that - - - terminals to parties who had their own independent obligation to trade legally, and then they went ahead and did what they did, and apparently, according to the SEC, made thousands of trades that were improper in one respect or another. So Bear Stearns was not merely passive but literally uninvolved in those trades other than to have entrusted the machines to those parties.

Then there were, of course, a significant number of trades that Bear Stearns did process, but again, it wasn't a party to those trades. It didn't decide what trades to make. It was simply accommodating customers who were - - -

JUDGE WILSON: You probably - - -

MR. OBUS: - - - essentially putting in these trades.

JUDGE WILSON: You probably need to discuss Kokesh.

MR. OBUS: I'm sorry?

JUDGE WILSON: You probably need to discuss Kokesh.

MR. OBUS: Probably. It - - - it's noteworthy that it wasn't until Kokesh came down that the insurers even argued that there was a public policy disgorgement issue that remained in the case after this court's decision or that the payment reflected a penalty within the meaning of the insurance policy. When Kokesh came down, summary judgment had already been entered against them. It moved to reargue. Judge Ramos entertained the argument, but properly rejected it.

JUDGE RIVERA: But counsel - - - I'm sorry; I'm on the screen. Counsel, beyond the procedure - - - I don't think you need to run through the procedure, in terms of the substance, which I think is what Judge Wilson is asking you about, Kokesh comes down on the side of saying disgorgement is a penalty, in part, because it leaves the defendant worse off.

If your position has been throughout, or your client's position has been throughout - - - or the client's position has been throughout that they are not blame-worthy at all, they're innocent in all of this, right, why - - - why isn't this then about penalizing you for being innocent, and the SEC doesn't think you are, but you think you are, and then why isn't that leaving you worse off because you're paying for something you otherwise - - - and assuming you're not liable, very much - - - very much in

the same way Judge Garcia asked?

MR. OBUS: Well, the SEC, which is the powerful litigant, claimed that Bear Stearns was reckless in failing to stop other people from doing things that they allegedly did, but shouldn't have done. So Bear Stearns faced the liability.

Kokesh says because disgorgement has a deterrent element, we are going to treat it as a penalty for purposes of the federal statute of limitations. Even the Supreme Court said in Liu, it isn't necessarily a penalty for all purposes.

JUDGE RIVERA: Yes, but if I may, but the point of that, again, is because it leaves you worse off. Certainly, from the position you have always taken, it must inexorably do that because you say we never made any of that money; a third party made all of that money. So it seems to fall right in line with what Kokesh's analysis is, even if it's for that statutory question that was presented to us.

MR. OBUS: No, it leaves Bear Stearns worse off in the same sense that a tortfeasor is worse off when it makes somebody whole. But in this case because, unlike the real penalty, the ninety million dollars, Bear Stearns was entitled to use this payment, in effect, to discharge its civil liability. So it wasn't worth - - - worse off in

that sense. It was simply making a party whole who Bear Stearns was accused of having contributed to their injury.

I mean, the - - - the settlement agreement - - - and this is a settlement agreement; it's very important - - - affirmatively distinguishes, in multiple ways, between the penalty and the disgorgement payment. And although it's convenient that the penalty is called a penalty, even if they were just called payment A and payment B, the differences would be stark and material. Payment A, the ninety million, could not be used to discharge our liability, could not be the subject of an insurance claim, and if, for whatever reason, some court or individual gave Bear Stearns credit for having paid the ninety million towards any injury, Bear Stearns is obligated to actually replenish the ninety million to - - - to preserve the deterrent effect of that payment.

JUDGE RIVERA: But that was an agreement between you and the SEC. It doesn't implicate the language of the policy. Or am I misunderstanding something?

MR. OBUS: It certainly was an agreement between Bear Stearns and the SEC. But what it shows is that the SEC didn't think this was a penalty, it didn't call it a penalty. It had no authority to invoke a penalty in this way. I mean, the whole point of the Liu litigation was not that Mr. Liu wanted it to be called a penalty instead of a

disgorgement. He wanted his money back. Because everybody agrees the SEC has no power to impose a penalty of the sort that was at issue in this case and in that case, although in our case, because it's compensatory, it's still not the question.

JUDGE RIVERA: Do we interpret the insurance contract by the law at the point in time when you entered that - - - or when you purchased the insurance policy, when you signed off on the stipulation, or at the point in time that we are now on appeal?

MR. OBUS: I think we interpret the insurance policy at the time the parties agreed and entered into it as a matter of New York law, which means that this is an insurance policy carve-out, if not an exclusion. But in either case, in the absence of direct evidence of a negotiation, one applies the - - - any plausible definition of a penalty imposed by law that favors coverage.

Here, this - - - this couldn't be a penalty imposed by law because it wasn't permitted as a penalty by law, the SEC wasn't purporting to invoke a penalty, and instead, under many New York cases that I mentioned a moment ago, if it's not more than necessary to make whole an injured party, it's not a penalty, even in a context like Borden where the statute calls it a penalty in the context of treble damages that the part that only is

compensatory is not a penalty.

JUDGE FAHEY: Can I just ask you a question. Take a step back a second. You made reference to the - - - the penalty. You referred to the exclusion as not an exclusion but a carve-out.

MR. OBUS: Yeah.

JUDGE FAHEY: Does - - - why do you say it's not an exclusion?

MR. OBUS: Well, only because it appears - - - and the insurers argue this - - - it appears in the coverage grant, as opposed to as a separate exclusion, and there are several, of course, in this policy.

JUDGE FAHEY: Right.

MR. OBUS: We say it doesn't make any difference in this case because, either way, an ambiguous term is resolved in favor of coverage, at least absent evidence that the parties actually meant something else, and there's no such evidence in this case.

JUDGE FAHEY: Well, I just think the ambiguity of the exclusion is dealt with differently than other terms in the contract and has different effects. That's why I asked that.

MR. OBUS: Exactly. But when there is no extrinsic evidence of the meaning of the term, it comes out the same because, the court has said in Belt Painting that

every term in an insurance contract, if it's ambiguous, is resolved in favor of coverage, absent some specific evidence that the parties meant something else. And so we have a settlement here - - -

JUDGE FAHEY: Wait, wait - - -

MR. OBUS: - - - of a claim for equity.

JUDGE FAHEY: Wait let me - - - slow down. I take you back. If we agree that there's a public policy question or a public policy qualification, then that would solve that question against your interest.

MR. OBUS: I'm sorry; I don't understand the question.

JUDGE FAHEY: If we agree that there was a public policy question, and we resolved that against you, then that would deal also with the exclusion question.

MR. OBUS: I think so. Public policy has nothing to do with - - - the public policy says even though you absolutely promised to provide coverage for this, this is a - - -

JUDGE FAHEY: It's not insurable - - -

MR. OBUS: - - - policy - - -

JUDGE FAHEY: It's not insurable.

MR. OBUS: - - - we're just going to abrogate the contract, and for a lot of reasons that this court mentioned the last time we were here - - -

JUDGE FAHEY: No, I understand the argument.

MR. OBUS: Yeah.

JUDGE FAHEY: So I just want to understand - - - I understand your argument on the exclusion. That's what - - -

MR. OBUS: Right. The exclusion has nothing to do with public policy, although, in some cases, the courts have - - - have noted that the expectation of an insured might be different if you were working under a liability policy as opposed to, for example, a homeowners policy, where nobody would expect it to cover sexual abuse or something like that.

Here the whole policy is about covering alleged wrongful acts, including regulatory investigations. This is exactly what this policy is supposed to cover. So I think the considerations are even stronger. The public policy has no part in all of this.

Now, it may be that under the new Kokesh and Liu decisions, the SEC will stand down or take a different position in terms of what kind of disgorgement it can seek. But the fact is this is exactly what the SEC sought in 2006; it was a reasonable settlement, given the prevailing decisions, which this court actually noted in 2013, and there were, you know, several others as well. It was hundreds of millions of dollars less than the SEC was

demanding under this Delta NAV theory, which the insurers stipulated, in response to our summary judgment motion, was a well-accepted theory for measuring this kind of - - - of injury, loss. And - - -

JUDGE FAHEY: Thank you.

JUDGE CANNATARO: Could you address - - -

MR. OBUS: And it was done at a time when - - -

JUDGE CANNATARO: Excuse me. Could you address briefly the exclusion that actually exists in the Underwriters in the Lloyd's policy - - -

MR. OBUS: Yes.

JUDGE CANNATARO: - - - which, arguably, seems more applicable to what happened here?

MR. OBUS: Well, certainly, for one thing, it only applies to the Underwriters and their co-insured, and not anybody else. But that exclusion says that if an officer - - - and that's an undefined term - - - was aware of facts from which it could have reasonably foreseen a claim, which in this case didn't even happen until three years after the policy was put into place, then those particular consequences from that act would not be covered, not anything that happened later, and lots - - - almost all of what the SEC alleged happened after March of 2000, but their sum that was before.

So the insurers say there is 4,000 out of 10,000

Bear Stearns employees who should be considered officers. We say, again, because this absolutely is an exclusion, that it needs to be construed in the manner most favorable.

Judge Smith, the last time we were here, was positing any number of alternatives that were much more narrow, certainly the executive committee, the senior policy makers, were not implicated in any of this.

And I should note, and it's in the record, that the purpose of this exclusion is to prevent somebody from running out and getting insurance when they anticipate a claim. There isn't a hint of that here. Instead, you've got low-level people. Most of the ones they point to aren't even officers by their definition who, in two cases, say they heard from somebody, who meets that lowest level of officer using their framework but not ours - - - heard that somebody retracted a trade at, quote, the "last minute", one of them said the next morning. But again, without any evidence of what the circumstances were, was it a mistake, what happened. Some of them don't even indicate the time frame that the person is talking about.

So you could say the - - - certainly the insurers have the burden on that, and they failed completely, no matter what the concept of officer is that you apply, but certainly if you apply the officer concept that we think is plausible and - - - and the most favorable to - - -

JUDGE CANNATARO: Was that adjudicated in the Supreme Court? I don't think it was at the Appellate Division.

MR. OBUS: Adjudicated?

JUDGE CANNATARO: Yes.

MR. OBUS: That's right. I mean, the Appellate Division, again, forgot the whole class action. They forgot everything other than looking at Kokesh. So no, it wasn't - - - it wasn't addressed in the Appellate Division at all.

Judge Ramos went through every one of these items, and we think correctly held that there was no genuine dispute as to any of the factual disputes that the insurer's claim has been - - - has arisen in this case. We've got a reasonable settlement that absolutely clearly reflected the 140 million dollars was reflective of the gains of others and not of Bear Stearns.

The court here, in our case, was at pains to say that the standard for intent to harm, which was the other argument that - - - that the insurers make, really means you have to actually intend harm. And I don't think the insurers even claim that this record reflects that, so instead, they're arguing that you should change the standard.

That would be a seismic shift in the way wrongful

acts and professional liability policies are - - - are applied, if one were to do that and to start saying, well, this is conduct that it could be foreseen would cause harm or it was substantially certain or whatever formulation you want. Those all would be very different.

These are all things that an insurance company can protect itself from. It could say we don't cover - - - it could adopt whatever standard it wants and put that in an exclusion, but it didn't do that here. It said we are going to cover all wrongful acts and omissions, which they define basically as every wrongful act and omission, including misrepresentation.

The only qualification was where there was a finding - - - an actual final adjudication of dishonesty or fraud in the underlying matter. And of course, that didn't happen here. So they promised to pay this. The briefs - - - a couple of times, I think, the insurers say that Bear Stearns should be required to live with the consequences of the contract that it entered into. That is all we want here.

It is the insurers who are seeking, certainly in the public policy sphere, and also by reframing standards that have existed for decades in New York law to - - - to get out of making good on an obligation that they should have made good on fifteen years ago. And although insurers

have argued that this court doesn't have the power, for some reason which I don't really understand, to address the class action or the pre-judgment interest, all of that was in the record, all of that was in the judgment that Judge Ramos entered, that was vacated by the Appellate Division, so all of it is before the court, and the court certainly has the power to put back in place the judgment that we obtained in the trial court.

CHIEF JUDGE DIFIORE: Thank you, counsel.

MR. OBUS: Thank you.

CHIEF JUDGE DIFIORE: Counsel?

MR. SULLIVAN: Good afternoon, Your Honor. Daniel Sullivan appearing for respondents.

You know, as I think about this case, Your Honors, it really can be simplified. The U.S. Supreme Court has held now twice that the kind of disgorgement payment that Bear claims the SEC imposed is a penalty because it means the wrongdoer - - -

JUDGE GARCIA: But counsel, let's stop for a second. Let's say, back when this contract was entered into, there is evidence in the record, which I understand there's not here, but let's say there's evidence in the record that the parties agreed that this type of a settlement is not a penalty. We sign this contract, fifteen years go by, the Supreme Court comes out with its

nice rulings, can you now say it's a penalty, even though that's not what the parties intended when they entered into the contract?

MR. SULLIVAN: Oh, if I - - - if I understand the question correctly, Your Honor, if the contract specifically said to - - -

JUDGE GARCIA: No, not specifically said. Let's say it's ambiguous - - -

MR. SULLIVAN: Right.

JUDGE GARCIA: - - - but there's extrinsic evidence that this is what the parties intended, right?

MR. SULLIVAN: Right. If you construed - - - one way or another, right, if you construed the policy to mean SEC disgorgement is covered - - -

JUDGE GARCIA: Right.

MR. SULLIVAN: - - - then - - - then the fact that something happens in the law later that might - - - that, you know, might - - - might affect the penal nature of SEC disgorgement, wouldn't affect the interpretation of the contract.

JUDGE GARCIA: Right.

MR. SULLIVAN: But that's not what happened here because Kokesh doesn't change the law.

JUDGE GARCIA: But the problem, I think, that I see - - - and explain why it isn't - - - is that your

position changes after Kokesh.

MR. SULLIVAN: No, Your Honor, so I'll take it two ways. First, there's Kokesh itself, right? Kokesh itself is the clearest evidence of what the court was doing there, right, the opinion of the Supreme Court. And the opinion of the Supreme Court doesn't announce any new rule. It doesn't discover a new rule of law. It applies hundred-year-old case law to the context of SEC disgorgement, and decade-old law on what disgorgement is to - - - to analyze it.

With respect to our position, we've always argued in this case, Your Honor, that the disgorgement payment was not a covered loss. Our primary submission was that it - - - that didn't fall into the - - - into the affirmative coverage ground in the first place because it's not damages. And we argued, in response to Bear's position, well, you know, we - - - we were - - - we were obligated to - - - to disgorge third-party gains, not our own gains. We said that's not what happened here, in part, because outside of the narrow context of insider trading, the SEC does not have authority to do that because it would be a penalty. So I think that we made the argument against the background of the cases as they existed at the time. Kokesh comes out and very clearly lies - - -

JUDGE GARCIA: But did you argue at that time

specifically that this was a penalty falling within that provision of the contract?

MR. SULLIVAN: We didn't have to, Your Honor, because our argument was that it wasn't a covered loss for a separate reason. It wasn't a covered loss because it was not damages, right? And that was at the motion - - - so that was at the motion to dismiss stage, and then the case went on.

So you know, the fact, though, that - - - and again, Kokesh and Liu are not - - - are not cases that purport to be inventing new rules of law. They apply longstanding case law, which is mirrored in New York law as well as in federal law, defining what a penalty is to the context of SEC disgorgement. And they find yes, disgorgement of third-party gains, unusual though it may be, is a penalty. And Liu says that's why the SEC is not entitled to get it in the first place. That - - -

JUDGE CANNATARO: But counsel, that's interesting, because what I got from Kokesh, especially in conjunction with Liu, is that this is, you know, a judgment remedy that derives from the equity - - - inherent equitable powers of the court, and that it has a kind of multifarious function. It can be many things. Penal, yes, but compensatory sometimes, and maybe demonstrative as well. Is it as clear-cut a penalty as you claim it be

right now?

MR. SULLIVAN: Yes. So remember, Liu drew a line in the sand, right, between two different kinds of SEC disgorgement, disgorgement of your own ill-gotten gains, and Bear admits that - - - that the - - - what it calls, you know, the twenty-million-dollar slice is uninsurable because it represents its own ill-gotten gains. We're talking about what, you know, Bear's version of the other slice, right, the 140 million dollars for third-party gains.

So Liu draws a line in the sand and says if - - - if it's third-party gains beyond the net proceeds obtained by the wrongdoer. And remember, Bear claims it never made a cent of profit from its wrongdoing here. So you know, it's all in excess of the net proceeds. The Supreme Court says in Liu if you have those two characteristics, you're on the penal side of the line.

Now, what does Bear say in response to this? And this might get a little bit to Your Honor's question. Bear says, in response to all of this, I think they make really two points: follow the labels and follow the money. With respect to the labels, right, they say, well, the SEC denominated the - - - the civil penalty expressly as a penalty and, you know, it didn't do that for the disgorgement piece, and that should control.

But New York jurisprudence, defining what a penalty is, which to Judge Rivera's question, I think that that's the law that applies, right, what is a penalty imposed by law. Because the contract, I think, is not ambiguous. I think it's clear: imposed by law means is a penalty pursuant to the law. And the cases are very clear that something is a penalty, an exaction is a penalty if it's imposed for a wrong to the public in order to deter. And every source on SEC disgorgement that we have, including - - - up to and including Kokesh, says SEC disgorgement fits that bill. So with respect to the label - - -

JUDGE CANNATARO: It fits the bill of imposed by law, but it's this question of penalty that seems more vague when you read these cases, because I - - - again, I'm sorry to keep harping on it; I don't get from these cases that it is, under all circumstances, a penalty.

MR. SULLIVAN: You're talking about SEC disgorgement, Your Honor?

JUDGE CANNATARO: Yes.

MR. SULLIVAN: So right, I mean, I think just to be clear I was talking about the - - - the New York law defining what the penalty is and the principles that you apply to find that out. Those are the same principles that Kokesh applies. Kokesh says SEC disgorgement is imposed

for a wrong to the public, and it's imposed to deter. With respect to - - -

JUDGE WILSON: Well, doesn't - - -

MR. SULLIVAN: - - - what a compensatory element might be - - -

JUDGE WILSON: Let me stop you for a second. I just want to follow up on Judge Cannataro's questions a little bit. So the Supreme Court does say in Kokesh that SEC disgorgement can serve compensatory goals, right? It uses those words.

MR. SULLIVAN: Um-hum.

JUDGE WILSON: So how do you square that, then, with our holding in Zurich that says a risk is insurable if - - - essentially, if the payment, even if it's disgorgement, serves a compensatory goal?

MR. SULLIVAN: Sure. So - - -

JUDGE WILSON: Even in part.

MR. SULLIVAN: Sure. I'm glad you asked, Your Honor, because I wanted to get to Zurich. I know it's an important part of the argument here. I'll preface my remarks just by saying that Zurich, of course, only goes to the public policy, right? It's a public policy case. It doesn't go to the meaning of the contractual carve-out for fines or penalties imposed by law. So I just want to bracket that.

With respect to Zurich on the merits, if you like, I think Bear's reading of Zurich is completely wrong for a couple of reasons. First of all, Zurich does not stand for the proposition that if there's a dual-purpose remedy - - - a phrase that does not appear in Zurich - - - that - - - you know, if there's any drop of compensation, it's therefore insurable. It's never been cited for that proposition in this court or in any other court, and no case that I'm aware of relies on it for that rule of law.

But more importantly, Your Honor, more importantly, Zurich cannot possibly have meant, when it talked about compensatory elements, it cannot possibly have meant the compensatory elements Bear is relying on here. Bear says follow the money. The 140 million dollars was - - - went into the Fair Fund for distribution to investors.

Your Honors, Zurich was a case about punitive damages. Punitive damages always go to the victim, right? And Zurich didn't say, well, the money went to the victim and therefore it's - - - it's insurable. If that were the case, Zurich could have been a two-sentence opinion. And many of the court's cases on public policy involve punitive damages. Many of the cases defining what a penalty is, the exaction goes to the - - - the wronged - - - the injured party. So that can't be what Zurich had in mind when it talked about a compensatory element. And you know, what

you - - - what you - - - what I think you have to do to - - -

JUDGE WILSON: I heard Mr. Obus actually emphasize - - - I realize his papers make the argument that - - - that you just recited. But in argument, he just sort of gave a different reason, not the "follow the money" argument as you're describing it, but rather that because the - - - let me see if I can get his argument exactly right. It wasn't - - - it wasn't where the money was going, right? It was that - - - let's see if I can even remember it.

MR. SULLIVAN: I think he was talking about the offset, Your Honor, if I - - - if I - - -

JUDGE WILSON: Yes, exactly - - -

MR. SULLIVAN: And I wanted to address that.

JUDGE WILSON: Because he could use the money to - - - so you've got the argument. I don't need to finish the question. Go ahead.

MR. SULLIVAN: No. So I don't think that that changes the conclusion, Judge Wilson, because, you know, the - - - the - - - you know, all the SEC did was say - - - with respect to the civil penalty, we're going to say you can't use that for insurance, and you can't use that to offset against civil liability. It didn't say anything about what can or should be done with respect to the

disgorgement amount. And as my friend is eager to point out, it's a settlement. Right? It's a negotiation. We don't know what the SEC would have pushed for, had it had its druthers. More importantly, none of that can change the fact that SEC disgorgement, as Kokesh took two pages to conclude, meets the definition of a penalty that New York courts apply.

JUDGE FAHEY: Can I ask you, counsel, opposing counsel had mentioned Judge Smith, and he always used to ask the ultimate question, is what rule do you want here? What are you asking us exactly to do? Because I'm struggling here with disgorgement may or may not be a penalty, but it's hard for me to see it as always a penalty. So what rule are you asking us to - - - to - - - or what rule are you proposing?

MR. SULLIVAN: Right. I think - - - I think the - - - the rule that we're proposing, Your Honor, is that when SEC disgorgement is directed to or addresses third-party gains, in other words, not the gains of the wrongdoer, and exceeds the wrongdoer's net proceeds, those two characteristics that the Supreme Court said in Liu, put the disgorgement remedy on the impermissible penal side of the line. When disgorgement has those two characteristics it's - - - it's uninsurable, either under the public policy or, if you don't want to go that far, pursuant to the terms

of the insurance contract, it's a fine or penalty imposed by law.

I mean, it's remarkable, Your Honors, that - - - that when the Supreme Court has - - - when we're dealing with a federal sanction deemed - - -

JUDGE FAHEY: No, let me stop you. Let me stop you. The rule is disgorgement applies when? It's a penalty when?

MR. SULLIVAN: It's a - - -

JUDGE FAHEY: public policy, that's straightforward: intentional wrongdoing. What else?

MR. SULLIVAN: No, no, it's - - -

JUDGE FAHEY: Go ahead. You tell me.

MR. SULLIVAN: Sure. Disgorgement is either a penalty imposed by law or uninsurable under the public policy against indemnification for punishments when it represents third-party gains, not the gains of the wrongdoer, and when it exceeds the wrongdoer's net proceeds.

The reason why I say that, Your Honor, is because those are the two characteristics that the Liu court focused on, the U.S. Supreme Court focused on in saying that this is when disgorgement wanders over the line into penal territory.

JUDGE CANNATARO: And the fact that that excess

award, which goes beyond the ill-gotten gains of the wrongdoer, is then subsequently, say, put into some sort of fund which is used to compensate the victims is of no moment to the analysis that - - -

MR. SULLIVAN: It can't be.

JUDGE CANNATARO: - - - you're proposing?

MR. SULLIVAN: It can't be, Your Honor, because, again, where the money ends up, what the State does with the money can't be dispositive. It can't determine the question because, again, lots of exactions end up with the victim. Punitive damages, and we know that punitive damages are uninsurable as a matter of New York public policy, they always go to the victim.

Again, if that were dispositive, Your Honor, Zurich would have been a two-sentence opinion: money went to the victim, not insure - - - or it is insurable. That's not what the court did. It analyzed the legal basis for the exaction in Zurich and said this is a - - - an unusual statute of a sister state that allowed a jury to impose an award either as compensation or as deterrence. We don't know which one it is, so we're not going to apply New York public policy to the award.

You know, it didn't - - - it didn't say where did the money go. It said what's the legal justification. That's exactly what the court did. And all of the cases we

cite, on 27 to 29 of our brief - - - I encourage the court to review those, as I'm sure you will: Cox, Sicolo, Sperry v. Crompton, you know, all those decisions focus on, as the court said in Sicolo, the intrinsic nature of the exaction. That's what we're asking you to do here.

And you know, just another point on the Fair Fund and the offset, Your Honors, the only way for Bear's argument about, you know, where did the money go and - - - and sort of how was it used to make - - - to be anything more than labels, and I was talking about labels earlier, that the court's jurisprudence focuses on substance not labels. The only way that it could be anything more than labels is if - - - is if Bear could prove that the money actually went to investors.

Going to the Fair Fund doesn't mean the money goes to investors. Liu and Kokesh were at pains to point that out, that a lot of time the money does not go to investors. And in fact, Liu points out that the Fair Fund was created, in part, to do things like pay whistleblowers and fund the IG, good and salutatory goals, of course, but not the same thing as money going to the investors.

And it's not as though Bear proved in this case, you know, here were the investors, they lost X, and they received Y from the SEC, and you know, it matches their - - - their losses, and so therefore it's compensation. And

insurance coverage shouldn't turn on - - - it's not an administrable rule. Coverage shouldn't turn on, you know, the - - - the sort of - - - the complex facts of what - - - of, you know, what went on. We'd have to subpoena the regulators, depose the investors - - -

JUDGE FAHEY: If I understand your argument - - -

MR. SULLIVAN: - - - to understand the losses.

JUDGE FAHEY: If I understand your argument, you're saying coverage shouldn't turn on where the damages reside, where they end up?

MR. SULLIVAN: Correct.

JUDGE FAHEY: Are you arguing that?

MR. SULLIVAN: I'm sorry?

JUDGE FAHEY: Are you arguing - - - I'm sorry. Are you arguing that coverage should not turn on where the damages, when they're provided by the carrier, and where you're paid, where that ends up. That's not your responsibility.

MR. SULLIVAN: Well, it's not just that it's not the insurer's responsibility, it's that it doesn't affect what actually matters, which is the legal justification, the legal nature of the award. It's fines or penalties imposed by law. That - - - that speaks a legal analysis, not a factual question into what the SEC meant, in its heart of hearts, or what actually ended up happening with

the money. It's not an administrable rule. That's the point I was trying to make about administrable.

JUDGE WILSON: I think the thing that makes this case maybe a little hard is the following. If all that happened - - - so there are people who are injured, right, investors. Let's assume that happened, and it was a lot of money. If all that happened was that Bear Stearns returned only the profit it made off of the trades, we wouldn't really have an issue, right? That's not a penalty. Right?

MR. SULLIVAN: Right.

JUDGE WILSON: And - - - hold on. If, on the extreme other end, Bear Stearns had to pay a huge amount of money that was above and beyond what everybody lost, we would have to conclude that's a penalty, right?

MR. SULLIVAN: Well, I think you would conclude it for the same reasons we're arguing it here - - -

JUDGE WILSON: Well - - -

MR. SULLIVAN: - - - but I guess Bear would not have some of the arguments it's making, yes.

JUDGE WILSON: Right. And then the question is what - - - how do you conceive the middle where what Bear is paying back is everybody's loss but not more than everybody's loss? That - - - that's what makes this a little hard.

MR. SULLIVAN: Yeah, and so - - -

JUDGE WILSON: - - - because are you looking at what the government - - - and remember, it's the government suing, sort of in a parens patriae kind of role. So what you're asking is, is what the government is doing here trying to put everybody back in the position that they were, and that's all they're taking? Now, they do take an additional penalty which is not at issue here. Or are they taking from Bear more than Bear actually was benefited, and so you view it as a penalty. And I - - - I'm not sure which way to view it.

MR. SULLIVAN: Yeah, so there's a couple of things there, Your Honor. I just want to unpack it and address each of them because I think that they're really important. So first of all, I don't think this is, sort of, a middle case, with all due respect. I understand what you're saying, but I think that the - - - for one thing, we've heard today, I think for the first time in this case, that - - - that the money that was distributed - - - the money that Bear was ordered to pay didn't exceed the losses. We have no way of knowing that. It's not as though Bear proved here's what the investors lost and here's what we paid. There's no X and Y to compare. You know, all that - - - all that they said was the - - - that the money went into the Fair Fund.

The theory of the case was not, from Bear, up

until its reply brief, frankly, in this court, it's theory of the case was not the SEC was measuring losses. Its theory was the SEC was measuring the timers' gains, right? It wasn't until its reply brief that it said, well, actually, maybe it was the same thing as the losses. And why did it - - - why did it make that shift? Because Liu came out, and Liu shows that its entire theory of the case was wrong.

Now, you know, and it's also wrong under the record here. I mean, not just the federal cases that say that the SEC does not have the power to obtain damages, does not try to compensate investors, Bear's own expert, Harvey Pitt - - - I encourage you to look at 1799 to 1800 of the record - - - he opined the SEC's enforcement regime is not intended to compensate injured investors since the SEC lacks the resources and is not a collection agency.

The entire theory of obtaining disgorgement of more than the wrongdoer's own ill-gotten gains has always been to deter. He says that at 1799 to 1800 of the record. You know, so whether you're looking at what the law is, and - - - and there are - - - there are numerous cases which we cite in our brief, SEC v. Tome, SEC v. First Jersey, two cases from the Second Circuit, if you read what they say about disgorgement, they say it's - - - it's imposed to deter not to compensate. That's not what the SEC is doing

when it obtains that remedy.

And to the extent it's not a penalty, they say, it's not a penalty if it - - - if it is limited to the wrongdoer's own ill-gotten gains. So I think that that's really the line to draw, Your Honor. And you know, so I suppose it might be different if Bear had a factual record about where the money actually went. But it doesn't. And I submit that it wouldn't be an appropriate test to use because it would - - - it would leave coverage determinations in doubt, unpredictable, ex ante, which would make it hard both for insurers and insureds to determine what the premiums ought to be.

And instead, it should be a clear rule, which is the rule that we are asking for. We're not saying, you know, any time a regulator imposes a disgorgement remedy it's not going to be insurable. We're talking, one, about SEC disgorgement, and remember, after Liu, there's not going to be disgorgement of third-party gains anymore because it's not allowed. So this was - - -

CHIEF JUDGE DIFIORE: Thank you, counsel.

MR. SULLIVAN: Thank you, Your Honor.

CHIEF JUDGE DIFIORE: Counsel?

Responding first.

JUDGE WILSON: Oh, sorry.

MR. KIRK: Good afternoon. Edward Kirk from

Clyde & Co. US LLP, for Underwriters at Lloyd's and AAIC.

The overwhelming and undisputed evidence in the record establishes that the prior-knowledge exclusion, which is only in Underwriters and AAIC's policy, applies as a separate basis to the noncoverage here with respect to Underwriters' excess policy. The First Department correctly vacated Judge Ramos' order, in properly granting summary judgment to Bear Stearns, dismissing Underwriters' defense based on this exclusion.

And I just want to address a few of the points raised by - - - by Mr. - - - by my opposition. First, he says that officer is an ambiguous term in the policy. Officer - - - the policy - - - the policy exclusion applies to any officer of Bear Stearns who had knowledge of wrongful acts that could lead to a claim before March 21, 2000.

That term, based on its plain meaning, is clearly not ambiguous. In fact, Bear Stearns itself defined what an officer was in its own internal documents, including its bylaws and other internal documents that we placed in our brief and are in the record. Also - - -

JUDGE CANNATARO: Are there really 400 of them?

MR. KIRK: I'm sorry?

JUDGE CANNATARO: Based on Bear Stearns' definition of what an officer is, was that number right,

that there were hundreds of officers?

MR. KIRK: There were many officers under the definition that Bear Stearns applied in its bylaws. But we don't even need to go there today because the SEC order clearly laid out that this case is all about a scheme by Bear Stearns to defraud mutual fund investors and mutual funds, that was known about and in which senior management at Bear Stearns participated.

So the people that we identify in our brief, and as laid out in the record, these are senior people. These are people with supervisory and management functions. They're people with senior titles. It's not the mailroom clerk, as my opponent has described them before.

And also, more importantly, the SEC order found willful violation of the securities laws by Bear Stearns itself. In order to make that finding, the SEC had to find that senior management at Bear Stearns knew about and participated in the fraud. So that's clearly set forth in the record. It's clearly the basis of the settlement, and the exclusion should apply.

They also argue that almost all of what happened was after the cutoff date of March 21, 2000. There are wrongful acts that occurred after March 21, 2000. We've set forth in the record many acts that were known by senior management at Bear Stearns before that cutoff date. And

with respect to the acts that occurred after that date, the exclusion applies not only to acts - - - wrongful acts before March 21, 2000, but also to interrelated wrongful acts that occurred after that date. And Bear Stearns itself has acknowledged and admitted in its complaint, in fact it pled this in its complaint, that all of these wrongful acts are interrelated, so there's no issue of fact there even.

With respect to the purpose of the exclusion, he argues that it's to prevent someone from buying insurance for a claim that they know is about to happen. Well, the policy exclusion actually applies where any officer of Bear Stearns knew or could have reasonably foreseen - - - so it's an objective standard - - - that the wrongful acts could lead to a claim, not that a claim had already happened or - - - or that a claim is just about to occur, but they're aware of facts.

And this is borne out in the case law that addresses this, including the Peabody case. And in fact, they knew of facts that any reasonable person in the position - - - in a business position at Bear Stearns and - - - and as an officer of Bear Stearns would have known could result in a regulatory claim, which is in fact what happened here.

And I'll just conclude by saying the - - - the

record is clear, and the evidence shows that, prior to March 21, 2000, Bear Stearns' officers were aware of and participated in the fraudulent trading scheme. And over - - - this overwhelming supports summary judgment in Underwriters' favor. At a minimum, this evidence raised a disputed issue of fact that would preclude summary judgment, as Judge Ramos granted. So we would request the court - - -

CHIEF JUDGE DIFIORE: Counsel, before - - -

MR. KIRK: - - - grant summary judgment.

CHIEF JUDGE DIFIORE: Counsel?

MR. KIRK: Yes.

CHIEF JUDGE DIFIORE: Before you take your seat, if we were to reverse on the penalty issue, should we send this back to the Appellate Division for it to address the other issues in the first instance?

MR. KIRK: I would say that the court should address our exclusion here. If it did choose to send it back to the First Department, I think it would be warranted for de novo review. The Appellate Division did not address it in its decision. We did argue it at oral argument - - -

CHIEF JUDGE DIFIORE: Right.

MR. KIRK: - - - and did brief it sufficiently. But I think it's all on the record here today, and I think it's an alternative basis for Underwriters' policy to be

dismissed from this case.

CHIEF JUDGE DIFIORE: Thank you, counsel.

MR. KIRK: Thank you.

CHIEF JUDGE DIFIORE: Mr. Obus?

MR. OBUS: Thank you. Briefly, on the wrongful acts exclusive, there were 4,000 officers, if you accept their concept, 40 - - - 40 percent of the entire workforce.

The SEC order is not evidence. We did not agree that the previous acts and the later acts were interrelated. We said that the acts alleged by the SEC were related to what was alleged in the civil class action, a completely different point, as I think is clear on the record.

With respect to the main argument, we most certainly did prove that there was a loss. Even their expert agreed that there was a loss here that was calculated - - - the SEC originally wanted it calculated under this Delta NAV method, which they acknowledge was an accepted method. We advocated a method that came to a smaller number. But the SEC, in fact, required Bear Stearns to dig its grave. The SEC had to compile all the transactions. It had to do the calculations. And we even had another expert in this case replicate that to show that there really was this - - - this loss, you know, putting aside, you know, issues of fault and the like.

JUDGE GARCIA: Counsel, how is the fine calculated? How is the fine calculated by the SEC?

MR. OBUS: You - - - in this case, what the SEC required, and this is what they were claiming was the injury, we - - - they compiled all of the transactions that were recorded after 4 p.m. Now, Bear Stearns was claiming many of those were legitimate transactions, because you can process them after 4, if the decision was made before. But in any case, compiled the transactions, measured the fair value analysis, the one that we championed and ultimately compared the value at 4 p.m. with the value in the futures market at the time when the transaction was given.

None of these are perfect, but when you're the defendant, and you're accused of wrongdoing, so any uncertainty about the precise measure redounds against you.

JUDGE GARCIA: But it seems like to me, and I'm struggling with this point and how to factor this in, if this is helpful - - - the SEC comes to you with a 720-million-dollar number, 520- and 200-, right?

MR. OBUS: Right.

JUDGE GARCIA: Ultimately, that's negotiated down to 160-, 90-, for a total of 250-.

MR. OBUS: Right.

JUDGE GARCIA: Right? And it seems to me there's a lot of play in the lines there. So the SEC and Bear

Stearns has an alignment of interests in saying this isn't a penalty or a fine, putting it into the disgorgement bucket because they can't impose a penalty, you can't recover for a penalty. And so now we have a settlement that's 250 million that your - - - Bear Stearns is on the hook for 110-, and your insurance companies are on the hook for 140-. And as a policy matter, you know, is that something that we would factor in when we're interpreting the contract?

MR. OBUS: I don't think so. Certainly on this record there isn't a hint of any collusive bargaining here. There was a requirement that we actually calculate this big number, the 500-million-dollar number. We had to go to a lot of effort to - - - to show the SEC that a fairer method, especially given that everything was presumed to be violative, whether it really was or not, that the 140- was a much fairer measure.

At the time, nobody was considering this was a penalty. Everybody thought it was an equitable remedy. They weren't trying to, you know, sneak it under the wire. It wasn't until ten years later that the Supreme Court said, you know what, the SEC, what you've been doing for the last decade is wrong, which really gets to a main point here.

We - - - this is a settlement agreement. The

claim that we settled was a claim for a compensatory equitable payment. It was not for a penalty. The SEC didn't think it could do a penalty. And we did it. It's just like any other damages award that comes in. Maybe it was too high. The jury was a run-away jury. They awarded damages for an element that really shouldn't have been. It's still covered if what it is is a compensatory damages remedy. In this case, it is a compensatory equitable remedy, and it's - - - that nobody dreamed was a penalty at the time, intended it to be, thought it was, thought they had the power to even impose.

It's not just a question of following the money to. We certainly acknowledge the ninety million went to people, mostly because I think the Delta NAV method was the one that was championed by others. But - - - but the payment that Bear Stearns made was functionally indistinguishable from what was paid to the civil class action. Every dollar, dollar for dollar, that went into the Fair Fund of the - - - of the disgorgement payment, set off the obligation that would otherwise have to have been paid in the class action.

If it had all been paid in the class action, we wouldn't be having this argument. But it's exactly the same thing. And it shouldn't make a difference. It's a mere formalism that the money, in one case, went into a

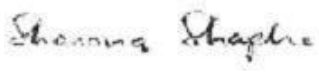
plaintiff's attorney's escrow fund, and in the other case, it went into the Fair fund. And there isn't any question that Bear Stearns bargained for the - - - the right to pay down its obligation using this money. This was absolutely - - - and which is why I say it's not just a matter of following the money; it's a matter of paying money to discharge a civil obligation to make someone whole. It's not in excess of that. It's not apart from it. You don't have to replenish it if somebody gives you credit for it. It's just a payment to discharge an obligation to make someone whole. That's all it was. And so we think it's - - - this is exactly what this insurance policy promised Bear Stearns it would cover.

CHIEF JUDGE DIFIORE: Thank you, counsel.

(Court is adjourned)

C E R T I F I C A T I O N

I, Sharona Shapiro, certify that the foregoing transcript of proceedings in the court of Appeals of J.P. Morgan Securities, et al. v. Vigilant Insurance Company, et al., No. 61 was prepared using the required transcription equipment and is a true and accurate record of the proceedings.



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