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COURT OF APPEALS

STATE OF NEW YORK

J.P. MORGAN SECURITIES, INC., ET AL.,

Appellant,

-against-

No. 113

VIGILANT INSURANCE COMPANY, ET AL.,

Respondent.

20 Eagle Street
Albany, New York 12207
May 1, 2013

Before:

ASSOCIATE JUDGE VICTORIA A. GRAFFEO
ASSOCIATE JUDGE SUSAN PHILLIPS READ
ASSOCIATE JUDGE ROBERT S. SMITH
ASSOCIATE JUDGE EUGENE F. PIGOTT, JR.
ASSOCIATE JUDGE JENNY RIVERA

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David Rutt
Official Court Transcriber

1 JUDGE GRAFFEO: Number 113, J.P. Morgan
2 Securities against Vigilant Insurance Company.

3 Mr. Gross, do you want to reserve any time for
4 rebuttal?

5 MR. GROSS: Three minutes, please.

6 JUDGE GRAFFEO: Three minutes.

7 MR. GROSS: Bear Stearns did not receive an ill-
8 gotten gain. Bear Stearns' payment was representative of
9 gains that the customers made.

10 JUDGE RIVERA: Counsel, isn't your position,
11 though, going to undermine or disincentivize entities like
12 Bear Stearns from avoiding the conduct that got them on
13 the SEC and the New York Stock Exchange radar to begin
14 with?

15 MR. GROSS: Your Honor, this court - - -

16 JUDGE RIVERA: Where's the deterrence?

17 MR. GROSS: This court has applied deterrence
18 only when the record showed intent to harm. There was no
19 intent to harm proven. The SEC did not even charge intent
20 to harm. Bear Stearns put in a Wells submission, a
21 seventy-two page Wells submission which clearly showed
22 that there wasn't intent to harm.

23 JUDGE RIVERA: You would - - -

24 JUDGE GRAFFEO: Why shouldn't we look at the SEC
25 order as a whole and consider this some kind of joint

1 venture-type situation where Bear Stearns was also working
2 with the hedge fund managers in order to come up with
3 these schemes to somewhat keep the mutual funds in the
4 dark? Why shouldn't we look at the whole 160 million or
5 140 million, whatever it is, that - - - once you take your
6 commissions out?

7 MR. GROSS: Judge Graffeo, no court in this
8 country has ever held that when a party did not receive
9 ill-gotten gain and paid money representing the gain of
10 another party, there was no coverage.

11 JUDGE GRAFFEO: Even if they accommodated that
12 gain?

13 MR. GROSS: No cases. And with respect to
14 intent to harm, when you're talking about indemnity, you
15 look at the entire record, not just the administrative
16 order. You look at Bear Stearns' amended complaint, you
17 look at the Wells submissions submitted by the Cleary
18 Gottlieb firm, and you look at the administrative order.
19 And as Judge Kaye said in Servidone, the question is not
20 what the pleadings show, the question is what were the
21 actual facts. The actual facts were that Bear Stearns
22 paid monies representing the gains of its customers.

23 JUDGE GRAFFEO: From a - - -

24 JUDGE READ: You mentioned the - - -

25 JUDGE GRAFFEO: From a public policy standpoint,

1 why should we - - - why should we place the burden of this
2 expense on the insurance industry as opposed to the
3 securities industry?

4 MR. GROSS: Your Honor, this - - - this court
5 has never applied public policy, as the First Department
6 did, absent intent to harm. The court didn't do it in
7 Public Mutual v. Goldfarb where the allegations were that
8 a dentist had engaged in sexual conduct with his patient.
9 This court said unless there is intent to harm, there will
10 be coverage. This court has never applied public policy
11 when the issue was conduct absent intent to harm.

12 JUDGE GRAFFEO: I guess I'm asking why shouldn't
13 we expand it a bit where we have this kind of activity.

14 MR. GROSS: Because you would potentially
15 eliminate all coverage. Take a look - - -

16 JUDGE GRAFFEO: But as Judge Rivera mentioned,
17 isn't it tied to the deterrence issue?

18 MR. GROSS: Your Honor, deterrence is a factor
19 in any remedy. Take the negligent operation of an
20 automobile. Why should we provide coverage for the
21 negligent operation of an automobile?

22 JUDGE PIGOTT: No, it's the guy that rams the -
23 - - you know, that runs over somebody intentionally
24 doesn't get coverage. And if we gave him coverage, he'd
25 say, good, I can hit the next guy, too. And I think

1 that's what they're trying to stop here.

2 MR. GROSS: Judge Pigott, this is not a question
3 of intent to harm. If it were - - -

4 JUDGE PIGOTT: No, I understand that, but the -
5 - - but what the SEC found was pretty damning.

6 MR. GROSS: What the SEC found, which are simply
7 allegations - - -

8 JUDGE PIGOTT: But you didn't deny them.

9 MR. GROSS: Pardon me?

10 JUDGE PIGOTT: You didn't deny them. You - - -
11 you - - -

12 MR. GROSS: Well, of course we did.

13 JUDGE PIGOTT: You neither admit nor deny that
14 you're responsible for all of this and - - -

15 JUDGE READ: Well, you mentioned your Wells
16 submission, but you did withdraw that, right?

17 MR. GROSS: The - - - the Wells submission was
18 withdrawn for the purpose of the SEC proceeding, but if
19 you look at the consent, the understanding between the SEC
20 and Bear Stearns was that Bear Stearns could take a
21 position in any other litigation that was now involving
22 the SEC.

23 JUDGE SMITH: Well, but back up. I mean, before
24 we get there, is there any fact found by the SEC that
25 you're contradicting here?

1 MR. GROSS: Yes. That's the - - - that be - - -

2 JUDGE SMITH: What - - - which facts?

3 MR. GROSS: Well, the - - - the SEC took the
4 position that Bear Stearns knew of all of the late trades
5 before they were put in, and we denied that.

6 JUDGE SMITH: Well - - - well, of course, that's
7 - - - that can be a - - - that sounds to me it could
8 almost be a question of law, what knowledge you impute to
9 Bear Stearns. But I mean, the - - - I mean, the detailed
10 recital of the evidence in the - - - in the order is
11 pretty - - - is pretty much uncontroverted, isn't it?

12 MR. GROSS: No, Your Honor.

13 JUDGE SMITH: They quote a lot of documents.
14 You're not saying they don't say what the SEC said they
15 say.

16 MR. GROSS: We do. That - - - that was the
17 purpose of the Wells submission. If you place - - -

18 JUDGE SMITH: Well, no, no. You draw - - - let
19 me put it more clearly. You're not saying they misquoted?

20 MR. GROSS: Are you talking about the SEC
21 misquoting - - -

22 JUDGE SMITH: Yes.

23 MR. GROSS: - - - telephone calls and e-mails?

24 JUDGE SMITH: Yeah.

25 MR. GROSS: Well, you know, you can look at

1 isolated events and - - -

2 JUDGE SMITH: I mean, this is actually intended
3 to be a friendly question. I don't know why you're
4 fighting it so hard. I'm suggesting - - -

5 MR. GROSS: I appreciate that, Judge Smith.

6 JUDGE SMITH: I've suggested to make the
7 argument you're making, you don't need just to flat out
8 deny the facts as found by the SEC. You can - - - you can
9 argue about the interpretation.

10 MR. GROSS: That's correct.

11 JUDGE GRAFFEO: Can I ask you about some of the
12 elements - - -

13 MR. GROSS: Thank you.

14 JUDGE GRAFFEO: - - - that you're looking for in
15 indemnification? Do you acknowledge that the ninety
16 million is outside the request for indemnification?

17 MR. GROSS: Yes, it's not covered under the
18 policy.

19 JUDGE GRAFFEO: Because that's - - - because
20 that's a penalty.

21 MR. GROSS: That's correct.

22 JUDGE GRAFFEO: What about the fourteen million
23 in the settlement?

24 MR. GROSS: The 14 million is the payment of a
25 civil penal - - - a civil remedy, so of course it's

1 covered, as are the 40 million of defense costs, as is the
2 140 million dollars which was payment of the customers'
3 gains, not an ill-gotten gain of Bear Stearns.

4 JUDGE GRAFFEO: Well, does - - -

5 JUDGE RIVERA: But what - - -

6 JUDGE GRAFFEO: - - - does any part of the 40
7 million in defense costs rise and fall with the 140 or the
8 160?

9 MR. GROSS: No, because if there's coverage for
10 the 14 million and coverage for the 140 million, then the
11 defense costs would have been used in both cases, so there
12 wouldn't be any question about allocation.

13 JUDGE RIVERA: So where - - - where's - - - for
14 lack of a better way of saying this - - - where's the hits
15 that you're taking? If the insurance company is paying
16 all of this, where - - - where is Bear Stearns paying?

17 MR. GROSS: We - - -

18 JUDGE RIVERA: What's the amount you're paying?
19 I've lost - - - I've lost the math now.

20 MR. GROSS: Sure. We paid a ninety million
21 dollar penalty. And Judge Rivera, it is important to note
22 that this is a settlement where the SEC got what they
23 wanted. They have to determine what is best for their own
24 deterrence, for their own enforcement remedies. And what
25 did they say? They said, Bear Stearns, you can seek 140

1 million dollars of insurance coverage for the so-called
2 disgorgement payment; Bear Stearns, you can't seek the 90
3 million dollar penalty. So even if Bear Stearns is - - -

4 JUDGE SMITH: How - - - how clearly did they say
5 that? Are you drawing the inference from the way they
6 characterized the payments?

7 MR. GROSS: No. I'm drawing the inference from
8 the fact that - - - first of all, of course, they knew it
9 wasn't covered under policy, but secondly, if we had tried
10 to use the penalty for the purposes of an offset in the
11 civil cases, then we would have had to go back to the
12 court, and the SEC said - - -

13 JUDGE SMITH: So they - - - they explicitly
14 allowed you to use the - - - the so-called disgorgement
15 money as an offset to the civil cases, right?

16 MR. GROSS: That's correct, Your Honor.

17 JUDGE SMITH: But they never actually said in so
18 many words, then go ahead and claim it against the
19 insurance company?

20 MR. GROSS: No, they never said it in so many
21 words. They just said, you're not admitting the
22 allegations of this administrative order, which means, of
23 course, that we can - - -

24 JUDGE SMITH: Admitting nor denying.

25 MR. GROSS: Not admitting - - - which means, of

1 course - - - and they used the word "and denying" - - -
2 which means, of course, that we could use it in the civil
3 litigations. And if you look at the consent, Judge Smith,
4 that Bear Stearns signed, Bear Stearns had the right
5 expressly to take different legal positions in a - - - in
6 a case with a third party than it was taking with the SEC.

7 Now, why is that all right? Because it was a
8 settlement. Bear Stearns settled with the SEC. They
9 settled with the SEC because the charges could have been
10 proved based upon reckless or negligent conduct, Judge
11 Rivera. And the charge was that the SEC was trying to
12 recover 520 million dollars. So yes, Bear Stearns settled
13 with the SEC.

14 Part of the agreement, Judge Smith, was that
15 Bear Stearns could, in an action with the insurers, take
16 the position that there was coverage notwithstanding the
17 allegations in the administrative order. But, as I think
18 you may have been pointing out before, the allegations in
19 the administrative order are not the end of the game.
20 This is not a duty-to-defend motion when the court looks
21 simply at the allegations.

22 JUDGE GRAFFEO: This is a - - - this is a motion
23 to dismiss.

24 MR. GROSS: That's correct.

25 JUDGE GRAFFEO: So if we agree with you, what

1 happens next? Is there any discovery to be had here?

2 MR. GROSS: If - - - if - - -

3 JUDGE GRAFFEO: Are there any issues of fact
4 other than the nature of the SEC order?

5 MR. GROSS: If you agree with us, Judge Graffeo,
6 and we go back to the trial court, we have made a motion
7 for summary judgment based upon the so-called fraud
8 exclusion. And that is this: the insurers sold us a
9 policy which said, "you are entitled to coverage for
10 deliberate, fraudulent, dishonest, criminal conduct unless
11 there's an adjudication." There was no adjudication here.

12 JUDGE SMITH: Okay, but - - -

13 JUDGE RIVERA: Why doesn't the SEC - - - I'm - -
14 - why is that not an adjudication? In an administrative
15 context, why - - - why is that not - - -

16 MR. GROSS: Be - - - because we didn't admit or
17 deny. And while the word "adjudication" is used in the
18 administrative proceeding, it's only used to compare it to
19 a rule-making process.

20 JUDGE SMITH: But they don't - - - those are
21 strong words: dishonest, fraudulent, criminal.

22 MR. GROSS: Not ours, Judge Smith.

23 JUDGE SMITH: I understand, but the SEC does not
24 find, in so many words, that you were dishonest,
25 fraudulent, and criminal.

1 MR. GROSS: Well, that - - - that is exactly why
2 we've made a motion for summary judgment.

3 JUDGE SMITH: Yeah, but on the other hand, it's
4 certain to - - - yeah, your motion for summary judgment -
5 - - as I understand it, you're saying even if it was
6 dishonest, fraudulent, and criminal, you haven't got an
7 adjudication, so it's fine. But wouldn't there come a
8 point when public policy would kick in if you did
9 something dishonest, fraudulent, and criminal and settled
10 the case? The day before the adjudication you can go to
11 your insurance company and say, cover me, if you committed
12 murder?

13 MR. GROSS: I - - - I think if you had committed
14 murder, if there was absolute - - -

15 JUDGE SMITH: You settled a wrongful death case,
16 so there's no adjudication.

17 MR. GROSS: Yes, I understand. If - - - if the
18 facts were so egregious, it is possible that the court
19 would decide that there should be a plenary hearing, as
20 Judge Kaye said in Servidone. So we are making - - - we
21 are making a motion for summary judgment. We are saying
22 to the court, Judge Graffeo, no further discovery is
23 necessary. Now, the court may agree or the court may
24 disagree. That's not before you now.

25 JUDGE GRAFFEO: Okay. You'll have - - - you'll

1 have further time in your rebuttal.

2 MR. GROSS: Thank you very much, Judge Graffeo.

3 JUDGE GRAFFEO: Thank you, counsel.

4 Mr. Finnerty.

5 MR. FINNERTY: Yes, Your Honor. Good afternoon.

6 Joseph Finnerty from DLA Piper. I'm here representing the
7 insurance company, the defendant-respondent insurers.

8 I think we need to retrace - - -

9 JUDGE GRAFFEO: The - - - the precedent is a bit
10 of a problem here for you. How do we look at this that
11 this is all Bear Stearns' ill-gotten gains?

12 MR. FINNERTY: Your Honor, in fact, the
13 precedent is clearly on point. The - - - and not really
14 disputed in this case. Bear Stearns concedes that
15 disgorgement is not insurable. The only question here is
16 whether or not Bear Stearns paid disgorgement. And in
17 this case, Bear Stearns was - - -

18 JUDGE SMITH: Well - - - well, but it seems
19 obvious that it's not - - - if it was disgorgement, it was
20 out of somebody else's gorge, wasn't it, or at least it
21 was - - - it never went down Bear Stearns' throat.

22 MR. FINNERTY: It did, Your Honor, for purposes
23 of the SEC enforcement liability. The S - - - the
24 securities laws that with enforced by the SEC commanded
25 Bear Stearns to disgorge because the profits from the

1 illegal scheme were imputed to Bear Stearns. Therefore,
2 all of the public policy - - -

3 JUDGE GRAFFEO: Have we ever done that before,
4 imputed?

5 MR. FINNERTY: No, Your Honor. You have always
6 called for no insurability of disgorgement on grounds of
7 public policy, that indeed, as Judge Rivera was pointing
8 out, it's - - -

9 JUDGE SMITH: But isn't there a difference
10 between imputed disgorgement and real disgorgement?

11 MR. FINNERTY: No, Your Honor. When you're
12 talking about a concerted action, criminals working
13 together to steal money from mutual fund shareholders - -
14 - one - - - one could not do it alone - - - the SEC found,
15 under the substantive law, that they were liable for
16 disgorge all of the profits from the concerted activity.

17 JUDGE SMITH: What - - - what case holds
18 disgorgement uninsurable on that concerted action theory?

19 MR. FINNERTY: There's - - - there's no case out
20 there that holds that concert - - -

21 JUDGE GRAFFEO: Across the nation, there's no
22 case?

23 MR. FINNERTY: There's no case that identifies,
24 in fact, a situation where you have concerted action and
25 one of the participants in the concerted action who does

1 not hold the money when the - - - when the wheel stops,
2 when the music stops and says now - - -

3 JUDGE SMITH: Well, is there any evidence they
4 ever held the 140 million dollars?

5 MR. FINNERTY: They - - - there's - - - the
6 evidence is replete in the SEC order and the settlement
7 agreement that details all of the bases for the payment
8 that Bear Stearns made that Bear Stearns was the hub, the
9 lynchpin of all of this activity pass through - - -

10 JUDGE SMITH: Yeah, but - - - yeah, but that
11 doesn't answer the question. Is there any evidence that
12 more than twenty million bucks went into Bear Stearns'
13 pocket from this scheme?

14 MR. FINNERTY: From - - - from the trade - - -
15 the benefit from the trades, actual profits from the
16 trades, 140 million dollars of the 160, the record shows,
17 went into Bear Stearns' collaborators, the hedge funds
18 that they did business with. There's also evidence in the
19 record from the SEC order that Bear Stearns profited from
20 the relationships it built with the - - - with the hedge
21 funds. And the SEC was clear to understand that this was
22 a collaborative enterprise by which all profited. In
23 other words, Bear Stearns, not a philanthropic
24 organization, ready to do a favor for hedge funds just by
25 providing a trading platform for illegal late trading and

1 deceptive market timing - - -

2 JUDGE READ: What do you - - -

3 MR. FINNERTY: - - - was not doing that for
4 free. And the SEC understood.

5 JUDGE READ: What do you do about the - - - what
6 do you do about the language of the policy? The
7 definition of a loss, it says, compensatory damages,
8 multiplied damages, punitive damages where insurable by
9 law, judgments, settlements, et cetera. I mean, what were
10 you intending to insure - - -

11 MR. FINNERTY: Well - - -

12 JUDGE READ: - - - by that language, if not this
13 kind of an event?

14 MR. FINNERTY: It's - - - it's a - - - it's a
15 good point that you make on the damages element of the
16 definition of loss. The definition of loss includes all
17 of those lists of things that are covered only when
18 they're paid as damages.

19 So Mr. Gross's suggestion that by taking a
20 position that there is no cover - - - that - - - that the
21 public policy is different than the limitations on
22 coverage, misses that point and misses the point that the
23 policy exclusions for personal profit and advantage claims
24 that in any way arise out of a personal profit or
25 advantage that's gained in the claim would be excluded.

1 So in this case - - -

2 JUDGE GRAFFEO: Why - - - why is the fourteen
3 million excluded under the language of the contract?

4 MR. FINNERTY: Your Honor, when the claim is not
5 covered, nothing that arises from it is covered. In other
6 words, the same central - - -

7 JUDGE GRAFFEO: That's - - - that's settlement
8 money; it's not disgorgement money.

9 MR. FINNERTY: Your Honor - - -

10 JUDGE GRAFFEO: Is that the fourteen million?

11 MR. FINNERTY: No, no, no. The question is
12 whether or not an exclusion to the coverage under the
13 policy, the personal profit and advantage exclusion that I
14 was just referring to, or a public policy like the
15 intentionally harmful conduct public policy - - -

16 JUDGE SMITH: So you're - - - you're saying this
17 claim - - -

18 MR. FINNERTY: - - - take out everything.

19 JUDGE SMITH: You're saying this claim is not
20 covered on its face.

21 MR. FINNERTY: I'm saying that the claim - - -
22 Your Honor, the claim is what is memorialized in the
23 settlement agreement. That's - - - just backing up one
24 second.

25 JUDGE SMITH: Suppose - - - suppose the same

1 thing - - - the same thing that was alleged in the
2 settlement agreement were alleged in a class action
3 complaint. You're saying that complaint's not covered;
4 you don't even have to defend.

5 MR. FINNERTY: But, Your Honor, this is not just
6 an allegation in a complaint; this is a settlement
7 agreement - - -

8 JUDGE SMITH: I know, but doesn't - - -

9 MR. FINNERTY: - - - that was consented to.

10 JUDGE SMITH: Isn't that what you're saying?
11 Doesn't that follow from what you're saying?

12 MR. FINNERTY: Your Honor, there - - - there are
13 many cases that define that when a complaint alleges
14 conduct that wouldn't be covered, the complaint and the
15 entire claim couldn't be covered.

16 JUDGE SMITH: I - - - that's my point. I guess
17 what I'm really saying is what are these people paying
18 their premiums for? Every class action alleges all sorts
19 of horrible things.

20 MR. FINNERTY: No, Your Honor, no. It - - - all
21 kinds of complaints out there allege all kinds of conduct
22 that could result in only liability for reckless conduct
23 or something that rises only to the level of some
24 uncoverable - - -

25 JUDGE SMITH: You've seen - - - you've seen a

1 lot of cases that don't allege - - - a lot of class
2 actions that don't have any allegation of willfulness in
3 them?

4 MR. FINNERTY: Your - - - Your Honor - - - no,
5 no, Your Honor. My point is only that - - - that the
6 specific facts alleged in the complaint are what this
7 court in Servidone told us to look at and this - - -

8 JUDGE GRAFFEO: I think what we're grappling
9 with is what are you covering?

10 MR. FINNERTY: Your Honor, the specific facts of
11 this case indicate that the scheme that was alleged and
12 the scheme that Bear Stearns agreed, in the settlement
13 with the SEC, it - - - it engaged in was intentionally
14 harmful up to - - - through the scheme they obtained ill-
15 gotten gains, massive profits in this - - - in this group.
16 Therefore, public policy of New York does not cover it and
17 - - -

18 JUDGE PIGOTT: You're saying if they - - - if
19 this was a mistake, if somebody moved a - - - moved a
20 decimal point too far and all of a sudden there was a
21 claim against them for 100 million bucks, you'd have to
22 cover that. That's just flat out negligence, and that's
23 what you pay for.

24 MR. FINNERTY: If it was a pure negligence
25 claim?

1 JUDGE PIGOTT: Right.

2 MR. FINNERTY: Yes, Your Honor. And - - -

3 JUDGE READ: So you're - - - so, intent. You
4 agree with your adversary that intent's key, but you say
5 it's all over this record, and he says no.

6 MR. FINNERTY: No. Your Honor, here - - -
7 here's what Bear Stearns did. Settled the case with the
8 SEC, memorialized that settlement in forty pages of
9 detailed findings, and the only piece of that that Bear
10 Stearns wants us to look at is the number that they paid.
11 What Servidone tells us in this - - - that this court told
12 us is that you need to look at the basis for the payment.
13 What's the reason for the liability? In this case, the
14 reason for the liability is laid out in 182 paragraphs
15 that detail exactly what the scheme was. The scheme that
16 forms the basis for this payment of 160 million dollars in
17 disgorgement and 90 million dollars in punitives is one
18 that was intentionally harmful. The point - - -

19 JUDGE SMITH: I - - - I guess what I'm - - -
20 what's bothering me is this - - - this is the sort of - -
21 - this is - - - looks to me like one of many, many
22 variations on the normal stuff of securities litigation.
23 This is not the most shocking allegation I've ever seen in
24 a securities case. Does the record show how much you've
25 got in premiums a year for this policy?

1 MR. FINNERTY: No, it doesn't, Your Honor.

2 JUDGE SMITH: Then the - - - they're not
3 generally cheap, these kinds of things, is - - - is my
4 impression.

5 MR. FINNERTY: No, Your Honor. But this is an
6 extraordinary case.

7 JUDGE SMITH: What - - - what are you - - - I
8 mean, don't - - - aren't you leading your insureds to
9 think that the mine-run of securities litigation is going
10 to be covered?

11 MR. FINNERTY: Your Honor, the policy covers
12 what it covers. Yes, indeed, these - - - these - - - Bear
13 Stearns was regulated by fifty state regulators, the SEC,
14 the CFTC, overseas regulators. It's a worldwide policy.
15 There's many numbers of things that could have been
16 covered by this and including regulators that are allowed
17 including the New York State Attorney General's Securities
18 Division that can sue for damages under the Martin Act.

19 JUDGE READ: Well, I'm still - - - I guess I'm
20 having the same problem Judge Smith is. Isn't this sort
21 of the mine-run kind of thing? What - - - why - - -

22 MR. FINNERTY: A mine - - -

23 JUDGE READ: Yeah. Why - - - why is this so - - -

24 -

25 MR. FINNERTY: Your Honor, Bear Stearns was

1 caught red-handed stealing from mutual fund shareholders
2 in violation - - - direct violation of the late trading
3 laws and - - - and in violation of deceptive trading
4 practices with mutual funds time trading. They were
5 stealing money by allowing their customers to come in - -
6 -

7 JUDGE READ: So you're saying what? This is so
8 much worse - - - this is not mine-run. This is so much
9 worst than the ordinary kind of - - -

10 MR. FINNERTY: Yes, Your Honor.

11 JUDGE READ: - - - enforcement action that SEC
12 would bring or an SRO might bring?

13 MR. FINNERTY: Yes, Your Honor. Yes, Your
14 Honor. There can't be late trading, negligently or
15 recklessly. It can't do deceptive market timing without
16 knowing that you're stealing from mutual fund
17 shareholders.

18 JUDGE SMITH: When - - - when the directors of
19 Enron got sued, did their insurance companies walk away?

20 MR. FINNERTY: Your Honor, I cannot recall
21 exactly what happened. I think there was litigation over
22 whether or not the - - - the insurance - - -

23 JUDGE SMITH: I mean, I guess what I'm - - -
24 yeah. I mean, is this so much worse than Enron, that it's
25 totally uninsurable - - -

1 MR. FINNERTY: Your Honor, it's only provable
2 here for insurance coverage as that terrible event because
3 they memorialized what happened in 80 - - - 182
4 paragraphs.

5 JUDGE GRAFFEO: But they're not - - -

6 MR. FINNERTY: And that - - -

7 JUDGE GRAFFEO: They're not the only entity that
8 has done one of these agreements with the SEC.

9 MR. FINNERTY: That's right. Millennium, Your
10 Honor. The First Department found that the - - - the
11 settlement agreement in the Millennium case, which is the
12 same form of settlement agreement as is at issue here - -
13 -

14 JUDGE GRAFFEO: Where they don't - - - where
15 they don't admit or deny?

16 MR. FINNERTY: They did not admit or deny,
17 exactly the same here. This - - - Your Honor, the
18 difference between - - -

19 JUDGE SMITH: But didn't Millennium involve true
20 disgorgement in the sense that it went - - - the same guy
21 who - - - who put it in took it out?

22 MR. FINNERTY: No more true disgorgement for
23 purposes of the public policy of insurability than the
24 disgorgement here. Your Honor, if you allow for payment
25 to any member of a conspiring team - - -

1 JUDGE SMITH: I understand that that's - - -

2 MR. FINNERTY: - - - that - - -

3 JUDGE SMITH: - - - your theory, but does
4 Millennium vindicate that theory, or is Millennium - - -
5 Millennium didn't involve accomplices getting the money,
6 did it?

7 MR. FINNERTY: Millennium itself got the profits
8 from the trades, Your Honor. But the issue here is
9 whether or not the public policy of New York will allow
10 insurance to walk into the room with an acknowledged
11 collaborating - - - illegal, collaborating group that was
12 stealing money from - - - from mutual fund shareholders,
13 and you're going to pay back one of those members of the
14 collaboration because they happen to not have had the
15 money. It's - - -

16 JUDGE RIVERA: So if the court holds in your
17 favor, what - - - the next time, if there is a next time,
18 what is going to incentivize them to enter those
19 agreements with the SEC?

20 MR. FINNERTY: Your Honor - - -

21 JUDGE RIVERA: - - - or should we not be
22 concerned about that?

23 MR. FINNERTY: I don't think - - -

24 JUDGE RIVERA: I mean, I'm just interested in
25 how the deterrence of - - - works if the court holds in

1 your favor.

2 MR. FINNERTY: Your Honor, there's - - - there's
3 no impact on the public policy supporting settlements.
4 Settlements will happen or won't happen based on the
5 enforcement authority of the SEC and the claims that could
6 have been asserted.

7 JUDGE READ: Well, you would have to admit they
8 might be - - - be made less attractive.

9 MR. FINNERTY: Well, Your Honor, that's only to
10 the extent that they - - - that it would be reasonable for
11 someone who stole money to expect an insurance company to
12 repay it and - - -

13 JUDGE RIVERA: Well - - -

14 JUDGE PIGOTT: That would kind of encourage
15 this, wouldn't it?

16 MR. FINNERTY: Pardon me?

17 JUDGE PIGOTT: I mean, you can willfully violate
18 17(c) any - - - or (a) anytime you want, which prohibits
19 fraudulent conduct because you know you guys are going to
20 pick up the tab.

21 MR. FINNERTY: That's exactly right, Your Honor.
22 It would - - - it would - - - exact - - - Your Honor,
23 exactly as the nature of the - - - the punitive damages
24 insurance bar, the same thing applies in the disgorgement
25 insurance bar. If, indeed, you allow insurance to repay

1 disgorgement, the entire purpose of the remedy is entirely
2 eviscerated, Your Honor, because - - -

3 JUDGE SMITH: Well, but doesn't - - - doesn't
4 all insurance involve some moral hazard?

5 MR. FINNERTY: No, not all - - - well, all
6 insurance to some degree, Your Honor, not of the nature
7 that I'm talking about here.

8 JUDGE SMITH: Yeah, but haven't we usually
9 limited the public policy limitation, things are so bad to
10 - - - that you can't insure them to things like
11 essentially, you know, murder, assault, larceny, that sort
12 - - - you say this is larceny but - - -

13 MR. FINNERTY: This is larceny, Your Honor.

14 JUDGE SMITH: But - - - yeah, they - - - nobody
15 indicted them.

16 MR. FINNERTY: Your Honor, the - - - the truth
17 is, this is exactly - - - this is larceny. This is
18 intentional conduct. The concept of moral hazard, Your
19 Honor - - -

20 JUDGE SMITH: The trouble is that every secure -
21 - - yeah - - -

22 MR. FINNERTY: No, Your Honor.

23 JUDGE SMITH: Isn't - - - has there ever been a
24 securities violation that a good lawyer couldn't stand up
25 and pound the podium and say, this is larceny?

1 MR. FINNERTY: No, Your Honor. This is
2 different. This is memorialized in detail. This shows
3 late trading - - - if I can come - - - finish my answer.
4 This shows late trading which is per se theft. The - - -
5 the SEC agreement, the order, details thousands of
6 requests by mutual funds to stop trading - - - market
7 timing their funds. What the - - - the agreement also
8 shows is that Bear Stearns said, sure, and then it
9 actively concealed its continuation of market timing in
10 those same funds by giving registered reps different
11 identifications. That's intentional conduct that can only
12 be interpreted as theft, direct theft.

13 And when you - - - the public policy of
14 intentional conduct, Your Honor, isn't about whether or
15 not you could also say it was reckless; it's whether or
16 not you can see the harm at the time that you commit the
17 act. And in this case, because it's math, it's dollars
18 and cents, you can see that you're going to reduce the
19 value of that mutual fund for the other shareholders that
20 don't have the benefit of your heightened knowledge based
21 on late trading after the NAV price is - - -

22 JUDGE RIVERA: You ran out of time. Just quick.
23 He says it's not an adjudication. Do you say it's an
24 adjudication?

25 MR. FINNERTY: Your Honor, this - - - there is -

1 - - it's another adjudication. It's not required that we
2 find it's an adjudication in order for it to be binding
3 for insurance coverage purposes. But the SEC order in
4 this case does detail enough to create all of the factual
5 record that's required in order to decide, as a matter of
6 law, that the payment by Bear Stearns was disgorgement and
7 that the conduct that's at the center of the payment that
8 was made - - - it's not about whether Bear Stearns did it
9 or not; it's the factual basis, according to Servidone,
10 this court's case, the factual basis for the payment made.

11 JUDGE GRAFFEO: Thank you, counsel.

12 Mr. Kirk.

13 MR. GROSS: Thank you, Judge Graffeo.

14 JUDGE GRAFFEO: No. Mr. Kirk has - - -

15 MR. GROSS: Oh, I'm sorry.

16 JUDGE GRAFFEO: Then you.

17 MR. KIRK: Thank you. Good afternoon, Your
18 Honor. May it please the court, Edward Kirk of Clyde &
19 Co. US for Underwriters at Lloyd's and AAIC.

20 Our clients issued an excess policy that applies
21 above 150 million dollars in coverage after exhaustion of
22 those underlying limits. And it includes a prior wrongful
23 acts exclusion that is not in the underlying policies.
24 Importantly, that exclusion does not have an in-fact or
25 final adjudication requirement. It applies if the claim

1 is for any alleged wrongful act that meets the requirement
2 of the exclusion. A plain reading - - -

3 JUDGE SMITH: But it - - - but it had to be
4 known to the officers before March of 2000, right?

5 MR. KIRK: That's correct.

6 JUDGE SMITH: And what - - - and what shows on
7 summary judgment that officers of Bear Stearns knew before
8 March of 2000 that this was going to result in a claim, or
9 had reason to believe it?

10 MR. KIRK: I'd say the - - - the nature of the
11 claims themselves generally, and then specifically, there
12 are specific allegations within the SEC order which, for
13 purposes of - - - of determining coverage, is binding on
14 Bear Stearns.

15 JUDGE SMITH: Which - - - which officers of - -
16 - of Bear Stearns do you say knew?

17 MR. KIRK: It doesn't - - - it doesn't identify
18 - - - the SEC order doesn't identify officers by names as
19 - - - as it would do.

20 JUDGE SMITH: Does it identify them by title or
21 by - - -

22 MR. KIRK: It does identify officers by title.

23 JUDGE SMITH: Would you say "officer" means
24 executive or does "officer" just mean corporate officer?

25 MR. KIRK: "Officer" means senior management and

1 - - - and - - -

2 JUDGE SMITH: How do - - - how do we know that?

3 MR. KIRK: We know that because - - - well, we
4 know - - - we know that the - - - the term "officer" is
5 not defined in the policy, so under standards of New York
6 - - - New York Insurance Law, one would look to the common
7 and ordinary meaning of the word "officer". This clearly
8 would include senior management, and Bear Stearns can't
9 dispute that.

10 JUDGE SMITH: And then isn't there - - - isn't
11 there a question about how senior the management has to
12 be? I mean, obviously, the - - - the divisions that were
13 doing this, their senior management knew, but you might
14 have a hard time proving that before March of 2000 the - -
15 - the executive committee of Bear Stearns knew about this.

16 MR. KIRK: I - - - I would - - - I would say
17 that it certainly doesn't have to be the executive
18 committee. I think the ordinary meaning of the term
19 "officer" would include individual employees at Bear
20 Stearns with exec - - - with supervisory or managerial
21 positions.

22 JUDGE SMITH: Anyone with - - - anyone with
23 supervisory or managerial authority is an officer?

24 MR. KIRK: Yes, I would - - - I would - - - I
25 would say it is. If you look at the ordinary and - - -

1 and - - - meaning of the term "officer", that's correct.

2 JUDGE GRAFFEO: Are there - - - is there any
3 case that you would point us to that deals with your
4 particular exclusion?

5 MR. KIRK: I would point you to Pepper Hamilton.
6 It doesn't deal with the specific issue of - - - of who is
7 an officer. But I think, if you look at - - - if you look
8 at cases interpreting - - - or demonstrating how - - - or
9 discussing how you determine coverage in New York, with
10 the duty to defend, it's the four corners of the
11 complaint.

12 Here, you've got a very detailed SEC order
13 which, for all intents and purposes, would serve as the
14 complaint in this situation. And looking at the four
15 corners of that SEC order, I think it's clear that the
16 nature of the allegations and the specific allegations
17 talk about senior management having knowledge during the
18 period 1999 to 2003, which is prior to the cut-off date of
19 the prior wrongful acts exclusion, and I think it's - - -
20 it's - - - it's beyond doubt that that SEC order addresses
21 - - -

22 JUDGE SMITH: It's only off - - - it's only
23 knowledge in the first several months of that period that
24 would do it for you, right?

25 MR. KIRK: Well, it would be in the period 1999

1 - - - some of these allegations actually go back to 1998.
2 Clearly, there are specific allegations in 1999, and we've
3 set them forth in our brief, where senior officers with
4 titles such as the head of the MFOD department, his
5 supervisor, general counsel, senior managers, those at the
6 highest levels of Bear Stearns, et cetera, et cetera. And
7 I think, taking the highly technical and specific meaning
8 of the term that Bear Stearns would ask the court to
9 adopt, I don't think that's how New York courts would
10 apply these - - - would apply these exclusions.

11 JUDGE GRAFFEO: Thank you, counsel.

12 Now you're up, Mr. Gross.

13 MR. GROSS: Thank you very much, Judge Graffeo.

14 The question of the wrongful act exclusion is
15 simply a question of fact for the court to decide on
16 summary judgment, not now. There aren't even any proven
17 facts on this record that Mr. Kirk can rely upon. But in
18 any event, we rely on the opinion of Judge Ramos below in
19 which he said there were issues of fact, in part, what
20 happened before March 21st, 2000, who knew, who were
21 officers, did they know that it would lead to a claim.

22 JUDGE GRAFFEO: Why shouldn't we adopt this
23 imputed - - - this imputed intent for harm, the - - - the
24 concerted activity that your adversary is advocating? Is
25 that somewhat a natural extension of the public policy

1 that we've already adopted?

2 MR. GROSS: No. Judge Graffeo, first, with
3 respect to the ill-gotten gain issue, and that is no court
4 has ever said that when you were paying something that
5 somebody else received you did not have coverage. Now let
6 me switch to the public - - -

7 JUDGE PIGOTT: Can I just ask you about that?

8 MR. GROSS: Sure, yes, Judge Pigott.

9 JUDGE PIGOTT: Are you saying that what your
10 customers received is - - - should not be part of this?

11 MR. GROSS: That's absolutely correct.

12 JUDGE PIGOTT: All right. So then you wouldn't
13 be seeking reimbursement for that?

14 MR. GROSS: Seeking reimbursement?

15 JUDGE PIGOTT: You wouldn't be asking the
16 insurance company to care - - - to cover that?

17 MR. GROSS: We are, because - - -

18 JUDGE PIGOTT: But you didn't get it, and you're
19 saying that you're not paying it so why would they?

20 MR. GROSS: We paid - - - we had an out-of-
21 pocket loss of 160 million dollars, 140 of which we paid
22 as an out-of-pocket loss. It was money that the SEC said
23 represented money that the customers gained.

24 JUDGE PIGOTT: 40 or 160?

25 MR. GROSS: Twenty.

1 JUDGE PIGOTT: Twenty.

2 MR. GROSS: But - - - but we - - - we had an
3 out-of-pocket loss of 140 million dollars.

4 JUDGE PIGOTT: But that - - - but that went to
5 your customers.

6 MR. GROSS: The - - - the money went to the
7 customers which is why we have coverage.

8 JUDGE PIGOTT: Well, let them make a claim. Why
9 should you, because, I mean - - - and why should they pay
10 for it?

11 MR. GROSS: I'm sorry, Judge Pigott. We had a -
12 - - an out-of-pocket loss of 140 million dollars. They
13 gave us - - -

14 JUDGE SMITH: As - - - as I understand your
15 claim, it's that your customers got the money and you had
16 to pay it back.

17 MR. GROSS: Correct.

18 JUDGE SMITH: And you say we can be insured for
19 that.

20 MR. GROSS: Correct.

21 JUDGE PIGOTT: Okay.

22 MR. GROSS: And that's what the policy - - -

23 JUDGE PIGOTT: I misunderstood. I - - -

24 MR. GROSS: I'm - - - then I wasn't clear. I
25 apologize.

1 JUDGE PIGOTT: That's all right.

2 MR. GROSS: And that's what the policy says. So
3 - - - and also, Judge Pigott, "willfully" does not mean
4 intent to harm. Will - - -

5 JUDGE PIGOTT: Well, I know, but to pick up one
6 of Judge Smith's, if you punch somebody in the jaw and you
7 - - - and you - - - and you get fined fifty dollars for
8 it, you don't get covered for the fifty bucks, but at the
9 same time, if the guy you hit sues you for your dental
10 bills, you're not getting covered for that either.

11 MR. GROSS: Well, in - - - in Slayco (ph.),
12 somebody shot with a shotgun - - -

13 JUDGE PIGOTT: All analogies limp, don't they?

14 MR. GROSS: Yes - - - shot - - - shot his
15 friend, and Judge Kaye, writing for this court, said, no
16 intent to harm and therefore, even though he pointed the
17 gun at his friend, he - - - there was a question as to
18 whether he intended to harm, and therefore, since there
19 was no proof on that record, we're going to provide
20 coverage. Let me go - - -

21 JUDGE GRAFFEO: I know your red light's on, but
22 there's quite a bit of factual information in the record
23 that Bear Stearns either suggested some of these
24 activities to their customers or precipitated it. They
25 certainly supported it. Doesn't that put that in a bit of

1 a different light than if it was something that your
2 customers initiated and asked you to do?

3 MR. GROSS: No. Judge Graffeo, as - - - as I
4 think Judge Smith may have been pointing out, these are
5 typical securities allegations. I don't mean that J.P.
6 Morgan Chase doesn't know - - -

7 JUDGE GRAFFEO: Well, I mean, like, for
8 instance, there's 150 account numbers given to one
9 customer so that the mutual funds can't track the - - -
10 the repeat - - -

11 MR. GROSS: Yes, but - - -

12 JUDGE GRAFFEO: - - - the repeat dealings.

13 MR. GROSS: Yes, but - - -

14 JUDGE GRAFFEO: I mean, that's not terribly
15 typical, is it?

16 MR. GROSS: Those are - - -

17 JUDGE RIVERA: I thought the stock exchange
18 panel said it was outrageous.

19 MR. GROSS: I'm sorry?

20 JUDGE RIVERA: Did I miss something? I thought
21 the stock exchange panel said your conduct was outrageous
22 and unacceptable. Am I misquoting?

23 MR. GROSS: That - - -

24 JUDGE RIVERA: Just checking.

25 MR. GROSS: That's not a finding - - - that's

1 not a finding after an adjudication.

2 Judge - - - Judge Graffeo, there are - - - there
3 are allegations made in the administrative order. Bear
4 Stearns disputes that with its Wells submission and its
5 amended complaint. This is a motion to dismiss. Please
6 don't accept the allegations of the SEC as proven. There
7 was no adjudication.

8 JUDGE SMITH: But there are allegations that you
9 agreed not to deny, also - - - not - - - not to admit but
10 also not to deny. You're saying that - - - that you're
11 only not going to deny them to the SEC, you're free to
12 deny them to us?

13 MR. GROSS: Judge - - - Judge Smith, if - - - if
14 you were to ask your former partner, Brad Karp, whether
15 this is typically the way settlements are done - - -

16 JUDGE SMITH: Oh, I don't have to ask him. Of
17 course it's typical, but we're talking about the - - - the
18 implications of it.

19 MR. GROSS: The implications are the reverse of
20 what you're suggesting, Judge Smith. If this court were
21 to decide that because we signed a - - - an administrative
22 order, we therefore had collateral estoppel or were not
23 able to seek coverage which the SEC allowed us to do, that
24 would have a chill on settlements. It would be contrary
25 to the public policy that this court - - -

1 JUDGE SMITH: Well, it's - - - yeah, sure - - -

2 JUDGE RIVERA: Of course, the other thing that
3 might happen, the deterrence the other way is assuming you
4 have to pay it, you might not break the law. Just - - -
5 no?

6 MR. GROSS: Judge Rivera, this court has said,
7 only where there is intent to harm we're going to apply
8 deterrence. They don't apply it in automobile cases.
9 They don't apply it in 10(b)(5) cases. They don't apply
10 it in securities cases. I mean, you could say no
11 directors are entitled to insurance because, after all,
12 don't we want to make sure that corporations are properly
13 run, in which case there would be no directors serving in
14 New York corporations. So, yes, deterrence is always a
15 remedy, but the court has only applied deterrence when
16 there's intent to harm.

17 And please, the SEC decided what it needed for
18 its own enforcement purposes. The SEC is permitting Bear
19 Stearns to seek coverage here. The SEC imposed a penalty
20 which we're going to forever be out of pocket for, and the
21 SEC did that as a deterrent. So it - - - it's a
22 deterrent. The - - -

23 JUDGE GRAFFEO: Okay. Thank you, counsel.

24 MR. GROSS: Thank you, Judge Graffeo.

25 JUDGE GRAFFEO: Thank you very much.

(Court is adjourned)

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

I, David Rutt, certify that the foregoing transcript of proceedings in the Court of Appeals of J.P. Morgan Securities, Inc., et al. v. Vigilant Insurance Company, et al., No. 113 was prepared using the required transcription equipment and is a true and accurate record of the proceedings.



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