CLIENT MEMORANDUM

New York’s Highest Court and The United States Court of Appeals Issue Three Decisions Impacting the Scope and Application of Longstanding Insurance Principles

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In June, the New York State Court of Appeals and the United States Court of Appeals for the Second Circuit issued three important decisions that, while dealing with well-established rules of insurance law, clarified the scope and application of each rule. Each decision, discussed below, will have a significant impact on the resolution of insurance coverage disputes.

Medhi Ali, et al. v. Fed. Ins. Co., No. 11-5000, slip op. (2d Cir. June 4, 2013)

In *Medhi Ali, et al. v. Federal Insurance Company*, the United States Court of Appeals for the Second Circuit affirmed a district court’s decision finding that excess directors and officers liability insurance policies issued to the former executives of Commodore International Limited could not be triggered absent actual payment of the limits of liability of all underlying insurance, even when the underlying insurers are insolvent.

The insurance coverage dispute arose when Federal Insurance Company, Commodore’s second and fifth-layer D&O insurer, brought a declaratory judgment action seeking a declaration that it was not required to “drop down” to provide coverage to the former directors and officers for litigation related to Commodore’s bankruptcy that would have otherwise been provided by Reliance Insurance Company and Home Insurance Company, both of which were in liquidation. The former directors and officers argued that their excess policies were triggered once the total amount of their defense and/or indemnity *obligations* reached the policies' attachment points, regardless of whether those amounts had been paid by the underlying insurance companies (or by them). The Second Circuit affirmed the district court decision and held that the excess D&O policies could not be triggered unless and until the limits of all underlying insurance were exhausted by *payment*, even if the liability exposure or obligation in a settlement or judgment had reached the excess insurance layers. The Second Circuit focused on the express language of the policies finding that "the plain language of the contracts specifies that the coverage obligation is not triggered until *payments* reach the respective attachment points." *Ali*, slip op. at 11 (emphasis in original).

Significantly, the Court also noted that the district court, "echoing the terms of the relevant insurance policies—described the exhaustion requirement in the passive voice and did not specify which party was obligated to make the requisite payments." *Id.* at 12. As a result, the Court left open the possibility that the former directors and officers could fill the gap between attachment points through payment from sources other than the insolvent carriers, such as their own pockets.

K2 Investment Group, LLC, et al. v Am. Guar. & Liab. Ins. Co., No. 106, slip op. 4270 (N.Y. June 11, 2013)

In *K2 Investment Group, LLC, et al. v. American Guaranty & Liability Insurance Co.*, the New York State Court of Appeals affirmed a trial court's decision finding that when a liability insurer has breached its duty to defend an insured, it may not later rely on policy exclusions to avoid its duty to indemnify the insured for an underlying judgment.

American Guarantee & Liability Insurance Company disclaimed coverage for K2 Investment Group's defense costs and indemnification in connection with a malpractice suit. In the absence of defense coverage, K2 defaulted on a judgment entered against K2 in an amount that exceeded AGLI's limit of liability. K2 then brought a breach of contract claim against AGLI for failure to settle the underlying litigation. AGLI moved for summary judgment relying on various policy exclusions.

The Court considered whether an insurer that breaches its duty to defend the insured, a duty that generally is broader than the duty to pay for settlements or judgments, can later rely on policy exclusions to disclaim coverage for a judgment against the insured. The Court held the insurer could not do so. Once an insurer has "chosen to breach its duty to defend, [it] cannot rely on policy exclusions to escape its duty to indemnify." *K2 Investment Group, LLC*, slip op. at 8. The Court relied on its previous decision in *Lang v. Hanover Ins. Co.*, which states that an insurer "having chosen not to participate in the underlying lawsuit, [] may litigate only the validity of its disclaimer and cannot challenge the liability or damages determination underlying the judgment." *Id.* at 7 (quoting *Lang v. Hanover Ins. Co.*, 3 N.Y.3d 350, 356 (2004)). The Court stated that to hold otherwise would "promote unnecessary and wasteful litigation" whereby an "insurer, having wrongfully abandoned its insured's defense, could then require the insured to litigate the effect of the policy exclusions on the duty to indemnify." *Id.* The Court noted, however, that there would be exceptions to the rule to address public policy concerns such as in cases involving intentional wrongdoing by the insured.

J.P. Morgan Securities v. Vigilant Insurance, No. 113, slip op. (N.Y. June 11, 2013)

In *J.P. Morgan Securities v. Vigilant Insurance*, the New York State Court of Appeals reversed a finding by the Appellate Division, First Department, that insurers were not obligated to provide coverage for a $160 million "disgorgement" payment by J.P. Morgan to the SEC as a result of a 2006 settlement.

In 2003, the SEC began an investigation of Bear Stearns, J.P. Morgan's predecessor, and concluded that Bear Stearns allegedly facilitated deceptive market timing and late trading on behalf of its customers for the purchase and sale of shares of mutual funds, and this alleged conduct permitted its clients to profit wrongfully at the expense of mutual fund shareholders. In March 2006, without admitting or denying the findings made pursuant to the SEC's offer of settlement, Bear Stearns agreed to the entry of an SEC Administrative Order directing the company to pay $160 million in "profit disgorgement" and $90 million in civil penalties. Bear Stearns sought indemnification from its insurers for losses attributable to the SEC order and a number of private class action lawsuits. The insurers denied coverage arguing that their policies included an exclusion precluding coverage for indemnity for the disgorgement of illegal profits and, because the SEC's Administrative Order labeled the $160 million as "disgorgement," Bear Stearns could not recharacterize the payment as compensatory damages and had to bear its own loss.

The Court of Appeals held that the insurers were "not entitled to dismissal of [the] coverage claim premised on the SEC disgorgement payment." *Vigilant*, slip op. at 12. The Court stated that "the rule precluding coverage for disgorgement should apply only where the insured requested coverage for the disgorgement of its own illicit gains." *Id.* The Court found, however, that "much of the payment, although labeled disgorgement by the SEC, did not actually represent the disgorgement of its own profits …." Instead, the $160 million "actually represented the improper profits acquired by third-party hedge fund customers, not revenue that Bear Stearns itself pocketed." *Id.* As a result, the Court held that, based on the record before it, the insurers were not entitled to an order establishing that they had no duty to provide coverage for the claim. The decision in *Vigilant* thus made clear that whether or not a settlement payment is insurable does not turn on whether it is labeled "disgorgement," but instead on whether the payment represented a return of profits earned by the insured or some other party.

If you have any questions concerning the foregoing or would like additional information, please contact Christopher J St. Jeanos (212-728-8730, cst.jeanos@willkie.com), Megan Y. Hogan (212-728-8942, mhogan@willkie.com) or the Willkie Farr & Gallagher attorney with whom you regularly work.

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