State of New York
Court of Appeals

OPINION

This opinion is uncorrected and subject to revision before publication in the New York Reports.

No. 61
J.P. Morgan Securities Inc.,
et al.,
Appellants,
v.
Vigilant Insurance Company,
et al.,
Respondents.

Steven E. Obus, for appellants.
Daniel M. Sullivan, for respondents Vigilant Insurance Company et al.
Edward J. Kirk, for respondents Certain Underwriters at Lloyd's London et al.
David F. Abernethy, for respondent Travelers Indemnity Company.
Securities Industry and Financial Markets Association, James Corcoran et al., amici curiae.

DiFIORE, Chief Judge:

This appeal involves a dispute between the insured securities broker-dealers and certain excess insurers concerning the availability of coverage under a "wrongful act" liability policy for funds the insureds "disgorged" as part of a settlement with the Securities and Exchange Commission. We conclude that the settlement payment in question was not excluded from insurance coverage as a "penalt[y] imposed by law" under the policies at issue and therefore reverse.

In 2000, The Bear Stearns Companies purchased a primary insurance policy from defendant Vigilant Insurance Company providing coverage for "wrongful acts" of the Companies and its subsidiaries. The Bear Stearns Companies also purchased various excess insurance policies from defendants Travelers Indemnity Company, Federal Insurance Company, National Union Fire Insurance Company of Pittsburgh, Pa., Liberty Mutual Insurance Company, Certain Underwriters at Lloyd's London, and American Alternative Insurance Corporation or their predecessor entities that followed form to the policy issued by Vigilant. As relevant here, the policies provided coverage for "loss" that Bear Stearns became liable to pay in connection with any civil proceeding or governmental investigation into violations of laws or regulations, defining "loss" as including various types of damages—including compensatory and punitive damages ("where insurable by law")—but not "fines or penalties imposed by law."

In 2003, the Securities and Exchange Commission (SEC) and other regulatory agencies began investigating Bear, Stearns & Co. Inc. and Bear, Stearns Securities Corporation—securities broker-dealers that processed and cleared trades for clients (collectively, Bear Stearns). The investigation concerned allegations that, between 1999 and 2003, Bear Stearns had facilitated late trading and deceptive market timing practices[1]

[1] "Late trading is the practice of placing orders to buy, redeem or exchange mutual fund shares after the 4:00 p.m. close of trading, but receiving the price based on the net asset

by its customers in connection with the purchase and sale of shares of mutual funds. Bear Stearns notified the Insurers of the pending investigation, but the Insurers effectively disclaimed coverage (151 AD3d 632, 633 [1st Dept 2017]). Eventually, the SEC informed Bear Stearns that it intended to commence a civil action or administrative proceeding charging violations of federal securities laws and that it would seek, among other things, $720 million in monetary sanctions. Although Bear Stearns disputed the proposed charges, in early 2006 it settled with the SEC.

Pursuant to the settlement order, the SEC censured Bear Stearns and ordered it to cease and desist from any future securities law violations. Among other "findings," the administrative settlement order stated that Bear Stearns "facilitated late trading" and "the deceptive market timing activity" of certain clients. "[W]ithout admitting or denying the findings" and "[s]olely for the purpose of these proceedings," Bear Stearns agreed to a $160 million "disgorgement" payment and a $90 million payment for "civil money penalties." Both payments were to be deposited in a "Fair Fund" to compensate mutual fund investors allegedly harmed by the improper trading practices (*see* 15 USC § 7246). Further, "[t]o preserve the deterrent effect of the civil penalty," the settlement order directed that the $90 million payment—but not the disgorgement payment—was ineligible

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value set at the close of trading," which practice "allows traders to obtain improper profits by using information obtained after the close of trading" (*J.P. Morgan Sec. Inc. v Vigilant Ins. Co.*, 21 NY3d 324, 330 n 1 [2013]). Market timing is the "practice of frequent buying and selling of shares of the same mutual fund or the buying or selling of mutual fund shares to exploit inefficiencies in mutual fund pricing"; although this is "not per se improper, it can be deceptive if it induces a mutual fund to accept trades it otherwise would not accept under its own market timing policies" (*id.*).

to offset any sums owed by Bear Stearns to private litigants injured by the trading practices. Bear Stearns was also required to treat the $90 million payment as a penalty for tax purposes. Following the settlement, Bear Stearns transferred the $160 million disgorgement and $90 million penalty payments to the SEC. Bear Stearns also eventually settled a series of class actions brought on behalf of injured private investors based on similar late trading and market timing allegations.

Plaintiffs, Bear Stearns' successor companies,[2] subsequently commenced this action alleging that the Insurers had breached the insurance contracts and seeking a declaration of coverage for the disgorgement payment, private settlement, and various other defense costs and expenses. The Insurers moved to dismiss the complaint arguing, among other things, that the disgorgement component of the SEC settlement was not insurable as a matter of public policy. Supreme Court denied the motions to dismiss, but the Appellate Division reversed and granted the motions (91 AD3d 226 [1st Dept 2011]). On Bear Stearns' appeal, we reinstated the complaint, concluding that the Insurers were not entitled to dismissal because the disgorgement payment, allegedly "calculated in large measure on the profits of others," was not clearly uninsurable as a matter of public policy (21 NY3d 324, 336 [2013]).

Following additional motion practice, Bear Stearns moved for summary judgment, seeking dismissal of the Insurers' various defenses to coverage and arguing that $140

[2] In 2008, The Bear Stearns Companies merged with a subsidiary of JPMorgan Chase & Co. and became plaintiff The Bear Stearns Companies LLC. After the merger, Bear, Stearns & Co. Inc. became plaintiff J.P. Morgan Securities Inc. and Bear, Stearns Securities Corporation became plaintiff J.P. Morgan Clearing Corp.

million of the disgorgement payment represented disgorgement of its clients' gains, as compared with Bear Stearns' own revenue, and was an insurable "loss" under the policies.[3] In support of this argument, Bear Stearns proffered evidence from the SEC settlement negotiations that $140 million of the disgorgement payment reflected an estimate of the profits gained by Bear Stearns' clients as a result of the late trading and deceptive market timing practices. The Insurers opposed and cross-moved for summary judgment, arguing that the $140 million did not represent client gains and relying on various policy exclusions and public policy-based arguments against indemnification. Supreme Court denied the Insurers' motions and granted summary judgment to Bear Stearns, concluding that the disgorgement of $140 million in client gains constituted an insurable loss (57 Misc 3d 171, 179-183 [Sup Ct, NY County 2017]). Supreme Court subsequently amended its order to award Bear Stearns prejudgment interest (2017 NY Slip Op 31690[U], *5 [Sup Ct, NY County 2017]) and entered judgment in Bear Stearns' favor. The Insurers appealed.

The Appellate Division, among other things, reversed, denied Bear Stearns' motion for summary judgment, and granted the Insurers' motions for summary judgment declaring that Bear Stearns was not entitled to coverage for the SEC disgorgement payment (166 AD3d 1 [1st Dept 2018]). Relying on the intervening decision of the United States Supreme Court in *Kokesh v SEC* (581 US ___, ___, 137 S Ct 1635, 1639 [2017]), the Appellate Division determined that the relevant portion of the disgorgement payment was

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[3] Bear Stearns did not seek coverage for the remaining $20 million of the $160 million disgorgement payment, representing the revenues it received from clients in connection with its processing of the challenged trades.

a “penalty” and, as such, was not an insurable loss under the language of the policies (166 AD3d at 8). On remand, Supreme Court dismissed the amended complaint as to certain excess insurers and severed the remaining claims as to defendant insurers Vigilant, Travelers, and Federal. We granted Bear Stearns’ motion for leave to appeal as against four of the excess insurers, bringing up for review the prior nonfinal Appellate Division order (34 NY3d 1196, 1197 [2020]).[4]

Bear Stearns argues that the $140 million disgorgement for which it seeks coverage was derived from estimates of client gain and investor harm and, therefore, the Insurers failed to meet their burden of establishing that the payment was not a covered loss because it was a “penalty imposed by law.” We agree that the payment is not a “penalty” within the meaning of the policy.

Whether the $140 million SEC-ordered disgorgement constitutes a “penalt[y] imposed by law” such that it is not recoverable as a “loss” under the relevant insurance policies is a question of contract interpretation. As we have often stated, insurance contracts are subject to the general rules of contract interpretation. Like other agreements, insurance contracts are typically “‘enforced as written’”; absent a violation of public policy, “‘parties to an insurance arrangement may generally contract as they wish and the courts will enforce their agreements’” (*Matter of Viking Pump, Inc.*, 27 NY3d 244, 257

[4] We granted Bear Stearns’ motion for leave as against National Union Fire Insurance Company of Pittsburgh, Pa., Liberty Mutual Insurance Company, Certain Underwriters at Lloyd’s London, and American Alternative Insurance Corporation. Bear Stearns’ motion for leave as against the remaining insurers was dismissed on the ground that the order sought to be appealed from did not finally determine the action as against those insurers. Nevertheless, all of the Insurers have submitted briefing and arguments to this Court.

[2016], quoting *J.P. Morgan Sec. Inc.*, 21 NY3d at 334 [internal quotation marks omitted]). In determining a coverage dispute, we look to the specific language used in the relevant policies (*see Jin Ming Chen v Insurance Co. of the State of Pa.*, 36 NY3d 133, 138 [2020]; *Roman Catholic Diocese of Brooklyn v National Union Fire Ins. Co. of Pittsburgh, Pa.*, 21 NY3d 139, 148 [2013]), which "must be interpreted according to common speech and consistent with the reasonable expectation of the average insured" at the time of contracting, with any ambiguities construed against the insurer and in favor of the insured (*Dean v Tower Ins. Co. of N.Y.*, 19 NY3d 704, 708 [2012] [internal quotation marks and citation omitted]; *see Lend Lease [US] Constr. LMB Inc. v Zurich Am. Ins. Co.*, 28 NY3d 675, 682 [2017]; *Evans v Famous Music Corp.*, 1 NY3d 452, 458 [2004]).

While an insured must establish coverage in the first instance, the insurer bears the burden of proving that an exclusion applies to defeat coverage (*see Consolidated Edison Co. of N.Y. v Allstate Ins. Co.*, 98 NY2d 208, 218 [2002]). "Indeed, before an insurance company is permitted to avoid policy coverage, it must satisfy the burden . . . of establishing that the exclusions or exemptions apply in the particular case, and that they are subject to no other reasonable interpretation" (*Seaboard Sur. Co. v Gillette Co.*, 64 NY2d 304, 311 [1984] [citations omitted]; *see Cragg v Allstate Indem. Corp.*, 17 NY3d 118, 122 [2011]). This standard may be implicated even when an insurer relies on "limiting language in the definition of coverage" instead of "language in the exclusions sections of the policy" because, in some circumstances, that limiting language functions as an exclusion (*Planet Ins. Co. v Bright Bay Classic Vehs.*, 75 NY2d 394, 400 [1990]).

This dispute turns on the proper interpretation of various components of the coverage provision, particularly the definition of "loss." Under the relevant policies, the Insurers agreed to pay all "loss" which Bear Stearns became legally obligated to pay as the result of any claim—defined as including any civil proceeding or governmental investigation—for any wrongful act, which encompassed any actual or alleged act, error, omission, misstatement, neglect, or breach of duty by Bear Stearns and its employees while providing services as a securities broker and dealer. The policies defined "loss" to include compensatory damages, punitive damages where insurable by law, multiplied damages, judgments, settlements, costs, and expenses resulting from any claim and, further, "loss" expressly encompassed "costs, charges and expenses or other damages incurred in connection with any investigation by any governmental body." However, an exception in the definition of "loss" provided that "loss" shall not include "fines or penalties imposed by law." This language is at the core of this appeal.

Here, although the policy limitation on the definition of "loss" as exempting "penalties imposed by law" is contained in the coverage section, the carve out excepting certain "penalties" from coverage amounts to an exclusion because, absent that language, the definition of loss would otherwise encompass such payments (*see Planet Ins. Co.*, 75 NY2d at 400). Thus, the question is whether the Insurers demonstrated that a reasonable insured purchasing this wrongful act policy in 2000 would have understood the phrase "penalties imposed by law" to preclude coverage for the $140 million SEC disgorgement payment. The Insurers have not met this burden.

The phrase “penalties imposed by law” is not defined in the insurance policies. However, the term “penalty”—the focus of the parties’ arguments here—is commonly understood to reference a monetary sanction designed to address a public wrong that is sought for purposes of deterrence and punishment rather than to compensate injured parties for their loss. We have explained that, in the context of statutory penalties, “the word penalty . . . does not apply to actual damages” but, rather, exacts sums from a wrongdoer that “exceed the injured party’s actual damages” (*Borden v 400 E. 55th St. Assoc., L.P.*, 24 NY3d 382, 396 [2014] [internal quotation marks and citations omitted]). This view is consistent with dictionary definitions in effect around the time the policies were issued, describing a “penalty” as a monetary punishment “distinguished from compensation for the injured party’s loss” and determined “without reference to any actual damages suffered” (Black’s Law Dictionary [8th ed 2004], penalty]). Still today, a penalty is often characterized as a monetary “recovery without reference or regard to the actual damage sustained” that “is not designed to compensate anyone” (36 Am Jur 2d, Forfeitures and Penalties § 2; *see* 60 NY Jur 2d, Forfeitures and Penalties § 124). This is in accord with our longstanding view, in the liquidated damages context, that a contractual provision imposes an unenforceable “penalty” when it requires, in the event of a breach, the payment of a sum that is grossly disproportionate to any reasonable estimate of actual damages (*see Truck Rent-A-Ctr. v Puritan Farms 2nd*, 41 NY2d 420, 424 [1977]). In other words, a penalty is distinct from a compensatory remedy and a penalty is not measured by the losses caused by the wrongdoing.

Before the insurance contracts were issued here, we had determined that, where a sanction has both compensatory and punitive components, it should not be characterized as punitive in the context of interpreting insurance policies. In *Zurich Ins. Co. v Shearson Lehman Hutton*, the insurer asserted it had no duty to indemnify its insured for punitive damages awarded in two out-of-state actions because, in New York, public policy precludes indemnification for punitive damages (*see* 84 NY2d 309, 312-313 [1994]). We explained "that the purpose of punitive damages is solely to punish the offender and to deter similar conduct" and "not . . . to compensate or reimburse" an injured party (*id.* at 316). Addressing one of the awards in that case, we held that the insurer was obligated to provide coverage because, under the applicable out-of-state law, the jury could have awarded the damages in question for either deterrence purposes or as additional compensation for the plaintiff's injury and, thus, the damages award was not solely punitive so as to preclude indemnification (*see id.* at 316-317). *Zurich* did not directly address the meaning of the term "penalty." Our analysis nonetheless indicates that a reasonable insured purchasing a wrongful act policy would expect an award or settlement payment that has compensatory purposes and is measured by an injured party's losses and third-party gains to fall within its coverage grant and, concomitantly, not be deemed a penalty.[5]

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[5] Contrary to the dissent's contention, our interpretation of *Zurich* does not conflict with *Sperry v Crompton Corp.* (8 NY3d 204 [2007]). In *Sperry*, we held that a statutory damages provision authorizing a successful antitrust plaintiff to recover three times the actual damages sustained constituted a penalty such that a class action for a treble damages award was not permitted under CPLR 901 (*see Sperry*, 8 NY3d at 209). The dissent here overlooks that, in *Sperry*, we were not interpreting the term "penalty" in an insurance policy where it must be given a narrow interpretation in accordance with the principles governing insurance contracts (*see Seaboard Sur. Co.*, 64 NY2d at 311). Moreover, we

Simply stated, under relevant New York law, penalties have consistently been distinguished from compensatory remedies, damages, and payments otherwise measured through the harm caused by wrongdoing. Thus, at the time the parties contracted, a reasonable insured would likewise have understood the term "penalty" to refer to non-compensatory, purely punitive monetary sanctions. In this case, the question therefore distills to whether the disputed $140 million settlement payment meets that standard.

In that regard, although the Insurers argue otherwise, Bear Stearns demonstrated the absence of any material question of fact as to what the $140 million payment represented. Bear Stearns submitted evidence regarding its communications with the SEC throughout the negotiation process indicating that, at the direction of the SEC, Bear Stearns undertook various valuations of its customers' gains and the corresponding injury suffered by investors[6] as a consequence of the challenged trading practices. In particular, the correspondence—taken together with other corroborating testimonial and documentary evidence—supported its contention that, after negotiations regarding the appropriate valuation method, Bear Stearns estimated third party gains to approximate $140 million

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subsequently clarified in *Borden* that the "penalty" component of a statutory treble damages sanction is only that part which exceeds actual damages (24 NY3d at 396-397). Thus, the dissent's assertion that a treble damages award necessarily constitutes a penalty in its entirety under *Sperry* is inaccurate.

[6] Along with evidence indicating that data evincing client gain was used to determine the resulting losses incurred by the harmed investors, Bear Stearns' expert report explaining the methodologies used in the underlying SEC negotiations asserted that the SEC viewed "the gain" earned through market timing and late trading as "the same amount as the loss to the other mutual fund shareholders" inasmuch as the timing practices "achiev[ed] gains at the expense of long term shareholders by 'diluting' the value of their shares."

and Bear Stearns ultimately agreed with the SEC to incorporate that amount into the settlement as representative of client gains and the concomitant investor losses.[7] Thus, Bear Stearns demonstrated that the $140 million disgorgement payment was calculated based on wrongfully obtained profits as a measure of the harm or damages caused by the alleged wrongdoing that Bear Stearns was accused of facilitating. This can be contrasted with the $90 million payment denominated a "penalty," which was not derived from any estimate of harm or gain flowing from the improper trading practices.

In opposition, the Insurers failed to submit any evidence rebutting this proof. Contrary to the dissent's suggestion, that the SEC originally sought a higher sanction and negotiated with Bear Stearns to accept the settlement figures proffered as representative of third-party gains/injured investor losses ($140 million) and Bear Stearns' own revenues (approximately $20 million) supports, rather than contradicts, Bear Stearns' proof regarding the nature of the disgorgement payment. Moreover, the SEC's press release—referencing a settlement that required Bear Stearns to disgorge its own gains—cannot be said to raise a material question of fact as to whether the entire disgorgement payment constituted Bear Stearns' gains where, as here, it is conceded that Bear Stearns did, in fact, disgorge its own revenue—approximately $20 million—as part of the settlement, as reflected in the press release.

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[7] The Insurers' contention that Bear Stearns' evidence should have been disregarded as inadmissible hearsay lacks merit. The evidence of the SEC negotiations was admitted, not for its truth—i.e., to prove that actual amount of loss or gain—but, rather, to show the intent underlying the settlement agreement (*see generally People v Salko*, 47 NY2d 230, 239 [1979]).

Further, the $140 million payment served a compensatory goal. While the settlement directs that both the disgorgement payment and the monetary penalty be placed in a fund to compensate the injured parties, Bear Stearns was required to treat the $90 million penalty, but not the disgorgement, as a penalty for tax purposes. In addition, although the $90 million civil penalty funds were ineligible to be used to offset a private claim against Bear Stearns, the same was not true of the disgorgement payment.[8] To be sure, neither the label assigned to the payment by the SEC and Bear Stearns, nor the mere fact that injured parties may ultimately receive the funds, is dispositive (*see generally Zurich Ins. Co.*, 84 NY2d at 317). But, in determining whether Bear Stearns' "disgorgement" of client gains was a "penalty" within the meaning of the insurance policies, such factors must be taken together with the fact that the payment effectively constituted a measure of the investors' losses. Inasmuch as it was derived from estimates of the ill-gotten gains and harm flowing from the improper trading practices, and was intended—at least in part—to compensate those injured by the wrongdoing allegedly facilitated by Bear Stearns, the $140 million disgorgement payment could not fairly have been understood as a "penalty" in the context of this wrongful act professional liability insurance policy (*see Zurich*, 84 NY2d at 316-317).[9]

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[8] Documentation relating to the negotiations between Bear Stearns and the SEC also indicates that it was contemplated that Bear Stearns would not seek insurance coverage for the civil penalty, presumably to prevent Bear Stearns from avoiding that aspect of the settlement that was designed purely to punish Bear Stearns' wrongdoing.

[9] Our reliance on *Zurich*—decided just a few years before these insurance contracts were entered and addressing insurance coverage where a payment may constitute both compensation for injured parties and a punishment or deterrent for the wrongdoer—is far

Indeed, in considering the expectations of a reasonable insured purchasing this type of policy, we are mindful that the policies in question were purchased to cover liability arising from "wrongful acts" relating to Bear Stearns' business as a securities broker and dealer subject to regulatory oversight by the SEC, and the policies expressly covered settlements and other sums related to investigations by a governmental regulator. At the relevant time, the SEC's primary enforcement remedies were injunctive relief, disgorgement, and monetary penalties. While, in New York, the term "disgorgement" typically refers only to "the return of wrongfully obtained profits" (*People v Greenberg*, 27 NY3d 490, 497 [2016] [internal quotation marks and citation omitted]), when the parties entered these insurance contracts, the SEC believed it had the power—as an equitable remedy—to require an entity that facilitated wrongdoing to "disgorge" profits wrongfully obtained by third parties and courts authorized that remedy (*see SEC v Contorinis*, 743 F3d 296, 304 [2d Cir 2014]; *SEC v Warde*, 151 F3d 42, 49 [2d Cir 1998]; *SEC v Clark*, 915 F2d 439, 454 [9th Cir 1990]). The dissent makes much of the fact that the SEC lacked authority to seek compensatory relief and that compensation of injured parties is only a

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more apt than the dissent's reliance on cases addressing discrete questions of whether certain statutes imposing liability for corporate debts on officers of corporations imposed "penalties" for purposes of statutes of limitation and the court's jurisdiction (*see Merchants' Bank v Bliss*, 35 NY 412, 416 [1866]; *Bird v Hayden*, 2 Abb Pr NS 61, 65-66, 1 Robt 383 [Super Ct 1863]; *see also Dabney v Stevens*, 40 How Pr 341, 2 Sweeny 415 [Super Ct 1870], *mod sub nom. Dabney v Stephens*, 46 NY 681 [1871]). Such cases neither stand for the general proposition that joint and several liability or disgorgement of third-party gains constitutes a "penalty," nor involved interpretation of insurance contracts. Thus, these cases do not answer the question presented here—whether a disgorgement payment derived from estimates of harm and which has some compensatory aims is a "penalty" within the meaning of an insurance policy exclusion.

secondary goal, not the primary purpose, of disgorgement (*see SEC v Fischbach Corp.*, 133 F3d 170, 175 [2d Cir 1997]). However, under the regulatory climate in effect at the time these insurers agreed to provide coverage for losses arising from governmental investigations, disgorgement payments—including some comparable to the one at issue here—were nevertheless viewed by the SEC, the primary regulator of securities broker-dealers, as an equitable remedy and not a monetary penalty (*see e.g. SEC v Lorin*, 869 F Supp 1117, 1122 [SD NY 1994]; *see also SEC v Warde*, 151 F3d at 49). Were we to now conclude that payments of that nature constitute an excluded penalty, indemnity for loss arising from otherwise covered governmental investigations would be substantially curtailed in a manner arguably inconsistent with an average insured's reasonable expectations.

For all of these reasons, we are unpersuaded by the Insurers' argument, credited by the Appellate Division, that the $140 million SEC-ordered disgorgement must be considered a penalty within the meaning of the policies as a result of the 2017 United States Supreme Court decision in *Kokesh v SEC* (581 US at ___, 137 S Ct at 1639). There, rejecting the SEC's position that there was no applicable statute of limitations for SEC actions seeking disgorgement, the Supreme Court held, as a matter of statutory interpretation, that the five-year limitations period for actions to enforce a "penalty" (28 USC § 2462) encompassed "disgorgement" claims (*see Kokesh*, 581 US at ___, 137 S Ct at 1639). In reaching that conclusion, the Supreme Court determined that SEC-ordered disgorgement is a "penalty" because it is imposed to vindicate a public, rather than a private, wrong and is used to deter future wrongdoing even though it may have compensatory purposes (*see id.* at ___, 137 S Ct at 1643).

The Insurers argue that a payment requiring Bear Stearns to disgorge profits that it never actually received fits within the Supreme Court's characterization of a penalty. But, *Kokesh* does not control here. Initially, the Supreme Court was not interpreting the term "penalty" in an insurance contract (much less one governed by New York law) and, as we have cautioned, the meaning of that term may vary based on context (*see Sperry*, 8 NY3d at 213). Indeed, the Supreme Court has since clarified that SEC-ordered disgorgement is not always properly characterized as a penalty insofar as the SEC may seek "disgorgement" of a defendant's net gain for compensatory purposes as "equitable relief" in civil actions (*see Liu v SE*C, ___ US ___, 140 S Ct 1936, 1940 [2020]).[10] Moreover, *Kokesh*—decided nearly two decades after the parties executed the relevant insurance contracts—could not have informed the parties' understanding of the meaning of the term "penalty."[11] Thus, *Kokesh* does not mandate that the $140 million disgorgement payment be considered a "penalty imposed by law" under the insurance policies at issue here. To the contrary, *Kokesh* and *Liu* demonstrate that whether SEC disgorgement is a penalty for various federal purposes has been a matter of much debate and confusion. While the dissent posits that *Kokesh* merely applied well-settled law to conclude that disgorgement is a penalty, this is

[10] *Liu* suggests, but does not definitively hold, that SEC "disgorgement" that exceeds a party's net profits and is not distributed to injured investors may transform the "disgorgement" into a punitive sanction beyond the SEC's then-existing equity powers.

[11] Indeed, it is telling that the Insurers did not emphasize the argument that the $140 million represented a penalty under the policy until after *Kokesh* was decided.

belied by the Supreme Court's grant of certiorari in that case specifically to resolve disagreement among the Circuit Courts over whether disgorgement claims in SEC proceedings constitute a "penalty" for statute of limitations purposes.

Under longstanding principles of insurance contract interpretation, these policies must be construed in a manner consistent with the expectations of a reasonable insured at the time of contracting, with the "penalty" exclusion given a "strict and narrow construction" (*Seaboard Sur. Co.*, 64 NY2d at 311). Although we do not condone the conduct alleged in the underlying investigation,[12] applying that standard and our precedent concerning the meaning of "penalty," the Insurers failed to establish that the $140 million "disgorgement" payment—a component of the SEC settlement that serves compensatory purposes and was measured by the profits wrongfully obtained and losses caused by the alleged wrongdoing—clearly and unambiguously falls within the policy exclusion for "penalties imposed by law." Therefore, the Appellate Division erred in granting summary judgment to the Insurers on that basis.

The parties raise additional arguments that were not reached by the Appellate Division due to its resolution of the penalty issue, including additional defenses to coverage proffered by the Insurers as alternative grounds for affirmance. Under the circumstances presented here, "the preferable, more prudent corrective action is remittal" to permit the Appellate Division to address those issues in the first instance (*Schiavone v City of New*

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[12] The dissent's suggestion that our holding undermines the SEC's ability to deter future violations of securities laws ignores that the SEC agreed to settle the investigation and, had it so chosen, the SEC could have negotiated a greater civil monetary penalty rather than, or in addition to, pursuing disgorgement.

York, 92 NY2d 308, 317 [1998]; *see Salinas v World Houseware Producing Co., Ltd.*, 34 NY3d 925, 926 [2019]).

Accordingly, the judgment insofar as appealed from and so much of the Appellate Division order brought up for review should be reversed, with costs, and the case remitted to the Appellate Division for further proceedings in accordance with the opinion herein.

RIVERA, J. (dissenting):

The Securities and Exchange Commission ordered Bear Stearns to pay millions of dollars in sanctions for violations of federal securities laws and regulations. Appellants claim that they are entitled to indemnification from respondent insurers for the portion paid as disgorgement because that category of sanction constitutes an insurable loss under the relevant insurance policy language. The claim is wholly without merit, as the sanction paid by way of disgorgement here is a nonrecoverable penalty. As long recognized by courts and the SEC, the primary purpose of disgorgement is to deter wrongdoing, by depriving the wrongdoer of fraudulently obtained profits—their own or those of another party—and thus punish the wrongdoer.

The majority erroneously concludes that the disgorgement amount constitutes the SEC's estimate of harm, which it demanded to compensate victims and, therefore, cannot be a penalty imposed on Bear Stearns (majority op at 12-13). This analysis is belied by the record below, which makes clear that SEC disgorgement of ill-gotten gains is not a compensatory form of relief authorized by federal securities law and that the SEC's primary goal here was to prosecute Bear Stearns for a public wrong, not to make unknown shareholder victims whole. The majority's conclusion that the disgorged funds are recoverable from the insurers is contrary to the insurance policy language and undermines both federal regulation of illegal conduct in the securities market and the SEC's efforts to discourage future violations. I dissent.

I.

THE SEC INVESTIGATION OF FEDERAL SECURITIES VIOLATIONS BY BEAR STEARNS AND ITS HEDGE FUND CLIENTS

After an extensive investigation into mutual fund trading abuses, the SEC found that Bear Stearns, through its own acts and those of its subsidiary, willfully violated federal securities laws and regulations by facilitating fraudulent market trading practices by its hedge fund customers.[1] The SEC found that Bear Stearns and the hedge funds made millions in profits through this fraud. In accordance with a negotiated settlement between the SEC and Bear Stearns, the SEC issued an Order in 2006, "deeming it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to the [federal securities laws] against [Bear Stearns]."

According to the SEC's factual findings contained in the Order, from 1999 to 2003 Bear Stearns "facilitated illegal mutual fund trading by knowingly processing large numbers of late trades. . . and by helping market timing hedge funds evade detection by mutual funds that did not want market timing business." Bear Stearns's "conduct benefitted their customers . . . by enabling those customers to generate hundreds of millions of dollars in profits from these trading tactics at the expense of mutual fund shareholders." Bear Sterns neither admitted nor denied these findings.

The Order, imposed extensive "remedial undertakings to improve [Bear Stearns's] compliance structure." Specifically, Bear Stearns was required to: (1) "cooperate with the [SEC] in any and all investigations, litigations or other proceedings relating to or arising from the matters" described in the Order; (2) retain and reimburse independent compliance consultants and institute their recommended changes to Bear Stearns's policies and practices; (3) train and educate directors, officers, and employees to minimize possible

[1] The investigation was against Bear, Stearns & Co., Inc. and its subsidiary Bear, Stearns Securities Corp. For ease of reference, I refer to both entities as "Bear Stearns."

future violations of securities laws and rules; (4) maintain and implement a compliance and oversight infrastructure, as described in the Order; (5) establish a compliance hotline and appoint a compliance officer to respond to employee complaints and inquiries regarding business practices and ethical issues; and (6) preserve records of compliance with the Order for six years. By way of sanctions, the SEC censured Bear Stearns, mandated that it cease-and-desist from all current and future violations of the securities laws and rules, and imposed $250 million in sanctions—$160 million in disgorgement and $90 million in civil penalties.[2]

According to the SEC press release announcing the settlement and Order,

> "For years, Bear Stearns helped favored hedge fund customers evade the systems and rules designed to protect long-term mutual fund investors from the harm of market timing and late trading. As a result, market timers profited while long term investors lost. This settlement will not only deprive Bear Stearns of the gains it reaped by its conduct, but also require Bear Stearns to put in place procedures to prevent similar 'misconduct from recurring'" (Press Release, SEC, SEC Settles Fraud Charges with Bear Stearns for Late Trading and Market Timing Violations: Firm To Pay $250 Million in Disgorgement and Penalties [Mar. 16, 2006], available at https://www.sec.gov/news/press/2006-38.htm).

Bear Stearns was "the hub that connected the many spokes of market timing and late trading—hedge funds, brokers and the mutual funds" (*id.*). As the SEC described, "two roles played by Bear Stearns that were fundamental to mutual fund trading abuses" were

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[2] According to respondents, the New York Stock Exchange initiated an investigation that led to similar findings, censure of Bear Stearns, and a $250 million sanction, which the NYSE deemed satisfied by the payment of the SEC settlement.

that "Bear Stearns made it easier for the hedge funds and the brokers to engage in market timing, and harder for the mutual funds to detect and stop it" (*id.*).

The SEC also settled with several of Bear Stearns's hedge fund customers, owners, and managers, entering similar orders, both before and after the settlement with Bear Stearns. These orders imposed a total of $313,601,430.60 in disgorgement; $8,091,030.22 in prejudgment interest, and $61,675,000 in penalties.[3] The SEC publicly described the first of these settlements as

[3] The settlements imposed the following monetary sanctions: Millennium Partners, LP and its feeder funds were required to pay $121.4 million in disgorgement; Millennium Management, LLC, and Millennium International Management were required to pay, jointly and severally, $26.6 million in disgorgement; the managing member of Millennium Management and of Millennium International Management and the largest beneficial owner in Millennium Partners was required to pay $1 in disgorgement and a $30 million penalty; the Chief Operating Officer and Vice Chair of the Millennium entities was required to pay $1 dollar in disgorgement and a $2 million penalty; Millennium's General Counsel was required to pay $1 in disgorgement and a $25,000 penalty; a trader at Millennium associated with both Millennium Management and Millennium International Management was required to pay $1 in disgorgement and a $150,000 penalty; Veras Capital Master Fund, VEY Partners Master Fund, Veras Investment Partners (VIP), LLC, two owners and managing members of VIP were required to pay, jointly and severally, $35,554,903 in disgorgement and $645,585 in prejudgment interest, and both owners were each required to pay a $750,000 penalty; Ritchie Capital Management, LLC, and Ritchie Multi-Strategy Global Trading, Ltd. were required to pay, jointly and severally, $30 million in disgorgement and $7,441,966.82 in prejudgment interest; Ritchie Capital Management, LLC, and its Chief Executive Officer, jointly and severally were required to pay a $2.5 million penalty and the CEO was also required to pay $1 in disgorgement; the person in charge of oversight and supervision of mutual fund trading at Richie Capital was required to pay $1 in disgorgement and a $250,000 penalty; and CIHI and World Markets were required to pay, jointly and severally, $100 million disgorgement and prejudgment interest and a $25 million penalty.

In addition, the SEC settled with brokerage firms Kaplan & Co. and Brean Murray & Co., Inc. Kaplan & Co. and its CEO were required to pay, jointly and severally, $46,521.60 in

> "demonstrat[ing]) the [SEC]'s commitment to prosecute vigorously all the wrongdoers involved in fraudulent market timing practices, not just mutual fund managers and broker-dealers, but also the hedge funds and other entities that profited so handsomely from the fraud" (Press Release, SEC, SEC Charges Millennium Partners, L.P., Israel Englander, and Others for Engaging in Fraudulent Market Timing Scheme: Respondents to Pay over $180 Million in Disgorgement and Penalties [Dec 1, 2005], available at https://www.sec.gov/news/press/2005-170.htm).

In addition to structural changes to their business practices ordered by the SEC,[4] the settlement imposed over $180 million in disgorgement and penalties on the various parties. As emphasized by the SEC,

> "[t]he substantial disgorgement and civil penalties imposed on the respondents underscore how seriously the [SEC] views hedge funds' roles in deceptive market timing schemes and demonstrate to the investing public that beneficiaries of market timing fraud will not be permitted to retain their ill-gotten gains" (*id.*).[5]

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disgorgement and $3,487,40 in prejudgment interest, and each was also required to pay a $50,000 penalty. Brean Murray & Co., Inc. was required to pay a $150,000 penalty.

[4] For example, the SEC prohibited certain named high-level officials from "serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter for a period of three years" (*id.*).

[5] *See also* Press Release, SEC, SEC Charges Veras Capital Master Fund, VEY Partners Master Fund, Veras Investment Partners, LLC, Kevin D. Larson, and James R. McBride in Fraudulent Market Timing and Late Trading Scheme: Respondents to Pay over $35 Million in Disgorgement [Dec 22, 2005], available at https://www.sec.gov/news/press/2005-182.htm; Press Release, SEC, SEC Charges Ritchie Capital Management, CEO and Other Employees for Illegal Late Trading Scheme: Chicago-Area Hedge Fund Adviser to Pay $40 Million in Settlement [Feb 5, 2008], available at https://www.sec.gov/news/press/2008/2008-10.htm).

In total, Bear Stearns and its customers paid over half a billion dollars in monetary sanctions to settle and end the SEC investigation into their market trading practices.

II.

APPELLANTS' INDEMNIFICATION CLAIMS

Appellants initiated the underlying action against respondent insurers for indemnification of $140 million of the disgorgement funds paid by Bear Sterns in satisfaction of the SEC Order. Appellants maintain that these monies are a covered loss insured by respondents. The relevant policy language states that respondents would reimburse losses that the insured Bear Stearns "shall become legally obligated to pay as a result of any Claim or Claims first made against the Insured" for its "Wrongful Act."[6] A recoverable loss includes "compensatory damages, multiplied damages, punitive damages where insurable by law, judgments, settlements[,]. . . costs, charges and expenses or other damages incurred in connection with any investigation by any governmental body or self-regulatory organization" but does not include "fines or penalties imposed by law."

The question on this appeal distills to whether the disgorgement sanction in the SEC Order is a penalty within the meaning of the policy language, as respondents argue, or compensatory relief, as appellants claim and the majority concludes. The majority is correct that the insurance policy language must be interpreted in accordance with the law of contract. Thus, "[a]nalysis of the claims in this action begins with the basic principle

[6] In turn, "Wrongful Act" is defined as "any actual or alleged act, error, omission, misstatement, misleading statement, neglect or breach of duty by" the insured.

that insurance contracts, like other agreements, will ordinarily be enforced as written" (*J.P. Morgan Sec. Inc. v Vigilant Ins. Co.*, 21 NY3d 324, 334 [2013]). Under that principle, "unambiguous provisions of an insurance contract must be given their plain and ordinary meaning, and the interpretation of such provisions is a question of law for the court" (*Vigilant Ins. Co. v Bear Stearns Cos., Inc*., 10 NY3d 170, 177 [2008] [internal quotation marks omitted], quoting *White v Continental Cas. Co.*, 9 NY3d 264, 267 [2007]). "Freedom of contract prevails in an arm's length transaction between sophisticated parties such as these, and in the absence of countervailing public policy concerns there is no reason to relieve them of the consequences of their bargain" (*Oppenheimer & Co. v Oppenheim, Appel, Dixon & Co*., 86 NY2d 685, 740 [1995]).

The policy clearly applies to losses incurred in connection with the SEC investigation, which was an action undertaken by a government regulatory entity that oversees compliance with federal securities laws and regulations. The policy signatories are sophisticated parties who, we must assume, understood both the law and the SEC's enforcement authority at the time they entered into their contracts. Thus, resolution of the interpretive question here requires an understanding of the SEC's authority to seek disgorgement for securities violations when the parties agreed to the policy language providing that penalties were not recoverable.

III.

SEC ENFORCEMENT AUTHORITY AND DISGORGEMENT AS A TOOL TO DETER WRONGDOING

As a creature of Congress, the SEC only has those powers granted by legislation (*see Louisiana Pub. Serv. Comm'n v. FCC,* 476 US 355, 374 [1986]). Although the SEC has always had injunctive authority (15 USC §78a et seq), it has no authority to seek compensatory damages and it was not until the 1990s that Congress expressly granted the SEC the power to seek disgorgement and civil penalties (*see e.g.* 15 USC § 77h–1 [e] adopted in Pub L 101–429, 104 Stat 931 [101 Cong, 2d Sess, Oct. 15, 1990] ["In any cease-and-desist proceeding under subsection (a), the Commission may enter an order requiring accounting and disgorgement"]; 15 USC § 77t [d], adopted in Pub L 101–429, 104 Stat 931 [101 Cong, 2d Sess, Oct. 15, 1990] ["Whenever it shall appear to the Commission that any person has violated any provision . . . the (SEC) may bring an action in a United States district court to seek . . . a civil penalty to be paid by the person who committed such violation"]; *see also Kokesh v SEC,* 581 US —, —, 137 S Ct 1635, 1640 [2017]). Thus, when the insurance policies were signed, the SEC could not demand compensatory relief but regularly sought—and the courts granted—disgorgement of a wrongdoer's ill-gotten gains as a tool to deter securities violations.

Federal courts have long understood that "the primary purpose of disgorgement is not to compensate investors. Unlike damages, it is a method of forcing a defendant to give up the amount by which [they were] unjustly enriched" (*SEC v Commonwealth Chem. Sec.*, *Inc*., 574 F2d 90, 102 [2d Cir 1978]; *see also SEC v Texas Gulf Sulphur Co.,* 446 F2d 1301 [2d Cir 1971] ["Restitution of the profits on these transactions merely deprives the appellants of the gains of their wrongful conduct"]; John D. Ellsworth, *Disgorgement in Securities Fraud Actions Brought by the SEC*, 1977 Duke LJ 641, 641 & n 1; *SEC v Huffman,* 996 F2d 800, 802 [5th Cir 1993] [Disgorgement "is an equitable remedy meant to prevent the wrongdoer from enriching (themselves) by (their) wrongs. Disgorgement does not aim to compensate the victims of the wrongful acts, as restitution does. Thus, a disgorgement order might be for an amount more or less than that required to make the victims whole"] [citations omitted]; *SEC v First City Fin. Corp. Ltd.*, 890 F2d 1215, 1232 n 24 [DC Cir 1989] ["(I)n the context of an SEC enforcement suit, . . . deterrence is the key objective"]; *Official Comm. of Unsecured Creditory of WorldCom, Inc. v SEC* (467 F3d 73, 83 [2d Cir 2006] [Sotomayor, J.] ["(T)he SEC's purpose in seeking disgorgement of ill-gotten profits has always been deterrence, not the compensation of victims"]).

At the time Bear Stearns purchased its wrongful acts insurance coverage from respondents, it was further well-established that "(a)lthough disgorged funds may often go to compensate securities fraud victims for their loses, such compensation is a distinctly secondary goal" (*SEC v Fischbach Corp.*, 133 F3d 170, 175 [2d Cir 1997]). Indeed, "the measure of disgorgement need not be tied to the losses suffered by defrauded investors" (*id.*).[7] As early as 1987, the United States Supreme Court, in another government

[7] Black's Law Dictionary similarly defined disgorgement as "[t]he act of giving up something (such as profits illegally obtained) on demand or by legal compulsion" (Black's Law Dictionary [7th ed 1999]), without mention of compensation to victims.

enforcement action context, had referred to disgorgement as a “limited form of penalty” (*Tull v United States*, 481 US 412, 424 [1987]).[8]

Shortly before the SEC commenced its investigations into Bear Stearns, Congress passed the Sarbanes-Oxley Act of 2002, which codified, in part, the existing judicial practice of placing civil penalties and disgorgement into a fund.[9] However, those funds might never be distributed. Instead, they will be added to the Federal Treasury when victims cannot be identified or, as provided by SEC rules,

> “[w]hen, in the opinion of the [SEC] or the hearing officer, the cost of administering a plan of disgorgement relative to the value of the available disgorgement funds and the number of potential claimants would not justify distribution of the disgorgement funds to injured investors, the plan may provide that the disgorgement funds and any civil penalty shall be paid directly to the general fund of the United States Treasury” (17 CFR § 201.1102 [b]).

[8] Contrary to the majority’s suggestion (majority op at 15), the fact that the SEC has interpreted its authority as encompassing the power to seek third-party disgorgement in no way alters that the SEC has always understood the primary purpose of this remedy is punishment.

[9] The Act provides that “[i]f, in any judicial or administrative action brought by the [SEC] under the securities laws, the [SEC] obtains a civil penalty against any person for a violation of such laws, or such person agrees, in settlement of any such action, to such civil penalty, the amount of such civil penalty shall, on the motion or at the direction of the [SEC], be added to and become part of a disgorgement fund or other fund established for the benefit of the victims of such violation” (15 USC § 7246 [a]).

Unsurprisingly, given the statutory framework and judicial holdings, the SEC has, on numerous occasions, represented in court that disgorgement is not compensatory.[10] As the SEC has consistently explained,

> "the fact that disgorged funds generally are used to compensate investors does not mean that restitution for investors is the purpose of the remedy. That the purpose is to remove ill-gotten gains from wrongdoers, and deter future violations, is made clear by the fact that in those instances where the funds cannot be used to compensate investors, and the money reverts to the Treasury—a use which clearly is not restitutionary since the Treasury is not being restored money taken from it" (brief for appellant in *SEC v AMX Intl., Inc.* 7 F3d 71 [5th Cir 1993], available at 1992 WL 12127856, *13).

Therefore, the "purpose of disgorgement. . . is. . . not satisfying creditors or repaying investors," but "depriving wrongdoers of their ill-gotten gains" (brief for appellee in *SEC v Custable*, 796 F3d 653 [7th Cir 2015], available at 2015 WL 3383280, *24 [brackets and quotation marks omitted]). Specifically, and "[i]n contrast to the compensatory purpose of damages in private actions, i.e., compensation for the harm suffered by the plaintiff, the purpose of disgorgement in [SEC] actions is to prevent unjust enrichment and to deter

[10] When Congress imposed a five-year statute of limitations on the SEC's enforcement of civil penalties in 28 USC § 2462, the SEC took the position that disgorgement was not subject to this limitations period. Thus, the SEC relied on its authority to seek disgorgement outside the five-year period. For example, between 2013 and 2016, disgorgement payments jumped 25%, as against only a 9% increase in penalties (*compare* SEC, Select SEC and Market Data, Fiscal 2016, at 2, available at https://www.sec.gov/reportspubs/select-sec-and-marketdata/secstats2016.pdf [disgorgement of $2.809 billion and penalties of $1.273 billion] *with* SEC, Select SEC and Market Data, Fiscal 2013, at 2, available at https://www.sec.gov/reportspubs/selectsec-and-market-data/secstats2013.pdf [disgorgement of $2.257 billion and penalties of $1.167 billion]).

future violations" (brief for appellee in *SEC v Smyth*, 420 F3d 1225 [11th Cir 2005], available at 2004 WL 4802488, *41). In fact, the "loss sustained by the victims. . . is irrelevant to the calculation of disgorgement in an SEC enforcement action" (brief of appellee in *SEC v Smith*, 646 Fed Appx 42 [2d Cir 2016], available at 2015 WL 7185051, *32 [quotation marks omitted]). "Compensation to injured investors is a distinctly secondary goal" (brief of appellant in *Martin v SEC*, 734 F3d 169 [2d Cir 2013], available at 2012 WL 8126225, *4).

Notably, in a previous unrelated appeal between Bear Stearns and insurers Vigilant Insurance Company and Federal Insurance Company—two of the respondents here—the SEC filed an amicus brief with our Court vehemently opposing the same argument Bear Stearns asserts in the instant appeal, namely that disgorgement funds are the equivalent of compensatory damages (*see* brief for amicus curiae in *Vigilant Ins. Co.*, 10 NY3d 170, available at 2007 WL 5024287). The SEC emphasized that "compensatory damages [are] a form of relief that is not permitted in [SEC] actions under the federal securities law, rather than disgorgement of ill-gotten gains, which is a permitted form of relief" (*id.* at *1-2). "The purpose of disgorgement is to deprive wrongdoers of ill-gotten gains. Once funds are disgorged, there remains the separate issue of what to do with the money, and it is within the court's discretion to determine how and to whom the money will be distributed" (*id.* at *10-11 [quotations and citation omitted]). "Compensation of injured victims…does not transform the payment into compensatory damages" (*id.* at *11).[11] The same holds true here.

Bear Stearns's own expert—former SEC Chair and the originator and principal draftsperson of the distribution fund provision of the Sarbanes-Oxley Act, Harvey Pitt—acknowledged in his expert report in this case that

> "[t]he SEC's Enforcement Program is not designed to make injured investors whole, since the SEC was not intended, and lacks the resources, to become a 'collection agency.' Nor is the program designed solely to confiscate a securities violator's 'ill gotten' gains, although the program endeavors to prevent those who engage in misconduct from keeping any such 'ill gotten gains'—the classic, but by no means the sole, definition of 'disgorgement.' SEC enforcement actions also have a far broader purpose—namely, to discourage any person from 'facilitating' the violative conduct of others that is detrimental to the interests of investors and the integrity and fairness of this Country's capital markets."

He further expounded that,

> "[b]y achieving that broader purpose, the SEC fulfills its tri-partite mission—to protect investors; assure fair, orderly and efficient securities trading markets; and facilitate corporate capital formation. For that reason, the SEC has successfully pursued equitable remedies—like disgorgement—despite the absence of express authority to do so, virtually from its inception, at first in settled administrative actions, subsequently by invoking judicial equitable powers, and finally pursuant to express statutory authority. The SEC's theory has always been that persons and entities acting

[11] *Vigilant Ins. Co. v Bear Stearns Cos. Inc.* involved an insurance dispute in which Bear Stearns "breached a policy provision obligating it to obtain the consent of its liability carriers before settling claims in excess of $5 million" (*Vigilant Ins. Co.*, 10 NY3d at 174). In reaching this conclusion, the Court did not address the insurers' alternative argument "that the $25 million disgorgement payment was uncollectible either as a matter of public policy or under contract interpretive principles" (*id.* at 176).

> improperly should be subject to a variety of remedies and sanctions that will discourage them, as well as others similarly situated, from engaging in similar conduct" (*see also* SEC, *Report Pursuant to Section 308 (C) of the Sarbanes Oxley Act of 2002*, at 3 n 2 [2003] ["Restitution is intended to make investors whole, and disgorgement is meant to deprive the wrongdoer of their ill-gotten gain. Defendants in Commission enforcement actions, especially in issuer financial fraud and offering fraud cases, may cause investor losses that are larger than any profit disgorgeable by them"]).

As the Supreme Court reaffirmed in *Kokesh*, "[s]anctions imposed for the purpose of deterring infractions of public laws are inherently punitive because 'deterrence [is] not [a] legitimate nonpunitive governmental objectiv[e]'" (*Kokesh*, 137 S Ct at 1643, quoting *Bell v Wolfish*, 441 US 520, 539 n 20 [1979]). Moreover,

> "SEC disgorgement sometimes exceeds the profits gained as a result of the violation. Thus, for example, 'an insider trader may be ordered to disgorge not only the unlawful gains that accrue to the wrongdoer directly, but also the benefit that accrues to third parties whose gains can be attributed to the wrongdoer's conduct.' Individuals who illegally provide confidential trading information have been forced to disgorge profits gained by individuals who received and traded based on that information—even though they never received any profits. In such cases, disgorgement does not simply restore the status quo; it leaves the defendant worse off" (*id.*, 581 US at —, 137 S Ct at 1644 [citations omitted], quoting *SEC v Contorinis*, 743 F3d 296, 302 [2d Cir 2014], and citing *SEC v Warde*, 151 F3d 42, 49 [2d Cir 1998], and *SEC v Clark*, 915 F2d 439, 454 [9th Cir 1990]).

The majority erroneously discounts the significance of *Kokesh*. First, the majority reasons that *Kokesh* was decided after the parties executed the insurance contracts (majority op at 16-17).[12] This basis for ignoring Supreme Court precedent is easily dispensed with because the part of the *Kokesh* analysis that is relevant here relies on case law that predates the insurance policy in this case. Put another way, *Kokesh* resolved the open legal question of whether disgorgement was subject to the five-year statute of limitations applicable to SEC civil penalties by reliance on well-established, undisputed, case law that disgorgement inflicts punishment as a means to deter a public rather than a private harm to any individual (*Kokesh*, 581 US at —, 137 S Ct at 1642 ["A 'penalty' is a 'punishment, whether corporal or pecuniary, imposed and enforced by the State, for a crime or offen[s]e against its laws'" (alteration in original)], quoting *Huntington v Attrill*, 146 U.S. 657, 667 [1892]; *see also Brady v Daly*, 175 US 148 [1899]; *Meeker v Lehigh Valley R.R. Co.*, 236 US 412 [1915]). Thus, contrary to the majority view (majority op at 17), the Supreme Court's interpretation of the statute did not disturb prior judicial understanding of disgorgement as punishment. The majority's second reason for disregarding *Kokesh* is similarly unavailing. According to that part of the majority analysis, *Kokesh* must be

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[12] Although the majority appears to question the insurers argumentation here because they "did not emphasize the argument that the $140 million represents a penalty under the policy until after *Kokesh* was decided" (majority op at n 11) the Insurers have never taken a contrary position. Indeed, since at least 2013, the Insurers have challenged the very argument raised here. In *J.P. Morgan Sec. Inc.*, 21 NY3d 324, the Insurers maintained that "there is no basis for Bear Stearns' assertion that its disgorgement payment is somehow not disgorgement but more akin to compensatory damages because it did not reflect Bear Stearns' own gains, but rather the 'gains the SEC alleged were received by Bear Stearns customers'" (brief for respondent in *J.P. Morgan Sec. Inc.*, 21 NY3d 324). The Insurers cautioned that calling the disgorgment in this case compensatory could raise questions about whether the SEC is seeking relief that is outside its authority—the same concern that obviously motivated the prior SEC amicus filing in our Court (brief for amicus curiae in *Vigilant Ins. Co.*, 10 NY3d 170).

understood as limited to the statute of limitations question because in the subsequent case of *Liu v SEC* (591 US —, 140 S Ct 1936 [2020]), the Court clarified that in other contexts disgorgement could serve a compensatory purpose (majority op at 16-17). *Liu* held that it is within the SEC's authority to award equitable relief to seek disgorgement of less than the wrongdoer's profits, which are in turn awarded to victims (*id.*, 591 US at —, 140 S Ct at 1940). *Liu* did not turn on whether disgorgement is a penalty, and *Liu* did not backtrack from *Kokesh*. Instead, *Liu* decided the question left open by *Kokesh*—whether a court has equitable power to award disgorgement as a penalty in an SEC enforcement action (*see id.*, 591 US at —, 140 S Ct at 1941). The Court concluded that Congress did not authorize an equitable remedy in excess of a defendant's net profits from wrongdoing (*see id.*, 591 US at —, 140 S Ct 1946). But a decision on the scope of the SEC's equitable remedies and a court's authority to impose a disgorgement amount in excess of a wrongdoer's gains is not a rejection of the longstanding principle that disgorgement is a deterrent because it penalizes the wrongdoer.

Indeed, enforcement of disgorgement against Bear Stearns is not at issue here. The SEC instituted a civil proceeding against Bear Stearns under 15 USC § 77h-1 (e), which provides that the SEC can seek disgorgement in a cease-and-desist proceeding under subsection (a) of that section. The SEC accepted Bear Stearns's offer of settlement, and Bear Stearns consented to the SEC Order requiring disgorgement. Unlike the petitioners in *Liu*, Bear Stearns did not challenge the SEC's authority to seek disgorgement in court, and for good reason since Bear Stearns argues before us that the disgorgement amount reflects exactly the amount it proposed in settlement negotiations with the SEC. Rather than controvert the SEC's authority to seek the amount it offered, Bear Stearns paid the entire sanction only to now demand indemnification of the $140 million portion of the total disgorgement sum.

The majority accepts appellants' claim that the $140 million in disgorged funds represents not Bear Stearns's own ill-gotten profits but those of its customers (majority op at 11-12). It is true that, at times, the SEC has required a wrongdoer to disgorge third-party ill-gotten gains, even if the wrongdoer "ultimately. . . lost" money (*SEC v First Pac. Bancorp*, 142 F3d 1186, 1192 & n 6 [9th Cir 1998]). Even if that were the case here—and for reasons I discuss in section IV infra, Bear Stearns failed to establish this fact—it would provide an even stronger basis for concluding that disgorgement is a penalty under the policy language. The inherently punitive character of having one wrongdoer pay for the illicit gains of another wrongdoer, maximizes the deterrent effect of disgorgement by increasing the economic disincentive for future wrongdoing. As the Supreme Court has recognized, in these situations, unlike disgorgement of one's own profits, third-party profit "disgorgement does not simply restore the status quo; it leaves the defendant worse off" (*Kokesh*, 581 US at —, 137 S Ct at 1645).

IV.

THE DISGORGED FUNDS ARE A PENALTY UNDER NEW YORK LAW

As discussed (*see* section III, *supra*), under federal law at the time the parties signed their contract, disgorgement would not have been understood as a compensatory payment.

Rather, the law at the time made clear that disgorgement was a penalty that served the primary purpose to discourage federal securities violations. However, even if the majority were correct that the meaning of "penalty" turns solely on New York law, the result would be the same.

Our Court has recognized that punishment for violations of public laws and deterrence of such behavior are "the traditional purposes of penalties" (*Sperry v Crompton Corp.*, 8 NY3d 204, 214 [2007]). And, at the time Bear Stearns signed the insurance policies, it was well established in our caselaw that the underlying purpose of the action determines the nature of the relief sought. For example, in *Sicolo v Prudential Savings Bank of Brooklyn, N.Y.* (5 NY2d 254, 258 [1959]), this Court considered whether the plaintiff's complaint seeking monetary relief under the General Municipal Law for injury suffered while working as a New York City firefighter was an action for a penalty. The Court concluded it was not because "it is the essential nature of the action that counts" and the General Municipal Law action "is essentially one for compensation to a person injured for a defendant's fault" (*id.* at 258). As the Court explained, "the true test" applied by New York courts is whether the exactions are "impressed for punishment or redress of injury to an individual" (*id.*).

As for disgorgement of third-party ill-gotten gains, since the 1800s New York courts have held that requiring a wrongdoer to account for payments owed by others is punitive (*see Merchants' Bank v Bliss*, 35 NY 412, 416-417 [1866] [holding that a statute imposing joint and several liability on officers for debts of the company "impose(s) a penalty"];

Dabney v Stevens, 2 Sweeny 415, 424, 10 Abb Prac [NS] 39, 44 [1870] [same]) *Bird v Hayden*, 1 Robt 383, 388, 22 Abb Prac [NS] 61, 65-66 [NY Super Ct 1863] [holding that a statute imposing liability on officers for corporation's debts for neglecting duty "is in the nature of a penalty, and was designed as a punishment"]). The majority places undue emphasis on *Zurich Ins. Co. v Shearson Lehman Hutton* (84 NY2d 309 [1994]), as instructive on the question presented here. In *Zurich*, insurers sought a declaratory judgement that a comprehensive general liability policy did not cover *punitive damages* in two separate out-of-state slander actions (*see id.* at 312-313). The Court identified the question presented as "whether New York's public policy precluding indemnification for punitive damages should prevail over the public policies of the [foreign] judgment States, which allow indemnification" (*id*. at 313). The Court explained "that the purpose of punitive damages is solely to punish and deter" and further stated that those damages "are not *intended* to compensate or reimburse the plaintiff" (*id.* at 316 [emphasis added]). The majority deletes the word "intended" when quoting *Zurich* and thus ignores that the point of the sentence is the historic focus on the underlying purpose of the award—the *intention to punish* versus the *intention to compensate*. But that distinction of purpose is crucial to the analysis in *Zurich*. The Court held that,

> "under the Georgia statute in effect at the time of the [trial], a jury in a tort action with 'aggravating circumstances' could award 'additional damages to deter the wrongdoer. . . or as compensation for the wounded feelings of the plaintiff.' . . . Inasmuch as the court charged the jury that the punitive damage award could include *both* punitive *and* compensatory elements and there was evidence to support each, the plaintiff must supply coverage" (*id.* at 316-317 [first alteration in

> original], quoting Ga Code Ann § 51-12-5 [a] [emphasis added]).

Zurich is thus limited to the facts of that case and the discrete question of whether New York's public policy barred insurance coverage for a foreign jurisdiction's jury award that failed to identify and disaggregate "compensation" from "penalty". In other words, in *Zurich* the intent of the award was unclear. *Zurich* is logically understood as a holding favoring an insured where a court cannot determine whether the award is wholly compensatory or punitive. In such a case, where the concerns animating New York's public policy against indemnification of penalties are not expressly implicated and the damages are not clearly punitive in character, New York courts should not bar application of the foreign jurisdiction's policy allowing insurance payment of penalties. *Zurich* avoids an outcome that was unintended by the parties' contract and against our public policy: denial of bargained-for coverage to an insured for an award that might be compensatory, which as a consequence, allows the insurer to escape payment based solely on the uncertainty of the award. The majority's reading of *Zurich* places its holding in the instant appeal at odds with the Court's decision in *Sperry,* which concluded that the total damage awarded under the Donnelly Act was a penalty, even though "one-third unquestionably compensates a plaintiff for actual damages" (8 NY3d at 214). Notably, Sperry "had consistently sought treble damages throughout his litigation and ha[d] not previously attempted to waive them to pursue only actual damages" (*id.* at 215). In contrast, the $140 million portion at issue here is approximately 88% of the total disgorgement sanction.[13] Under the majority's reading, absent some other ground to deny indemnification, Bear Stearns is off the hook for almost three times the compensatory amount in *Sperry*. That outcome would undermine the deterrent effect of disgorgement on Bear Stearns and on future securities fraud violators.

Moreover, unlike in *Zurich* and *Borden v 400 E. 55th St. Assoc, L.P.* (14 NY3d 382 [2014]), relied upon by the majority, Bear Stearns has failed to prove that any part of the disgorgement is purely compensatory (*see* section IV, *infra).* Therefore, contrary to the majority's assertion (majority op n 6), we cannot say that the $140 million "unquestionably compensates a plaintiff for actual damages." (*Borden*, 14 NY3d at 398, citing *Sperry*, 8 NY3d at 214). Simply put, treble damages where one can easily determine that one third of the amount is actual damages is not the same as an SEC disgorgement settlement payment. As Bear Stearns's own lawyer stated, the $140 million

> "does not constitute an admission. . . or constitute revenue[s] earned, advantage obtained, or damage caused by the customer, correspondent or account. . . Nor should the [$140 million] be construed as an admission that 'fair value' damage is an appropriate methodology or provides an appropriate measure of profitability, harm, or advantage gained as a result of market timing."

[13] Bear Stearns argues that $20 million of the $160 million disgorgement, or 12.5% of the total, represents the SEC's calculations of Bear Stearns's own ill-gotten gains and thus Bear Stearns does not seek recovery of that portion.

The majority's interpretation of *Zurich* also ignores that penalties are regularly paid to an injured party but without rendering the award any less punitive in nature. In fact, the civil penalties paid by Bear Stearns were placed into the Fair Fund along with the disgorged funds. The reason is obvious: the focus is on the nature of the action. Where the intent is deterrence of wrongdoing, the secondary benefit to a victim is a *consequence* of the penalty, not its motivating principle.

In summary, SEC disgorgement is a penalty within the meaning of the insurance policy language because it deters violations of public law—federal securities statutes and regulations—rather than compensating violations against a particular aggrieved individual. That some portion of a particular disgorgement may be distributed to an unidentified injured party does not change the essentially punitive character of disgorgement as a tool of deterrence. The majority's conclusion that disgorgement here is a recoverable compensatory payment may be a welcome outcome for appellants, but it is not a correct reading of the insurance policy language. Taking a view through the lens of the federal securities regulatory framework, the SEC and Congress could not have intended the possible anti-deterrent outcome that if appellants eventually succeed on remittal the insurers will indemnify Bear Stearns for the $140 million disgorgement sanction that was imposed to prevent their alleged wrongdoing in the securities markets.

IV.

APPELLANTS' SUMMARY JUDGMENT SUBMISSIONS WERE INADEQUATE

Based on Bear Stearns's argument that it had paid the SEC compensation for third party harm, Bear Stearns moved for summary judgment on the question of whether the $140 million disgorgement was a recoverable loss under the policy language. As the party moving for summary judgment, Bear Stearns was required to "make a prima facie showing of entitlement to judgment as a matter of law, tendering sufficient evidence to demonstrate the absence of any material issues of fact" (*Jacobsen v New York City Health & Hosps. Corp*., 22 NY3d 824, 833 [2014]). "This burden is a heavy one and on a motion for summary judgment, facts must be viewed in the light most favorable to the non-moving party" (*id*., 22 NY3d at 833 [internal citation omitted]). If the movant fails to meet this burden, the court must deny summary judgment without considering the sufficiency of the opposing papers (*Voss v Netherlands Ins. Co.,* 22 NY3d 728, 734 [2014]). "If the moving party meets this burden, the burden then shifts to the non-moving party to 'establish the existence of material issues of fact which require a trial of the action'" (*Jacobsen,* 22 NY3d at 833 quoting *Vega v Restani Constr Corp,* 18 NY3d 499, 503 [2012]). "Since [summary judgment] deprives the litigant of [their] day in court it is considered a drastic remedy which should only be employed when there is *no doubt* as to the absence of triable issues" (*Andre v. Pomeroy*, 35 NY2d 361, 364 [1974] [emphasis added]).

Even under the majority's rule that disgorgement of third-party gains to compensate victims is a penalty within the meaning of the policy language, Bear Stearns failed to establish that the $140 million disgorgement was based on the SEC's calculations of victim harm rather than Bear Stearns's own ill-gotten gains.

Bear Stearns's in-house counsel admitted that he did not know, or could not recall, any of the discussions with the SEC about the disgorgement and penalty amounts and did not know how they were calculated. When asked if Bear Stearns's settlement with the SEC reflected Bear Stearns's own gains from the illegal trading at issue, in house counsel testified "I can't tell you what the SEC was thinking, I don't know." When asked if he knew how the $250 million settlement amount was calculated, he responded that he knew "[i]t was a number that was acceptable to both the company and to the SEC staff in the course of the negotiations." He did not recall whether or not he was ever advised about how the disgorgement and penalty amounts were calculated.

Separately, Bear Stearns's general counsel could not recall how the $250 million was calculated or any of the discussions with the SEC about the disgorgement and penalty components of that payment: "I don't recall specifically any discussions about the components [of the settlement] sitting here today." The Bear Stearns board members who voted to approve the settlement with the SEC similarly testified that they did not know how the disgorgement amount was calculated.

The only person who could remember the negotiations was outside counsel for Bear Stearns. In his affirmation in support of Bear Stearns motion, counsel stated that the SEC advised him that it was not seeking damages from Bear Stearns but was in fact seeking disgorgement of their customers ill-gotten gains and the methods used to calculate those gains. He further affirmed that at the request of the SEC Bear Stearns employed a specific methodology to calculate those gains which resulted in an estimate of $519 million. Bear Stearns also employed two other methodologies, one resulting in an estimate of $306 million and the other $140 million. According to counsel the SEC informed him that it would use the $140 million but he did not explain why the SEC rejected an estimate (the $519 million) that was 270% higher, based on the methodology it had proposed in the first instance, and which was closer to the SEC's initial demand for $720 million in sanctions. Moreover, counsel admitted that damages are not the same thing as disgorgement, and that the SEC was not authorized to obtain damages from Bear Stearns in this proceeding. Thus, Bear Stearns failed to carry its burden of establishing the basis for the calculations and that the SEC was seeking to compensate victims for losses actually incurred.[14]

Indeed, the summary judgment submissions failed to establish that there was no material factual issue regarding whether the $140 million reflected anything other than Bear Stearns's own ill-gotten gains. Bear Stearns admitted that the SEC first sought $720 million in sanctions. The $250 million sanction was accepted only after the SEC agreed to its first two publicly-announced settlements with hedge funds—which imposed over $148 million in disgorgement. Others followed, approximating another $130 million in

[14] The majority wrongly concludes that Bear Stearns's evidence of the negotiations is not hearsay (majority op at n 7). The evidence was admitted to establish the truth of the matter submitted, i.e. that the SEC adopted the calculations submitted by Bear Stearns indicating that $140 million was a proper approximation of their customer's gains. Even if properly before the Court, the evidence is inadequate to satisfy Bear Stearns's burden on summary judgment.

disgorgement. As respondents point out, the SEC's press release describing the Bear Stearns settlement refers only to the companies' own gains and not those of its customers.[15] The same is true for the announcements concerning the hedge fund settlements and other industry players. Thus, the SEC settlement with Bear Stearns must be considered in the context of the SEC's prosecution of the fraudulent market practices by various entities and individuals and the negotiations that led to these multi-million-dollar settlements. It cannot be concluded on this record that the SEC sought to compensate harm to shareholders by disgorging from Bear Stearns's ill-gotten gains of third-party hedge funds while at the same time demanding that those hedge funds disgorge their profits. Bear Stearns took this very position before the SEC in correspondence explaining its methodology underlying the $140 million estimate:

> "[m]oreover, we believe that many—if not all—mutual fund shareholders have already been or will be fully compensated for an injury they sustained as a result of market timing or late trading by the settlements the [SEC] has reached with market timers themselves and with the mutual funds that permitted market timing."

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[15] The majority mischaracterizes the SEC press release, relying on Bear Stearns's self-serving "concession" that only the $20 million portion of the disgorgement reflects its "own revenue" (majority op at 12). But Bear Stearns has consistently argued that it discussed $16 million in losses with the SEC and has sought to explain the difference in the settlement amount as a unilateral rounding up by the SEC. How and why the SEC determined it should round up from one even number to another and why it rounded up four million dollars versus any other amount remains an unsolved mystery—or more precisely a factual question that cannot be resolved on summary judgment.

V.

CONCLUSION

The $140 million disgorgement is a penalty. First, compensatory damages are not an authorized form of relief in this type of SEC action. Second, disgorgement has long been utilized as a means to deter future violations of the securities laws by depriving a wrongdoer of ill-gotten gains. While disgorgement of the wrongdoer's own profits returns them to their pre-violation status, exaction of another party's ill-gotten gains puts the wrongdoer in a worse position, as they must pay the proceeds wrongfully earned by someone else. Whatever doubts the majority may invent as to the penal nature of the former, the latter is a quintessential penalty that maximizes deterrence. Put another way, it is one thing to risk the consequences of one's own illegality and loss of personal gain and quite another to gamble on paying the additional price of another's fraudulently earned profits. Third, the majority relies on an inapt binary—disgorgement is either penalty or compensation, but cannot be both. This ignores that the purpose of disgorgement is to discourage future illegality and serves to address a public rather than a private harm. Whether a victim is paid from the disgorged funds is irrelevant to those goals. Indeed, disgorgement does not lose its penal character because some of the funds may be distributed to a victim of the securities law violation. If that were the case, under the majority's reasoning, the civil penalties imposed here and many other civil penalties regularly awarded to injured parties would be "compensatory," but, of course, that is not the case, notwithstanding the majority decision today.

Judgment insofar as appealed from and so much of the Appellate Division order brought up for review reversed, with costs, and case remitted to the Appellate Division, First Department, for further proceedings in accordance with the opinion herein. Opinion by Chief Judge DiFiore. Judges Fahey, Garcia, Wilson, Singas and Cannataro concur. Judge Rivera dissents and votes to affirm in an opinion.

Decided November 23, 2021