

# Uninsurable Penalty, Direct Physical Loss Coverage Update

December 1, 2021

## Uninsurable Penalty – New York

***J.P. Morgan Securities Inc. v. Vigilant Ins. Co.***

--- N.E.3d ---, 2021 WL 5492781 (N.Y. Nov. 23, 2021)

The New York Court of Appeals, the state's highest court, found that a settlement payment resolving an investigation by the Securities and Exchange Commission (SEC) was a covered loss and not a penalty excluded from coverage under the insured's policies.

The Bear Stearns Companies (Bear Stearns) purchased a primary liability policy from Vigilant Insurance Company (Vigilant) in 2000, covering, among other things, wrongful acts. The Vigilant policy contained an exclusion precluding coverage for "fines or penalties imposed by law." In 2003, the SEC began investigating Bear Stearns for alleged wrongful conduct taking place between 1999 and 2003. Bear Stearns reached a settlement with the SEC in 2006. Its successor-in-interest, J.P. Morgan Securities Inc. (J.P. Morgan) sought coverage for a portion of the settlement amount from Vigilant and various excess insurers under the policies issued to Bear Stearns. Following the insurers' denial of the claim, J. P. Morgan commenced a declaratory judgment action.

The trial court found that the insurers were responsible for covering the partial settlement payment, but the state's intermediate appellate court reversed, reasoning that the SEC-ordered disgorgement of profits was a penalty. The Court of Appeals, however, disagreed with the appellate court and found that the settlement was a covered loss. The high court examined what a reasonable insured in 2000 would have expected when purchasing the Vigilant policy and excess policies – at that time, the SEC did not employ disgorgement or monetary penalties as its primary enforcement remedies. The portion of the settlement payment for which Bear Stearns/J.P. Morgan sought coverage was calculated based on the amount of Bear Stearns' wrongfully-obtained profits due to its misconduct. Another portion of the settlement, totaling \$90 million, was designated a penalty by the SEC.

The Court of Appeals found that "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.'" Accordingly, the Court of Appeals concluded that the \$140 disgorgement payment was not excluded from coverage.

By: Stephanie Brochert

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## Direct Physical Loss of or Damage to Property – California

### *The Inns by the Sea v. California Mut. Ins. Co.*

--- Cal. Rptr.3d ---, 2021 WL 598480 (Cal. Ct. App. Nov. 15, 2021)

The California Court of Appeals held as a matter of first impression that the plaintiff, The Inns by the Sea (plaintiff), could not recover from its insurer, California Mutual Insurance Company (California Mutual), its lost business income resulting from the COVID-19 pandemic. The plaintiff operated five lodging facilities in California. Its commercial insurance policy with California Mutual included commercial property insurance covering each facility. In the wake of government orders intended to slow the spread of the COVID-19 virus, the plaintiff was required to close its lodging facilities and incurred substantial business losses.

On March 24, 2020, the plaintiff made a claim to California Mutual for the loss of business income caused by the orders. California Mutual denied coverage on the same day, stating that “[l]oss of business due to reasons other than covered physical damage is beyond the scope of the insurance policy.” On April 20, 2020, the plaintiff filed a declaratory judgment action, alleging that the policy provided coverage for the loss of business income. The complaint alleged that the plaintiff was entitled to recover from California Mutual under either the policy’s business income coverage or the civil authority coverage. California Mutual filed a demurrer and argued that neither of the provisions applied because the pandemic did not give rise to direct physical loss of or damage to property. The trial court agreed with California Mutual and sustained the demurrer.

The appellate court affirmed, holding that neither the business income coverage nor the civil authority coverage provisions was triggered by the allegations in the plaintiff’s complaint. The first issue required determining whether the plaintiff’s suspension of its business operations was “caused by direct physical loss of or damage to property at [plaintiff’s] premises . . .” Following the majority of courts in the country, the appellate court held that the presence of COVID-19 on the premises did not result in direct physical loss of or damage to property at the plaintiff’s premises as that phrase is commonly understood. The second issue required determining whether the civil authority coverage applied because the government orders were based on direct physical loss of or damage to property to other premises. Similar to its analysis under the business income coverage, the appellate court held that the plaintiff’s complaint did not give rise to civil authority coverage because the orders were not a result of direct physical loss of or damage to other premises. For these reasons, the appellate court affirmed.

By: Joshua LaBar

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UNINSURABLE PENALTY, DIRECT PHYSICAL LOSS COVERAGE UPDATE Cont.

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