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Expert Analysis

Will Your D&O Policy Cover the Costs of Responding to Government Investigations?

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Directors and officers insurance policies provide coverage in varying degrees to pay the costs of investigating and defending a claim.

Under typical policy language, a "claim" must have come into existence during the policy period in order to trigger coverage, including such investigation coverage.

Facts may exist that give rise to a claim (a company has arguably committed securities fraud) but no claim arises under the D&O policy until the wronged party or a regulator takes an action that triggers coverage. The filing of a civil proceeding or a wronged party's written demand for payment are clear examples of a claim having been made.

What actions short of those, especially respecting the actions of regulators, also constitute a claim?

Two recent cases illustrate how insured entities must carefully consider, on the front end, the policy language that their underwriter proposes on this significant point. As is the case generally, they should review the policy with counsel and their broker to determine if it meets their needs.

Both decisions involved potential securities liabilities and governmental investigations to determine whether violations occurred and, if so, the extent of the problem. In each case, the court determined that the policyholder had submitted claims under its policy. No insurance proceeds were available under one policy, however, for the costs of responding to the government's investigation. Under the other, the insured was reimbursed for most, if not all, of its costs.

OFFICE DEPOT

In *Office Depot Inc. v. National Union Fire Insurance Co.,* the Securities and Exchange Commission requested cooperation from the office supply company during its informal pre-suit investigation of alleged securities law violations.[1] Office Depot submitted a claim to National Union, seeking to recover $23 million in costs it incurred in voluntarily responding to the SEC's requests. The appellate panel affirmed the trial court's grant of summary judgment in favor of National Union.

Sequence of the investigation

Key dates in the investigation were as follows:

- June and July 2007: Dow Jones reports potential securities violations at Office Depot, and the SEC sends Office Depot a letter advising of an impending inquiry. Office Depot informs National Union of the possibility of a future claim and begins an internal investigation, including hiring outside legal counsel and forensic accountants.
- August 2007: SEC asks for voluntary production of internal letters, and Office Depot cooperates.
- January 2008: SEC issues formal order of investigation followed by subpoenas (between November 2008 and February 2009) to various officers and directors and eventually Wells Notices.[2]

The problem for Office Depot was that the formal SEC proceeding did not begin until well after Office Depot had begun incurring investigation expenses, while the policy language specified coverage only for costs incurred after a proceeding was commenced.

Definition of securities claim

Under the policy, a "securities claim" included claims alleging securities violations, but with a carve-out for "an administrative or regulatory proceeding against, or investigation of an organization."[3]

In other words, neither an investigation nor administrative or regulatory proceedings constituted claims.

The carve-out was followed by what the court called a "carve-back": "Notwithstanding the foregoing, the term 'securities claim' shall include an administrative or regulatory proceeding against an organization, but only if and only during the time such proceeding is also commenced and continually maintained against an insured person."[4]

In other words, the carve-back partially reversed the carve-out and made administrative and regulatory proceedings, but not investigations, "security claims."

Ruling in Office Depot

Office Depot advanced several arguments under the policy language, including that there was no real difference between an investigation of an anticipated claim and an investigation of an actual claim. The court agreed with Office Depot on this point as a practical matter but interpreted the policy as covering only costs of investigating an actual claim.

The court ruled that Office Depot could only recover the costs it incurred once a proceeding had commenced and a claim existed. Therefore, none of the $23 million pre-claim (*i.e.,* prior to November 2008) costs of investigation were covered because a claim, as defined by the policy, did not exist during the SEC's investigation.

MBIA

Not so for the insured in *MBIA Inc. v. Federal Insurance Co.*[5] The *MBIA* court, like the *Office Depot* court, focused solely on the terms of the policy and their relation to the

facts — specifically, whether the sequence of events showed that the investigation costs had accrued after a claim existed under the policy's terms.

Sequence of the investigation

Key dates of the investigation were as follows:

- 2001: SEC issues a formal order of investigation into "certain companies' compliance with the securities laws, their financial recordkeeping, their financial reporting and related matters."[6]
- November 2004: Both the SEC and the New York state attorney general issued subpoenas to the insured to produce documents relating to "non-traditional products."[7]
- May 2005: MBIA initiates claims process by notifying insurers of the investigation and providing copies of the subpoenas.[8]

The investigation continued, eventually extending to three suspect transactions and involving a preliminary settlement of one followed by an independent investigation of the other two paid for by MBIA as part of the settlement.

Definition of securities claim

Under the policy, a "securities claim" included "a formal or informal administrative or regulatory proceeding or inquiry commenced by the filing of a notice of charges, formal or informal investigative order, or similar document."[9]

Notably, this is a broader definition than that in *Office Depot*. However, it was not simply the broader definition that created the decision in favor of coverage — it was the sequence of the investigation in relation to the costs.

Ruling in MBIA[10]

There apparently was no dispute that the SEC subpoenas constituted a securities claim, and one of the insurers agreed to pay about $6.4 million. The insurers, however, argued that the attorney general's subpoena was a "mere discovery device" and not within the scope of the definition of a securities claim.

After close analysis of New York law and the use of subpoenas in attorney general investigations, the court disagreed.[11] Specifically, the court found that the standard method the attorney general uses to conduct investigations consists of issuing subpoenas.[12]

The insurers also argued that costs related to the investigation of two of the three transactions did not fall within the scope of the SEC's 2001 formal order. The court rejected this contention because each of "the three transactions at issue [involved] MBIA's attempts not to report or to delay reporting a loss."[13] As in *Office Depot*, MBIA's voluntary cooperation with the investigation of the two transactions also came under fire from the insurers, who alleged it removed those claims from coverage.

According to the court, however, the two transactions were linked to the 2001 order, which already had resulted in formal subpoenas. Specifically, the court found that MBIA's request of the regulators to allow it to produce information and witnesses to the government without the additional public relations damage inherent in being subject to further subpoenas did not bar coverage.

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SUMMARY AND TAKEAWAYS

In both *Office Depot* and *MBIA*, there were no citations to any prior law to support the courts' rulings. No intricate "legal" analysis appears to have been required because each court's decision was based on meticulously walking through and applying the policy language to the facts.

The cases illustrate that there is no substitute for a very careful reading of the policy language. The best time to do that is during the negotiation for a new or renewed policy. That is the point at which counsel for, and especially the broker for, the insured will have the opportunity to affect the policy terms.

Because the potential expense involved in responding to securities regulators' preliminary inquiries can be very high, companies at risk for such claims should pay particular attention to this portion of their D&O policies.

Such insureds and their advisers should do the following:

- Carefully read the policy prior to initial binding or renewal.
- Consider what regulatory tools or approaches the insured is most likely to encounter and attempt to negotiate coverage to match.
- Once the regulators call, focus on the sequence/timing of the investigation.
- If voluntary cooperation is the best course, do so with an eye toward triggering coverage if at all possible.
- Do not plan to rely on the principle of broad interpretation of policies in a manner favorable to the insured if your policy's plain terms rule out coverage under the facts.
- On the other hand, where the policy's language supports it, insist on coverage from your insurer.

NOTES

[1] 453 F. App'x 871 (11th Cir. 2011).

[2] *SEC v. Internet Solutions for Bus.*, 509 F. 3d 1161 n.1 (9th Cir. 2007) (quoting *Carlson v. Xerox Corp.*, 392 F. Supp. 2d 267, 279 (D. Conn. 2005)). "'A Wells notice notifies the recipient that the SEC's Enforcement Division is close to recommending to the full commission an action against the recipient, and provides the recipient the opportunity to set forth his version of the law or facts.'" National Union conceded that the SEC's issuance of subpoenas between September 2008 and February 2009 constituted covered claims. *Office Depot*, 453 F. App'x at 876 n. 11.

[3] *Id.* at 875.

[4] *Id.*

[5] *MBIA Inc. v. Fed. Ins. Co.*, 652 F. 3d. 152 (2d Cir. 2011).

[6] *Id.* at 155.

[7] *Id.* at 155-56.

[8] *Id.* at 157.

[9] *Id.* at 155.

[10] In order to focus the article on coverage for costs of investigation, other portions of the *MBIA* decision, including coverage for costs of terminating derivative lawsuits and costs relating to the hiring of an independent consultant pursuant to the settlement with the SEC are not discussed.

[11] *MBIA*, 652 F. 3d. at 160.

[12] *Id.* at 159.

[13] *Id.* at 160

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