D&O Coverage for Government Investigations: Creating Reality from Myth?

by

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I. Introduction

SEC investigations and investigations by other regulatory agencies can be very costly. If the matter being investigated is not resolved by settlement,[1] serious consequences can result, including both criminal sanctions and penalties. Also, once an SEC investigation becomes a matter of public knowledge, it is common, if not certain, that (a) the company's stock price will decline and (b) disgruntled shareholders will file lawsuits, often on behalf of a class, seeking to "ride the coattails" of the government's investigation to a successful outcome. Does the fact that the investigatory costs incurred, including the fees of attorneys, investigators, experts and documents specialists, would also benefit the defense of private party securities lawsuits mean that the costs incurred in responding to an SEC investigation should be reimbursed? Not according to most carriers. Are the carriers correct or is non-coverage a "myth?" The purpose of this article is to distinguish myth from reality by discussing cases allowing and disallowing coverage for government investigations.

II. Sources of Potential Coverage for Government Investigations

Very few D&O policies obligate the insurance carrier to assume the defense of Claims or threatened Claims. However, such policies do obligate the carrier to pay defense costs and related expenses incurred in defending Claims, often by advancing agreed fees and costs to the insured. Accordingly, all such policies will include a definition of reimbursable

[1] Most SEC investigations are resolved during the investigatory process by negotiation and agreed consent decrees. As a court noted almost 30 years ago, "over 90% of the SEC's cases are resolved by such decrees." *SEC v. Clifton*, 700 F.2d 744, 748 (D.C. Cir. 1983) (emphasis added). The *Clifton* court noted that negotiated settlements enable the SEC "to conserve its own and judicial resources; to obtain contempt remedies, including fines and prison terms… and to protect the public by informing potential investors that a certain person has violated SEC rules…." However, last year, a federal judge in New York rejected a proposed $285 million settlement recommended by the SEC arising out of the dumping of "dubious assets" on investors, ruling that a settlement that "does not rest on facts is worse than mindless, it is inherently dangerous." *Sec. Exch. Comm'n v. Citigroup Global Markets, Inc.*, 827 F. Supp. 2d 328, 335 (S.D.N.Y. 2011)(appeal pending). It is very questionable whether this ruling will be upheld by the appellate court. *See Citigroup Global Markets, Inc.*, 673 F.3d 158, 163 (2d Cir. 2012)(granting stay of district court's order pending appeal and criticizing the district judge's failure to afford "deference to the SEC's judgment… [and] decision to settle… driven by considerations of governmental policy as to the public interest.").

"Defense Costs" that vary in length and content. A typical definition (from a Chubb form of "Executive Risks" policy) reads as follows:

> **Defense Costs** means that part of **Loss** consisting of reasonable costs, charges, fees (including but not limited to attorneys' fees and experts' fees) and expenses (other than regular or overtime wages, salaries, fees or benefits of the directors, officers or employees of the **Organization)** incurred in defending any **Claim** and the premium for appeal, attachment or similar bonds.

This definition, like most such definitions, incorporates the definition of "Claim" as the basis for determining whether or not defense costs are insured. Costs that are not incurred in defending a "Claim" are not recoverable. Another definition of "Defense Costs," which was relied upon in one of the two, leading appellate decisions considering D&O coverage for the costs of a government investigation, contained an even more specific (and arguably more limited) definition of Defense Costs:

> "Defense Costs" means reasonable and necessary fees, costs and expenses consented to by the Insurer… resulting solely from the investigation, adjustment, defense and/or appeal of a Claim against an Insured….[2]

This language actually refers to the "investigation" and "adjustment" of a Claim; but the federal courts considering the scope and extent of the investigatory coverage provided concluded that the language "resulting solely from" meant that the costs must be incurred "sequentially in time," after an *actual* Claim was filed. Accordingly, pre-suit or pre-actual claim investigatory costs could not be recovered, no matter how "related" or beneficial those costs might have been to the successful defense of the subsequent claim.[3]

It is generally well settled that the provisions of a D&O policy that limit or exclude the coverage provided should be strictly and narrowly construed. This is an important corollary to the rule applied in several jurisdictions, including Georgia, that vague, ambiguous policy terms must be construed in favor of the policyholders' reasonable interpretation, even if the carrier's interpretation is equally reasonable. However, courts also will rule (usually when deciding a coverage dispute in favor of the carrier) that the absence of a particular definition or the absence of a particular, express exclusion does not mean that the policy is otherwise vague and ambiguous and hence should be construed as covering the costs incurred in responding to a governmental investigation. This principle, when invoked, as it was in the *Office Depot* case, is potentially fatal to a coverage claim. This author has not yet seen a D&O policy that clearly and expressly excludes coverage for the costs of a government investigation, whether commenced by issuance of a subpoena or otherwise. The question arises, would a policyholder buy a policy that contains such a clear and express exclusion?

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[2] *Office Depot, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 734 F. Supp. 2d 1304, 1310 (S.D. Fla. 2010), *aff'd mem.*, 453 F. App'x 871 (11th Cir. 2011).
[3] *Id.* at 1323.

In considering whether or not a D&O policy covers investigatory costs, it typically makes no difference whether the activity being investigated is *potentially* covered by the D&O policy—whether it be bid rigging, securities fraud, price fixing or other business misconduct. Thus, when presented with a claim for the sometimes huge costs incurred in responding to a pre-suit government investigation, most carriers will deny coverage, invoking numerous coverage defenses that often turn on whether or not the limitations contained in the policy's definitions (as opposed to express exclusions) are construed as barring coverage for investigatory costs.

For instance, the *Office Depot* court denied coverage for more than $20 million in attorney's fees and related costs incurred in connection with a lengthy SEC investigation that culminated in entry of an agreed consent decree and fines and penalties paid by Office Depot and two of its executive officers. *See* note 1, *supra.* In the other, recent leading appellate decision addressing recovery of costs incurred in connection with an SEC investigation, *MBIA, Inc. v. Federal Insurance Co.,*[4] the Second Circuit ruled the other way, allowing coverage for more than $20 million in costs incurred during an investigation that culminated in payment by MBIA of an agreed $75 million in fines and disgorgement. These important cases will be discussed more fully later in this article, after first discussing a few of the cases that have allowed coverage for government investigations.

III. Overview of Cases Allowing Coverage for Government Investigations

Several courts have ruled that "pre-suit" investigatory costs that do benefit the defense of subsequent claims can be covered under a general liability policy, at least under policies that do not have the "resulting solely from" language relied upon in *Office Depot* as a restriction on coverage for pre-actual claim costs. Courts allowing coverage for pre-suit investigatory costs emphasize the point that the insurer clearly was "*benefited* by the early actions taken by [the insured] to defend…."[5] The key in these and in other cases construing D&O policies is to review the governing policy language carefully, especially the definitions of "Claim" and "Defense Costs," as well as the definition of "Loss," which usually provides that a covered Loss includes "Defense Costs," thereby incorporating the definitional language explaining the categories of Defense Costs that are covered when a "Claim" is considered made. Sometimes, as in *Polychron v. Crum & Forster Insurance Cos.,* [6] the absence of a controlling definition or controlling, clarifying words, can be outcome determinative; however, it is very unusual for a policy not to contain a very specific definition of "Claim."

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[4] 652 F.3d 152 (2d Cir. 2011). There was no dispute in this case or in the *Office Depot* case that the policies, like most D&O policies, excluded any coverage for fines and penalties.

[5] *State v. Blank,* 745 F. Supp. 841, 852 (N.D.N.Y. 1990), *aff'd,* 27 F.3d 783 (2d Cir. 1994).

[6] 916 F.2d 461, 463 (8th Cir. 1990)(allowing recovery of costs incurred in connection with pre-indictment grand jury proceedings). *See Liberty Mut. Ins. Co. v. Cont'l Cas. Co.,* 771 F.2d 579, 586 (1st Cir. 1985) (allowing coverage under a CGL policy because "most, if not all, of the pre-suit services would have been performed after suit was filed had they not been performed before and… [the insured] had little choice but to retain counsel and prepare to defend itself when it did").

When the definition of "Claim" references "administrative or regulatory proceedings," seeking "non-pecuniary" relief, a wide variety of investigatory proceedings, including criminal investigations commenced by the Department of Justice (DOJ), may be covered "Claims." Thus, in *Polychron*, the policy did not define "Claim," but contained a broad definition of "Loss" that referred to the "cost of investigation" and cost of "defense of legal actions, claims or proceedings…."[7] The court allowed coverage for the costs incurred in connection with a DOJ investigation and grand jury subpoena, concluding that absent a specific exclusion or other limiting language, a covered claim may include investigatory demands made before the insured is subject to criminal indictment. The court concluded that the compulsory nature of a grand jury subpoena "constitutes a 'claim' against a party," noting that if the D&O policy, as reasonably construed, "would justify recovery, it is the duty of the court to adopt that construction."[8] More recently, a district court reached a similar result in considering whether or not a D&O policy would cover a grand jury investigation of possible bid rigging in violation of federal antitrust laws.[9]

In *Servidyne*, the policy defined a covered "Claim" to include a "criminal proceeding against any Insured Person commenced by a return of an indictment, or… a formal civil administrative or regulatory proceeding against any Insured Person commenced by the filing of a notice of charges, formal investigative order or similar document."[10] The carrier argued that a pre-indictment grand jury subpoena was not a covered "criminal proceeding" or a civil "regulatory proceeding" within the scope of the Claim definition. The court disagreed. Citing the pro-insured rule that an insurance policy is considered ambiguous if its wording "may be fairly construed in more than one way," the court rejected the carrier's argument that "the adjective 'civil' applies to both administrative and regulatory proceedings, and that this is the only reasonable interpretation of the language…." The court decided that the adjective could be read as modifying the entire phrase "administrative or regulatory proceeding" or as limited only to a "civil administrative… proceeding." As a result, the court concluded that an "ambiguity exists" in the operative language and that a grand jury subpoena qualified as having commenced an insured regulatory proceeding by '"the filing of a notice of charges, formal investigative order, or similar document.'"[11]

Applying similar principles of policy construction, courts in several other U.S. jurisdictions have allowed coverage for investigatory costs incurred in responding to investigatory proceedings commenced by both federal and state authorities. The Fourth Circuit has allowed coverage for a DOJ investigation, concluding that it was "a proceeding brought by a government regulatory agency seeking nonpecuniary relief within the meaning

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[7] *Polychron*, 916 F.2d at 462 n.4.
[8] *Id*. at 463 (citations omitted).
[9] *Servidyne, Inc. v St Paul Mercury Ins. Co.*, No 1:07-cv-00096-TCB (N.D. Ga. Nov 7, 2007).
[10] *Id.* at 8.
[11] *Id* at 10-11 (denying the defendant insurer's motion to dismiss). However, concluding that an insured proceeding had to be commenced by the "filing of a formal document," the court ruled that an investigative letter from the SEC did not trigger coverage because it was not "filed anywhere" and was not a "formal document." *Id.* at 13-14.

of the [professional liability] insurance policy issued by National Union."[12] The *Bornstein* court based its decision on the rule of Virginia law that where a policy is "susceptible of two [reasonable] constructions," it should be liberally construed in favor of coverage. The court rejected the carriers' interpretation, even though reasonable, that the "purpose of the investigation was to gather information, not to seek nonpecuniary relief."[13] Other federal courts have found coverage for investigatory proceedings under a variety of circumstances.[14]

Uncertainty regarding potential insurance coverage should not influence the insured's strategy decisions in responding to a government investigation. However, this uncertainty raises the important question of whether the corporation or its insured individuals who incur investigatory costs should be penalized for cooperating with the government investigation? Usually, especially in connection with an investigation of securities claims, defense counsel will advise that it is in the best interests of their client insureds to cooperate with the government inquiry. A refusal to cooperate, thereby causing the governmental agency to initiate formal proceedings—filing a lawsuit or other formal, enforcement proceeding—will generate more significant liability and even higher costs than would be incurred in attempting to negotiate a rational settlement of the controversy being investigated.

The next section of this article focuses on the two leading federal appellate cases addressing D&O coverage for SEC investigations, one allowing coverage for the millions of dollars incurred, and the other denying coverage for an equivalent "loss."

IV. *Office Depot* and *MBIA:* The Coverage Lottery

A. *Office Depot*

In late July, 2007, an Office Depot executive participated in a telephone call with representatives of several brokerage houses, one of whom suggested, in a statement published in the *Dow Jones Newswire*, that the executive may have violated SEC Regulation FD by prematurely revealing adverse company financial information to the investment community before it was publicly released. This article led to issuance of an SEC "letter of inquiry" to Office Depot, which was promptly disclosed in a public filing and that Office Depot made the subject of a "notice of circumstances" submitted to its insurance carrier. Thereafter, the SEC expanded its investigation into other possible financial irregularities involving inventory accounting and vendor rebates, issuing follow-up letters of inquiry to both Office Depot and to insured individuals. Letters of inquiry from the SEC are not

[12] *Bornstein v Nat'l Union Fire Ins Co of Pittsburgh, Pa.*, 828 F 2d 242, 244 (4th Cir 1987). *See e.g.*
[13] *Id.* at 244-45.
[14] *See also Center for Blood Research, Inc. v. Coregis Ins. Co.*, 305 F.3d 38 (1st Cir. 2002); *Bodell v Walbrook Ins. Co.*, 119 F 3d 1411, 1413-15 (9th Cir. 1997) (allowing professional liability coverage for a postal service investigation as a proceeding seeking nonpecuniary relief under California law); *Minuteman Int'l, Inc. v. Great Am. Ins. Co.*, Civil Action No. 03 C 6067, 2004, WL 603482 (N.D. Ill. Mar. 22, 2004). In *Coregis*, the court considered a policy covering a non-monetary "claim," defined as a "judicial or administrative proceeding in which any INSUREDS may be subject to a binding adjudication of liability." The court decided that the insured "could not possibly have been subject to a binding adjudication of liability in the investigation…." 305 F.3d at 42.

considered to be "formal" proceedings, as such, but such letters are accompanied by SEC Form 1662, which references "false statements and documents" and advises the recipient that he or she may be subject to formal proceedings, including indictment, if any false information is submitted. The recipients of these letters, including Office Depot, cooperated with the SEC's inquiries, eventually producing more than one million pages of documents and appearing for several depositions, without requiring the SEC to issue formal subpoenas. Not surprisingly, after disclosure of the SEC investigation, several groups of disgruntled shareholders filed a securities class action and a derivative action against Office Depot, its Board, and two of the individuals named in the government investigation. Not long thereafter, the SEC issued a formal order of private investigation, which advised Office Depot and its insured persons of the possibility of future, adverse action.

More than fourteen months after the first investigatory letter, the SEC began issuing subpoenas to several individual insureds, including persons who had cooperated with the SEC at the outset of its investigation. A few months later, the SEC issued so-called "Wells Notices" to three individuals. Such notices advises that as a result of the recipient's conduct, the SEC staff intends to recommend commencement of a formal enforcement action and that any submission made by the recipient during the investigation may be used as an "admission" if an enforcement action is commenced. Throughout this period, Office Depot continued to cooperate with the SEC investigation and fully reimbursed all of the attorneys' fees and costs incurred by the individuals being investigated. The individuals involved were represented by separate defense counsel.

The SEC never commenced an adversary enforcement action or filed a lawsuit. Rather, almost two and one-half years after the investigation commenced, Office Depot and two of the individuals who had received Wells Notices agreed to a consent decree and payment of monetary fines, thereby ending the investigatory proceedings. In the meantime, the trial court's dismissal of the securities lawsuits filed during the SEC investigation had been affirmed by the Eleventh Circuit. The insurance carrier, which was kept informed of the progress of the SEC investigation, the securities lawsuits, the Wells Notices, and the settlement negotiations with the SEC, denied coverage for virtually all of the investigatory costs incurred, asserting that those costs had not been incurred "solely" in connection with a covered Claim or Securities Claim.

B. ***MBIA***

The sequence of events that generated the D&O coverage dispute in *MBIA*, *supra*, differed, but the outcome, a negotiated settlement with the SEC, was the same as in *Office Depot*. In early 2001, the SEC issued a "global" form of formal investigatory order regarding possible financial accounting improprieties by the insurance industry. The SEC's industry-wide investigation apparently did not extend to MBIA until more than three and one-half years later, when, in the fall of 2004, the SEC began to issue subpoenas to MBIA seeking a broad range of company documents regarding "nontraditional" financial transactions and related accounting practices. Almost simultaneously, the New York Attorney General ("NYAG") issued subpoenas that mirrored the SEC's investigation. As the

investigation progressed, both the SEC and the NYAG considered issuing additional subpoenas; but MBIA entered into an arrangement to avoid issuance of subpoenas if MBIA cooperated voluntarily with the investigations. MBIA also sent notice of the investigations to its D&O insurers, who treated such notice as notice of a "potential" claim, rather than an actual claim. Not long thereafter, MBIA entered into settlement discussions, requesting "consent" by its carriers to do so. The carriers advised that coverage had not been triggered, but agreed that they would not invoke the lack of written consent to a settlement as a defense to coverage. MBIA offered to pay a total of $25 million ($15 million in penalties and $10 million as disgorgement) in connection with the NYAG investigation and a $50 million civil fine in connection with the SEC investigation. The settlement was approved by the regulators in 2007.

Not surprisingly, as was the case in the *Office Depot* matter, after learning of the investigation, private parties filed a derivative lawsuit alleging various improprieties, which caused MBIA to convene a Special Litigation Committee ("SLC") to investigate the allegations. One of the two carriers (Federal Insurance Co.) that had issued the D&O coverage agreed to reimburse $6,600,000 of MBIA's costs including $200,000 in costs incurred by the SLC. However, the carriers refused to reimburse an additional $20 million plus of MBIA's investigatory costs, arguing that neither the SEC's nor the NYAG's investigations constituted covered "Securities Claims"[15] and that the SLC's investigatory costs either were not covered or were subject to a $200,000 policy sublimit. Both the trial court and the appellate court rejected the carriers' position.

C. The Outcome of *Office Depot* vs. the Outcome of *MBIA*

One court (the Second Circuit in *MBIA*) sanctioned coverage for the more than $20 million in disputed costs incurred during a government investigation of matters that generated a $75 million settlement payment, and the other (the Eleventh Circuit in *Office Depot*) denied coverage for more than $20 million in costs incurred during an investigation that generated a $1 million settlement. Can these different outcomes be explained by the relative difference in fines or by comparing the amount of defense costs incurred and claimed to the amount of the fines that were paid? Certainly not. Rather, the difference turns on distinctions in policy wording and the different approaches of the two courts to applicable rules of policy interpretation.

The *Office Depot* case involved coverage for "Claims" against individual insureds, as well as the insured Organization. The individual insureds had received SEC letters of inquiry, followed by subpoenas and in three instances, Wells Notices. The carrier acknowledged that the subpoenas and Wells notices constituted covered Claims; but by then, most of the investigatory costs at issue already had been incurred. The definition of "Claim" in the policy reads, in relevant part, as follows:

[15] As is typical, the definition of covered "'Securities Defense Costs,'… include[d] costs 'incurred in defending or investigating Securities Claims.'" *MBIA, Inc.*, 652 F.3d 652 at 155. In other words, if the costs at issue were not incurred in investigating covered "Securities Claims," as defined separately, the costs would not be insured.

(1) a written demand for monetary, non-monetary or injunctive relief;

(2) *a civil, criminal, administrative, regulatory or arbitration proceeding for monetary, non-monetary or injunctive relief which is commenced by: (i) service of a complaint or similar pleading; (ii) return of an indictment, information or similar document* (in the case of a criminal proceeding), or (iii) receipt or filing of a notice of charges; or

(3) a civil, criminal, administrative **or regulatory investigation** of an Insured Person:

(i) *once such Insured Person is identified in writing by such investigating authority as a person against whom a proceeding* described in Definition (b)(2) *may be commenced*; or

(ii) in the case of an investigation by the SEC or a similar state or foreign government authority, after the service of a subpoena upon such Insured Person.

The term "Claim" shall include any Securities Claim….[16]

Most of the costs at issue had been incurred following issuance by the SEC of its "letters of inquiry." The SEC subsequently served formal subpoenas and Wells Notices; but by then, most of the materials sought already had been produced. The Eleventh Circuit concluded that the SEC's letters of inquiry did not actually "allege that [Securities Law] violations have occurred or identify specific individuals that could be charged in future proceedings."[17] Indeed, deciding in effect that most of the costs had been incurred in connection with the investigation of Office Depot,[18] the appellate court focused on the issue of whether or not the investigation could be considered to be a covered "Securities Claim," which the policy defined as:

> a Claim, *other than an administrative or regulatory proceeding against, or investigation of an Organization,* made against any Insured:

[16] 734 F. Supp. 2d at 1309 (italics in original, bolding added).

[17] 453 F. App'x at 876. The courts considering the issue did not explain why a letter of inquiry directed to counsel for the individual insureds could not reasonably be construed as identifying individuals against whom an enforcement proceeding "may be commenced." The carrier acknowledged that the Wells Notices were claims because they did specifically allege that Securities Laws violations had occurred and identified insured persons (the recipients) who might be charged with such violations, but denied coverage for all previous investigatory costs that had been incurred in responding to the letters of inquiry.

[18] Because the courts decided that no covered "Claim" had been commenced against the insured individuals, they did not address cases, such as those cited above, in which courts allowed coverage for "pre suit" investigatory costs that aided the defense of a subsequent claim. *See also, Pepsico, Inc. v. Cont'l Cas. Co.*, 640 F. Supp. 656, 666 (S.D.N.Y. 1986)(allowing coverage for investigatory costs incurred by the company that aided insured individuals).

> (1) alleging a violation of any federal… regulation, rule or statute regulating securities [(including but not limited to the purchase or sale or offer or solicitation of an offer to purchase or sell securities)]….
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> Notwithstanding the foregoing, the term "Securities Claim" *shall include an administrative or regulatory proceeding* brought against an Organization, but only **if and only during the time such proceeding is also commenced and continuously maintained against an Insured Person**.[19]

There was no dispute that the SEC investigation had been commenced simultaneously against both Office Depot and Insured Persons and had continued until it ended upon issuance of negotiated SEC "cease and desist" orders and payment of fines by Office Depot and two insured individuals. The Office Depot courts did not follow cases (several cited above) in which the courts had construed the undefined terminology "regulatory proceeding" to encompass a regulatory investigation. Rather, the Eleventh Circuit, affirming summary judgment for the carrier, concluded that the "plain language" of the definition provided coverage only for a Securities Claim that qualified as an "administrative or regulatory proceeding" against Office Depot, rather than a mere "regulatory investigation."

Unlike the definitional language at issue in *Office Depot*, the definition considered in *MBIA* did not expressly reference issuance of subpoenas (either to the company or to individuals). As a result, the carriers argued that an investigatory subpoena was a mere "discovery device" that did not trigger coverage for a "Securities Claim." The controlling definition provided that 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."[20] The italicized language (missing from the Office Depot policy) proved to be outcome determinative in *MBIA*. Rejecting the carriers' position as a "crabbed view" of the impact of a subpoena, the Second Circuit ruled that "[b]acked by the enforcement authority of the state, the NYAG subpoena is at least a 'similar document' to a 'formal or informal investigative order' that commenced a regulatory proceeding, as stated in the policies."[21] The court likewise rejected the carriers' argument that the absence of any reference to a subpoena in the definition meant that a subpoena did not qualify as a covered Securities Claim, concluding that such a "reading puts form over substance; the fact that the definition does not say service of a subpoena is not dispositive."[22]

Turning to the costs of investigating the shareholders derivative demand, followed by a derivative lawsuit, the court rejected the carriers' argument that coverage for the SEC's

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[19] 734 F. Supp. 2d at 1309 (italics in original, bolding added).

[20] 652 F.3d at 159. (emphasis added). There was no reference to a "formal or informal" investigative order in the definitions at issue in *Office Depot.* Also, in *MBIA*, the SEC had issued an industry-wide investigative order, albeit not specifically to MBIA. There was no discussion of the issue of whether or not MBIA should have sent notice of the industry-wide order to its carriers. *See* note 33, *infra*, and accompanying text.

[21] *Id.*

[22] *Id.* at 160.

investigative costs was subject to the policy's $200,000 sublimit for the costs of investigating derivative demands, concluding that this argument required the sublimit to be treated as a policy exclusion and that the carriers must bear the burden of "proving that the claim falls within the scope of an exclusion."[23] Likewise, the court rejected the carriers' argument based on limiting language in the definition of "Loss" that barred coverage for any costs incurred "in connection with the investigation or evaluation of any Claim or potential Claim."[24] The court concluded that the carriers had not carried the burden of proving that the limitations they invoked were "clearly applicable to the costs incurred by the SLC because those costs were, *at least to some extent, related to litigation*, not investigation."[25]

The costs incurred by Office Depot in responding to the SEC investigation and in reimbursing the costs incurred by insured individuals in responding to the investigation and negotiating a settlement also would appear to have been related "to some extent," to securities lawsuits, derivative lawsuits and other events (investigatory subpoenas and Wells Notices) acknowledged by the carrier to be insured "Claims" and "Securities Claims." However, as noted above, the *Office Depot* courts interpreted the restrictive language "resulting solely from" contained in the definition of Defense Costs as requiring that all of the costs be incurred "sequentially in time," *after* actual claims are made. The Eleventh Circuit explained its ruling on this point as follows:

> The plain language [of the definition of Defense Costs] demonstrates that the costs must 'result solely from' a Claim. … the costs preceding the Claim cannot "result from" the Claim. Accordingly, the district court correctly concluded that expenses constituted only Defense Costs within the meaning of this policy if they were incurred after a Claim was made against Office Depot.[26]

Because discovery never commenced in the private party lawsuits, the Office Depot courts decided that none of the investigatory costs could be allocated to those proceedings.[27]

Can the outcome in the *Office Depot* case be reconciled with the very different outcome of *MBIA*, based on distinctions in the policy language, such as the "solely resulting from" language in the Office Depot policy and the absence of any language referring to a "formal or informal investigatory order?" Perhaps; or perhaps the different outcomes can be reconciled by the different approaches of the courts to questions of policy interpretation. The Second Circuit focused on what it considered to be the reasonable expectations of the policyholder regarding coverage and the failure of the carriers to carry the burden of proving

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[23] *Id.*
[24] *Id.* at 166.
[25] *Id.* (emphasis added).
[26] 453 Fed. App'x at 877.
[27] The securities class action (the consolidated lawsuits) and consolidated derivative lawsuits had been filed after the SEC investigation commenced and alleged securities violations arising out of the matters being investigated by the SEC. However, the lawsuits had been dismissed on motion before discovery commenced. The courts effectively decided that investigatory costs were unnecessary to the successful defense of the securities lawsuits.

that a policy exclusion (including the limitation in the definition of "Loss" for investigatory costs) barred the coverage. By contrast, the *Office Depot* courts effectively placed the burden on the policyholder to prove that the costs incurred did relate "solely" to an actual Claim or otherwise fit within the definition of Securities Claim.

The *Office Depot* courts' "plain language" approach effectively trumped the rule applied in Florida (and elsewhere) that if the policy language is "susceptible to more than one reasonable interpretation, one providing coverage and the other limiting coverage, the insurance policy is considered ambiguous… [and] should be construed in favor of the insured."[28] After reviewing limiting, "anti-stacking" language contained in policies considered by other courts, the *Anderson* court held that if the carrier had "intended to prevent stacking of coverages… it could have indicated its intentions clearly and unambiguously" by using appropriate policy language.[29] By contrast, while noting that other policies, including a subsequent policy issued by National Union, had expressly limited coverage to Loss (and accordingly Defense Costs) "incurred after [a] subsequent Claim is actually made," the *Office Depot* trial court concluded that if the parties had "'intended to define 'Defense Costs' as cost incurred in… investigating potential claims, they should have stated as such.'"[30]

How can a policyholder concerned about the costs of government investigations and how a particular court might interpret the governing policy language be assured that those costs are insured?

V. Obtaining "Real" Coverage for Government Investigations

A policyholder in a highly regulated business, as many are, and certainly a publicly traded company and its officers and directors, should have legitimate concerns about becoming the subject of a regulatory investigation. Can D&O coverage for the costs of such investigations be obtained? The answer is "yes" (at least under certain policies issued in New York) or "maybe" elsewhere (if the policy covers "informal" as well as "formal" investigatory proceedings and does not expressly bar coverage for pre-suit/ pre-claim investigatory costs). Another solution may be to purchase specific coverage for investigatory proceedings.

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[28] *Auto-Owners Ins. Co. v. Anderson*, 756 So.2d 29, 34 (Fla. 2000). *See also* text accompanying note 12, *supra*.

[29] *Id.* at 36.

[30] 734 F. Supp. 2d at 1323-24 (quoting *Nat'l Stock Exch. v. Fed. Ins. Co.*, No. 06C1603, 2007 WL 1030293 (N.D. Ill. Mar. 20, 2007). In *National Stock Exchange*, the court allowed coverage for investigatory costs incurred after, but not before, the SEC issued a formal order of private investigation to the insured, concluding that the regulatory investigation qualified as an insured "regulatory proceeding." The *Office Depot* court decided that the SEC's formal order of investigation was merely part of an uninsured "regulatory investigation" that did not qualify as a covered "proceeding," concluding that the word "proceeding" requires the initiation of "a formal legal action or hearing conducted in a court of law or before some other official tribunal." 734 F. Supp. 2d at 1319 (citing *Black's Law Dictionary* and *Webster's Online Dictionary*). The court did not cite another version of the definition, which defines a "proceeding" to include "any action, hearing, *investigation*, … or *inquiry* (whether conducted by a court [or] administrative agency…." *Black's Law Dictionary* (6th ed. 1990)(emphasis added).

Last year, for example, Chartis, a recently created AIG company, began to market what it called an "Investigation Edge" policy that expressly covered "Loss… incurred in responding to or resolving any Investigation of any Securities Violation… that commences during the Policy Period and is reported to the Insured as required…."[31] This broad grant of coverage is fine as far as it goes; but unfortunately, it does not go far enough. Thus, it is limited to securities law investigations and only covers the costs incurred by the named insured entity and "any subsidiary whose financial results are included in the [most recent] consolidated financial statements" of the insured entity. Costs incurred by individually insured directors and officers, including costs incurred by the entity in indemnifying individual directors and officers against investigatory expense, are not covered by this policy. However, the policy does cover the pre-actual Claim investigatory costs that Chartis' sister company, National Union, successfully argued were not covered in the *Office Depot* case.

The event that triggers the Investigation Edge policy coverage is not the receipt of an SEC "letter of inquiry" or similar document, but the retention of "panel counsel" in response to an investigatory request. Thus, the policy insures an investigation of a possible Securities Violation after any of the following has occurred:

> (a) *The* [*insured*] *has retained a Panel Law Firm to represent it* in response to a formal or informal written or telephonic communication from such Enforcement Authority requesting information, documents, interviews of meetings concerning a Securities Violation; or
> (b) *The Issuer has, after retaining a Panel Law Firm* in connection with a Securities Violation, *self-reported the Securities Violation* to such Enforcement Authority. (emphasis added).

Once panel counsel has been retained, the Chartis policy expressly covers pre-suit/ pre-Securities Claim investigations; but it also contains several limitations that may provide less coverage than the policyholder expected. If commenced as part of a previous settlement, an enforcement action is covered; but otherwise, all coverage ends if the "Enforcement Authority brings a civil, criminal, administrative, regulatory or arbitration proceeding" against the insured. Presumably, the purpose of this clause is to make sure that there is no overlapping coverage between the "pre-suit" investigatory coverage provided by the Chartis policy and the post-suit coverage provided by the typical D&O policy for the costs of defending and investigating an actual Securities Claim. Unfortunately, the Chartis policy might not have covered any of the investigatory costs that the Second Circuit found were covered by the policies at issue in *MBIA* because the Investigation Edge policy form contains an express exclusion barring coverage if the investigation involves "the conduct, practices or conditions within all or a portion of the [insured's] industry."

Several other coverage limitations apply. First, the coverage is limited to the investigation of "Securities Violations"—other types of government investigations are not covered. Second, as noted above, there is no coverage for an investigation that is not

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conducted under the auspices of "panel counsel." Such counsel must be selected from a Chartis website listing Chartis-approved counsel. In other words, to trigger the coverage, it is necessary first to send notice of the investigation to Chartis and then to retain Chartis-designated panel counsel to conduct the investigation. Third, while the policy arguably broadens coverage to include not only the defense costs incurred, but also the "insurable amount" paid to settle the matter, the definition of a covered "Loss" significantly limits the otherwise undefined "insurable amount" language. Thus, the definition contains a limitation barring coverage for disgorgement, fines and penalties and for any costs incurred "by or on behalf of a natural person." Accordingly, none of the $75 million that MBIA paid in settlement would be covered by the Investigation Edge policy; and none of the costs incurred by Office Depot in indemnifying insured individuals for investigative costs and attorneys' fees would be covered by the policy. Finally, the policy only covers the costs of panel counsel, not costs of accountants; and in addition to the express notice requirement mentioned above, the policy contains a limitation providing that the costs of any subsequent, related investigation are covered only "after the [insured] notifies the Insurer that the related Investigation has commenced."

Given the ruling in *Office Depot* and the limitations of specialized policies, such as the Chartis Investigation Edge policy, how can an insured faced with a government investigation be assured of coverage? One way would be to insist that the investigating authority proceed immediately to initiate a formal "enforcement action" or at least to issue formal subpoenas that qualify as covered "Claims" or "Securities Claims." The costs of investigating an actual claim should qualify as covered "Defense Costs." As noted above, however, adopting such a strategy could lead to more serious action by the government agency than otherwise would result from the accepted practice of cooperating with the investigation and negotiating a hopefully favorable settlement. Another way to obtain such coverage is to purchase the broadest available form of policy, including a policy, such as the Investigation Edge policy, that may cover some, all or at least most of the expenses incurred.

Despite the difficulties in obtaining insurance coverage for regulatory investigations by government agencies, it is critically important whenever an investigatory demand is received, to send immediate notice to the carrier, both to preserve whatever coverage may exist and to make sure that the carrier does not claim later, when a subsequent enforcement action or lawsuit actually is commenced, that all coverage is barred by the failure to submit timely notice of the earlier investigatory proceeding. The recent decision in *Employers' Fire Insurance Co. v. ProMedica Health System, Inc.*[32] is instructive on this point. In this lawsuit, the Federal Trade Commission (FTC) commenced an investigation of whether or not a planned merger should be halted as anti-competitive under Section 7 of the Clayton Act. The investigation commenced when the FTC issued informal letters, followed by investigatory subpoenas, a formal order of investigation, and a "Hold Separate Agreement" requiring the insured to maintain the hospital being acquired as an "independent entity." However, ProMedica did not sent notice of these proceedings to its D&O carriers until after the FTC filed a lawsuit seeking to enjoin the acquisition pending completion of proceedings

[32] No. 3:11 CV 923, 2011 U.S. Dist. LEXIS 150225 (N.D. Ohio Dec. 31, 2011).

challenging the acquisition. The court noted that this notice of claim was submitted 17 days after expiration of the 90 day "grace period" for reporting claims under the policy in effect when the FTC issued its investigatory order and Hold Separate Agreement.

Citing the well settled principle that "'[i]f the insured does not give notice within the contractually required time period… there is simply no coverage under the [claims made] policy,'"[33] the *ProMedica* court applied and quoted *MBIA* for the proposition that "'[i]nvestigations… commenced by a formal or informal investigative order or similar document are a Claim.'"[34] Indeed, like the policy at issue in *MBIA*, the policy at issue in *ProMedica* "specifically included a 'formal investigative order' under its definition of a Claim."[35] Not surprisingly, the insured relied on the *Office Depot* ruling, arguing that anything short of being equivalent to a Wells Notice advising that the "SEC is nearing a recommendation to take action for violation of securities law" should not constitute a claim. The court disagreed. In a ruling that should be instructive to all policyholders, the court stated the following:

> *Office Depot* does not stand for the principle ProMedica desires—chiefly that Wells Notices, or their equivalent, are the minimum required for a claim to arise. *Rather, the case demonstrates that these inquiries largely turn on the terms of the policy and the specific underlying facts*.[36]

As shown by the cases summarized above, the proposition that coverage for government investigations cannot be obtained under a D&O policy is indeed a "myth." Given that courts have allowed such coverage in a variety of circumstances, insureds should be aware that "depending on the terms of the policy and the specific underlying facts," an investigation might be considered to be an insured "Claim." If so, coverage is available for the investigatory costs incurred, but *if and only if* appropriate notice of the investigatory proceeding is submitted to the carrier within the time required by the policy's notice and claims reporting provisions. Even if the carrier disagrees and only treats the notice as notice of a "potential claim," if a Claim is later made, as occurred in *ProMedica*, coverage will be preserved.

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[33] *Id.* at *12 (citation omitted)(ellipsis and alteration in original).
[34] *Id.* at *17 (quoting *MBIA*, 652 F.3d at 162).
[35] *Id.* at *19. Indeed, the court noted that "[e]ven when the definition of a claim does not include a 'formal investigative order,' courts still find such order to constitute a claim against insureds for wrongful acts." *Id.* (citing *Polychron*, 916 F.2d at 463).
[36] *Id.* at **22-23 (emphasis added).