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Second Circuit Affirms D&O Insurance Coverage for Regulatory Investigation and Special Litigation Committee Costs

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With regulatory investigations on the rise in the aftermath of the financial crisis and the increasing frequency of shareholder derivative suits that follow them, D&O insurance policyholders frequently face two critical coverage-determining issues:

1. Is a government subpoena sufficient to trigger securities claim coverage?

2. Are the costs incurred by a special litigation committee to evaluate derivative suits covered as defense costs?

In its July 1, 2011 decision in *MBIA, Inc. v. Federal Insurance Co., et al*, the U.S. Court of Appeals for the Second Circuit answered both of these questions affirmatively, holding that subpoenas and oral requests for documents issued by the Securities & Exchange Commission ("SEC") and the New York Attorney General ("NYAG") constituted "claims" that triggered coverage, and that the special litigation committee's work constituted covered "defense costs." The MBIA decision will be an important tool for D&O insurance policyholders seeking securities claims coverage.

Background

The SEC and NYAG Investigations

In 2004, the SEC and the NYAG each issued subpoenas to MBIA seeking documents related to any transactions designed to "affect the timing or amount of revenue or expense recognized in any particular reporting period." While the SEC issued its subpoenas in connection with a 2001 formal order of investigation, the NYAG's subpoenas were its first requests related to these transactions.

The SEC and NYAG ultimately focused their investigations on three MBIA transactions. The first involved MBIA's purchase of reinsurance for financial guarantee insurance policies it issued to guarantee bonds issued by the Allegheny Health, Education and Research Foundation ("AHERF"). After AHERF declared bankruptcy and defaulted on the bonds, MBIA purchased retroactive reinsurance to assume its $170 million exposure under its policies allegedly in an effort to avoid recognizing this substantial one-time loss. MBIA produced documents related to the AHERF transaction in response to the SEC and NYAG subpoenas.

The second transaction involved MBIA's alleged attempt to transfer the risk of loss on an investment in Capital Asset Holdings GP, Inc. to one of its subsidiaries, and thus avoid reporting a loss on its investment in this company. The third transaction involved MBIA's

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guarantee of securities issued by U.S. Airways to purchase airplanes. MBIA foreclosed on those planes when U.S. Airways declared bankruptcy, allegedly in an effort to treat the transaction as an "investment" instead of an "insurance loss." In 2005, when the SEC and NYAG turned their investigations to the Capital Asset Holdings and U.S. Airways transactions, in an effort to avoid further adverse publicity, MBIA offered to voluntarily comply with the regulators' informal demands for information in lieu of receiving subpoenas. The SEC and NYAG agreed, and MBIA produced documents related to these two transactions.

MBIA ultimately reached settlements with the SEC and NYAG in which it agreed to pay civil penalties related to the AHERF transaction and also agreed to pay for an investigation by an independent consultant into the second and third transactions.

The Shareholder Derivative Suits

After the SEC and NYAG investigations became public, two shareholders issued letters to MBIA demanding that it file suit against the directors and officers involved in the alleged wrongdoing. MBIA set up a committee to investigate the shareholder demands. When the committee did not act on the demands, the shareholders filed two derivative lawsuits. In response to the suits, MBIA established a special litigation committee ("SLC") to determine whether maintaining the suits was in MBIA's best interests. The SLC retained outside counsel and ultimately determined that the suits were not in MBIA's best interests, and dismissed them.

The Insurance Dispute

After it received the SEC and NYAG subpoenas, MBIA sought coverage under a $15 million D&O policy issued by Federal Insurance Company ("Federal") and a $15 million follow-form excess policy issued by ACE American Insurance Company ("ACE"). The Federal policy contained an endorsement providing entity coverage for securities claims, which broadly defined "Securities Claim" to include:

> [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.

The policy covered "Securities Defense Costs," which were defined to include attorney's fees and expenses incurred in "defending or investigating Securities Claims."

The Federal policy also included investigative costs coverage, which covered pre-litigation costs incurred in connection with the "investigation or evaluation of any Shareholder Derivative Demand." The term "Shareholder Derivative Demand" was defined as any "written demand" by a shareholder "to bring a civil proceeding" against an MBIA director or officer. Coverage provided by this endorsement was limited to $200,000.

The insurers took the position that the 2004 subpoenas were not sufficient to trigger coverage under the policies. When MBIA settled with the SEC and NYAG, Federal agreed to pay approximately $6.4 million to cover losses from the SEC's investigation of the AHERF transaction, as well as the $200,000 sub-limit for the pre-suit investigation by the demand investigation committee. But Federal refused to cover losses related to the NYAG's investigation into all three transactions, the SEC's investigation into the second and third transactions, and the costs incurred by the SLC in evaluating and terminating the derivative suits. ACE refused to pay on the basis that the underlying Federal policy was not exhausted.

The Second Circuit's Decision

The Second Circuit rejected the insurers' positions and held that MBIA was entitled to coverage for the SEC and NYAG investigations into all three transactions and that the SLC's work constituted covered defense costs.

The court held that the NYAG subpoena related to the AHERF transaction was a "Securities Claim," defined as "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." The court recognized that regulatory investigations often are commenced by service of a subpoena, instead of issuance of a formal investigative order, and that a "businessperson would view a subpoena as a 'formal or informal investigative

order' based on the common understanding of these words."[1] At a minimum, the Second Circuit held, a subpoena is a "similar document" to an investigative order, and thus constitutes a "Securities Claim."[2]

The Second Circuit also held that the SEC and the NYAG's oral requests for information about the Capital Asset Holdings and U.S. Airways transactions were covered claims. The court held that the investigations into these transactions were connected to the AHERF investigation and rejected the insurers' contention that additional written demands for information were required: "The insurers cannot require that as an investigation proceeds, a company must suffer extra public relations damage to avail itself of coverage a reasonable person would think was triggered by the initial investigation."[3]

Turning to the SLC's evaluation of the derivative suits, the court held that the costs incurred by the SLC in evaluating the suits and ultimately deciding to terminate them were covered "Securities Defense Costs." The insurers' main argument against coverage was that the SLC, as an independent committee of MBIA's board, was not an "Insured Person," which was defined to include directors and officers and MBIA itself. The Second Circuit rejected this argument, recognizing that Connecticut law (like the laws of other states) authorizes a corporation to establish such a committee to determine whether maintaining a derivative suit is in the best interests of the corporation.[4] The court held that MBIA exercised its corporate power to evaluate the derivative suits through the SLC.

The insurers also argued that any coverage for the SLC's costs was capped by the $200,000 sub-limit for investigations of derivative demands. The sub-limit applied to costs incurred investigating or evaluating any "written demand" by a shareholder "to bring a civil proceeding" against a director or officer. Because the insurers' position required that the sub-limit operate as an exclusion to coverage, the Second Circuit placed the burden on the insurers to demonstrate by "clear and unmistakable language" that the SLC's work, which was commenced after the derivative suits were filed, fell within the sub-limit. The court held that the insurers failed to meet this burden, as the investigations endorsement did not specifically reference lawsuits, while other insuring clauses did.[5] The Second Circuit thus affirmed the district court's granting summary judgment in favor of MBIA.[6]

Implications for Policyholders

In the aftermath of the financial crisis, corporations increasingly find themselves the subjects of regulatory investigations. Once shareholders learn of these investigations, they frequently make derivative demands on the corporations and then file derivative lawsuits. Responding to regulatory investigations and evaluating derivative suits can be extremely expensive. The Second Circuit's *MBIA* decision addresses these two commonly incurred expenses and finds coverage for both.

MBIA Makes It Easier To Pursue D&O Entity Coverage for Securities Claims

In addition to providing coverage for claims against individual directors and officers (often called "Side A" coverage) and for a company's indemnification of those directors and officers (often called "Side B" coverage), many D&O policies also insure securities claims made against the company ("Side C" or "entity coverage"). Such coverage now is standard in some D&O policies, although policyholders may need to obtain this coverage by way of an endorsement.

Like the Federal policy at issue in *MBIA*, D&O policies that provide entity coverage typically agree to pay on behalf of the insured company all "Loss"—including defense costs—for which the company becomes legally obligated to pay on account of a "Securities Claim" first made during the policy period for a "Wrongful Act" (*e.g.*, error, misstatement, act, omission, or breach of duty) committed by a director or officer or the company.

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[1] __ F.3d __, 2011 WL 2583080, at *5-6 (2d Cir. July 1, 2011).
[2] *Id.* at *6.
[3] *Id.* at *7.
[4] *Id.* at *9. *See Lewis v. Anderson*, 615 F.2d 778, 783 (9th Cir. 1979); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 785 (Del. 1981); *Auerbach v. Bennett*, 393 N.E.2d 994, 996 (N.Y. 1979).
[5] *Id.* at *11.
[6] The Second Circuit reversed the district court's holding that the work of the independent consultant hired by MBIA to evaluate the Capital Asset Holdings and U.S. Airways transactions was not covered. The court held that MBIA did not breach the policies' right to associate and right to consent provisions by agreeing with the SEC and the NYAG to hire the independent consultant, as it kept the insurers sufficiently apprised of the settlement discussions. *Id.* at *14-16.

While the definition of "Securities Claim" varies from policy to policy—as discussed below, a point insurers likely will make in an effort to distinguish *MBIA*—it typically includes (i) a written demand for monetary damages or non-monetary injunctive relief, (ii) a civil complaint, (iii) a criminal indictment, or (iv) an administrative or regulatory proceeding commenced by a formal notice of charges "or similar document," arising out of the purchase or sale, or offer to purchase or sell, any securities issued by the company.

D&O policies that provide entity coverage increasingly include, as did MBIA's policy, a sub-limit for costs related to investigations of shareholder derivative demands. Under this coverage, the insurer agrees to pay all investigative costs resulting from a derivative demand up to a modest sub-limit, generally around $250,000. As discussed further below, some of these policies now expressly apply this sub-limit to derivative lawsuits, in addition to demands, which is different from the provision addressed by the Second Circuit in *MBIA*.

Subpoenas Are Sufficient to Trigger Coverage

The Second Circuit's holding that the NYAG's initial subpoena to MBIA constituted a "Securities Claim" under the Federal policy will be useful to policyholders faced with subpoenas but not formal investigative or charging documents, as few courts have addressed this issue.[7] Both the appellate court and the trial court recognized that a company will treat a subpoena from a federal or state regulator with the same attention as a formal or informal investigative order. Importantly, the Second Circuit's holding that a subpoena is, at a minimum, a "similar document" to "a formal or informal administrative or regulatory proceeding or inquiry commenced by the filing of a notice of charges, formal or informal investigative order" also applies to the construction of other D&O policies. While policies may differ in what enumerated "proceedings" constitute a "Claim"—and the language at issue in *MBIA* is quite broad—many policies include any administrative or regulatory proceeding commenced by the filing of a notice of charges, formal investigative order, "or similar document."

In addition, the court properly recognized that a company already faced with a regulatory investigation need not "suffer extra public relations damage to avail itself of coverage."[8] The court's holding that the SEC and NYAG's follow-up oral requests for information were covered claims does not address the situation where a policyholder voluntarily provides information in the absence of any regulatory demand. It does, nevertheless, provide support to any policyholder seeking to limit the adverse publicity of an ongoing investigation by agreeing to provide information without additional formal requests. As the Second Circuit correctly held, in such a situation, the policyholder's business decision should not compromise its insurance coverage.

Special Litigation Committee Costs May Be Covered

The *MBIA* decision also addressed coverage for costs incurred evaluating shareholder derivative lawsuits—a controversial issue in other coverage disputes.[9] When faced with derivative lawsuits, which now frequently follow legal actions or public regulatory investigations, companies generally establish SLCs to assess whether maintenance of the suits are in the their best interests. These committees are comprised of independent directors and are empowered to act on behalf of their companies. In what likely will be an influential decision, the Second Circuit held that the costs incurred by the SLC in terminating MBIA's shareholder derivative lawsuits, including the fees of outside counsel, were covered defense costs under the Federal policy because the SLC exercised MBIA's corporate power to terminate such suits. It also held that coverage for these costs was not limited by the $200,000 sub-limit applicable to investigative costs for derivative demands, which did not expressly cover derivative suits.

This holding is a valuable one—potentially adding coverage for millions of dollars of attorney's fees—for companies like MBIA with D&O policies that do not contain sub-limits for derivative suit costs. The applicability of this holding, however, may be tempered by recent changes to entity coverage available in the market. Unlike the policy at issue in *MBIA*, some policies now expressly provide investigative costs coverage to both demands and derivative lawsuits, but limit this coverage to $250,000. A court construing the language of these policies might not find, as did the *MBIA* court, that the sub-limit was inapplicable to SLC costs incurred after the filing of derivative suits. The holding nevertheless cautions insurers to think twice before taking the reflexive position that costs incurred by an SLC are not covered.

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[7] *See Polychron v. Crum & Forster Ins. Co.*, 916, F.2d 461, 463 (8th Cir. 1990); *Minuteman Int'l, Inc. v. Great Am. Ins. Co.*, No. 03-C-6067, 2004 WL 603482, at *7 (N.D. Ill. Mar. 24, 2004); *Richardson Elec., Ltd. v. Fed. Ins. Co.*, 120 F. Supp 698, 701 (N.D. Ill. 2000).
[8] 2011 WL 2583080, at *7.
[9] *See Hansen Natural Corp. v. St. Paul Mercury*, No. CV 08-5067-VBF, at 25 (C.D. Cal. Apr. 9, 2009) (denying insurer's motion for summary judgment that SLC costs are not covered defense costs).