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Claim

When Is an SEC Investigation a "Claim" for Purposes of D&O Coverage?

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As the U.S. Securities and Exchange Commission (SEC or Commission) ramps up its efforts to investigate corporate accounting and financial malfeasance in the wake of the current financial crisis, U.S. companies and their directors and officers may find themselves the subject of a formal or informal investigation. They will, in turn, look to their Directors & Officers (D&O) insurance policies to fund the high legal costs incurred in responding to investigations. As recent case law demonstrates, coverage for such expenses, in a given case, will likely depend on whether the specific investigatory action falls within the policy's definition of a "claim."

D&O Policies Provide Coverage for a "Claim"

A D&O policy typically provides coverage for a "claim" asserted against directors and officers that alleges that they committed "wrongful acts" in their official capacity (often called "Side A Coverage"), and for the company itself, should it indemnify its directors and officers against such a "claim" (often called "Side B Coverage"). D&O policies frequently also provide coverage for a "claim" asserted directly against the company itself (known as "Entity Coverage"). While all D&O policies follow this basic framework, they are by no means uniform when it comes to defining the term "claim." Examples of policy language defining "claim" may include:

- "a formal administrative or regulatory proceeding commenced by the filing of a notice of charges, formal investigative order or similar document;"[1]
- "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;"[2]
- "a written demand for monetary damages or non-monetary relief;"[3]
- "any written or oral demand for damages or other relief against any of the Assureds;"[4] or

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- "any judicial or administrative proceeding in which any INSURED(S) may be subjected to a binding adjudication of liability for damages or other relief."[5]

Seemingly minor differences in language can mean the difference between coverage and no coverage.

The Chronology of an SEC Investigation

All SEC investigations are conducted privately. The course of an SEC action involves various stages but typically starts with an informal investigation, which consists of interviewing witnesses, examining brokerage records, reviewing trading data, and other methods. At this stage in the process, the Commission does not yet have subpoena power and must depend on the voluntary cooperation of individuals and entities to collect information.

If the Commission determines that a violation of the federal securities laws has occurred or may be occurring, it may issue a "formal order of investigation." Such an order empowers designated Commission staff to subpoena witnesses, administer oaths, and compel the production of books, records, and other relevant documents.[6] If the recipient of a subpoena fails to comply with a subpoena, the Commission is empowered to bring a suit in court to require compliance.[7]

At the conclusion of the formal investigation, the Commission staff present their findings, including any recommendation to initiate enforcement proceedings, to the Commission for its review. At this stage, the Commission typically will issue a so-called "Wells Notice." This notice informs the recipient that the Commission is considering instituting enforcement proceedings against the recipient and provides the latter the opportunity to submit a voluntary statement (called a "Wells Submission") explaining why the Commission should not commence an action against the recipient. After reviewing the Wells Submission, the staff may adhere to, or reverse, its initial decision to recommend enforcement action.

Assuming the Commission staff recommends bringing an enforcement action, and the Commission agrees, the latter can authorize the staff to file a case in federal court or bring an administrative action. In many cases, the Commission and the party charged decide to settle the matter without trial.

At each stage in the SEC's investigation process, the target of the investigation–whether it is the company or its directors and officers–typically will retain counsel and incur substantial legal expenses and costs. The question thus arises: at what point in the investigatory process is the D&O insurer's duty to provide coverage for a "claim" activated or "triggered"? Policyholders and their D&O insurers frequently clash over this precise issue with an insurer taking the position that the SEC investigation is not a "claim" within the meaning of the policy language. Court decisions are not necessarily consistent on this issue, but two recent cases illustrate the critical importance policy language plays in the courts' coverage determinations.

Not Covered: Office Depot v. National Union Fire Insurance Co. of Pittsburgh, PA (Office Depot)[8]

In June 2007, a *Dow Jones* Newswire article reported that Office Depot may have violated federal securities laws by improperly disclosing nonpublic information.[9] Shortly thereafter, in July 2007, the SEC issued a letter to the company advising it that the SEC was conducting an inquiry to determine whether the company had violated federal securities laws. The letter requested certain information from Office Depot on a voluntary basis, including various documents relating to its contacts and communications with financial analysts. The letter stated that the SEC's inquiry should not be construed as an indication by the Commission that any violation of law had occurred. Subsequent letters from the SEC directed Office Depot to preserve the records of its numerous employees and officers.

In response to these letter inquiries, Office Depot opted to voluntarily cooperate with the SEC, as companies often do to avoid adverse publicity, by providing documents and making its employees and officers available for sworn testimony without the issuance of a subpoena.

In January 2008, the SEC issued a formal "order directing private investigation" of Office Depot, pursuant to which the Commission issued a number of subpoenas to the company and several of its employees or officers. After completion of the formal investigation, the SEC issued "Wells Notices" to three of its officers. Ultimately, Office Depot settled with the SEC.

Office Depot sought coverage from its D&O insurers for legal expenses incurred from the time it received the SEC's initial June 2007 inquiry letter. The insurers agreed to indemnify the company for those defense costs incurred after the SEC issued its January 2008 formal order of investigation, but denied coverage for legal expenses the company incurred in voluntarily responding to the SEC's informal investigation.

Office Depot's D&O policies provided coverage for a "Securities Claim" made against Office Depot for any "Wrongful Act." The policies defined "Securities Claim" to exclude "an administrative or regulatory proceeding against, or investigation of an Organization." That definition, however, contained "carve-back" language which restored coverage for "an administrative or regulatory proceeding *against* an Organization."[10]

In the ensuing insurance coverage litigation between Office Depot and its insurers, the trial court found, and the appellate court agreed, that the SEC's requests for voluntary cooperation constituted an informal "*investigation of*," Office Depot rather than an "*administrative or regulatory proceeding against*," Office Depot, and thus did not constitute a "Securities Claim." Accordingly, the court held that the sums expended by Office Depot prior to the date the SEC issued its formal order were not covered under the policy.[11]

The decision is important for two reasons. First, it reflects the distinction courts often draw between costs expended by the policyholder in responding to governmental or administrative

investigations on the one hand, and "formal" claims on the other hand. The costs incurred in responding to the former are often viewed by courts as "voluntary," even though such a view ignores the practical reality that an SEC investigation of a company is a threat which a company cannot ignore.[12] Second, the decision illustrates the emphasis the courts place on the actual language of the policy. Here, the court was persuaded by the insurer that the plain language of the policy excluded coverage for an investigation of Office Depot until such time as the company or its officers and directors received a subpoena or a Wells Notice.

Covered: MBIA, Inc. v. Federal Insurance Co. (MBIA)[13]

In March 2001, the SEC issued a formal order of investigation into certain accounting practices in the insurance industry, which involved attempts not to report or to delay reporting a loss. The formal order stated that the Commission was empowered to investigate whether insurance companies, including MBIA, engaged in securities fraud, accounting misstatements, or reporting misstatements.

In November 2004, pursuant to that investigation, the SEC issued the first of several subpoenas to MBIA. The subpoena did not identify specific transactions, but it compelled MBIA to produce all documents concerning transactions involving "non-traditional products," which were defined, in relevant part, as:

> any product or service developed, marketed, distributed, offered, sold, or authorized for sale . . . that could be or was used to affect the timing or amount of revenue or expense recognized in any particular reporting period, including without limitation, transferring assets off a Counter-Party's balance sheet, extinguishing liabilities, avoiding charges or credits to the Counter-Party's financial statements [or] deferring the recognition of a known and quantifiable loss.[14]

The subpoena also required, among other things, production of MBIA's accounting treatment of payments in connection with these transactions. Also in November 2004, the New York Attorney General (NYAG) initiated a parallel investigation and issued a subpoena, mirroring the SEC's subpoena. MBIA produced documents to both agencies in tandem.

Three different transactions (the "AHERF," "Capital Asset," and "U.S. Airways" transactions) came under the scrutiny of the SEC and NYAG. In the summer of 2005, the SEC and the NYAG considered issuing additional subpoenas but agreed to accept MBIA's offer of voluntary compliance with their oral demands for records relating to the Capital Asset and U.S. Airways transactions in lieu of issuing subpoenas to avoid adverse publicity for MBIA. Ultimately, MBIA reached a settlement with the regulators with respect to the AHERF transaction and was exonerated of any wrongdoing with respect to the other two transactions.[15]

MBIA sought coverage from its D&O insurers for, among other things, the legal costs and expenses of responding to the agencies' investigations. The primary D&O Policy provided coverage for a "Securities Claim," which was broadly defined 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."[16]

MBIA's primary insurer, Federal Insurance Company (Federal), agreed to pay for defense costs MBIA incurred in responding to the SEC's investigation of the AHERF transaction but denied coverage for defense expenses incurred in connection with MBIA's voluntary compliance with the SEC's oral document requests in respect of the Capital Asset and U.S. Airways transactions.[17] Federal took the position that the SEC's oral requests for documents were not pursuant to a "formal or informal investigative order of similar document" and thus did not constitute a "Securities Claim" under the primary D&O policy. Federal also denied coverage for expenses incurred in responding to the NYAG subpoenas on the grounds that a subpoena is a "mere discovery device" and not a "similar document" to "an investigative order" within the meaning of the policy's definition of a "Securities Claim."[18] Litigation ensued between MBIA and its insurers.

Focusing on the policy's language, the court found that the SEC investigations conducted by way of an oral request constituted a "Securities Claim" because the oral requests were connected to the SEC's 2001 formal investigative order or, alternatively, because the policy expressly provided coverage for "informal investigative orders," and the oral inquiries fit that description.[19] This aspect of the decision is significant for policyholders. In rejecting Federal's argument that there was no coverage for those portions of the SEC investigations conducted by way of oral requests rather than subpoenas, the court recognized that, "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."[20]

The court also found that the NYAG subpoena, which commanded the production of documents, threatened criminal penalties for noncompliance, and was backed by the enforcement authority of the state was a "Securities Claim" within the meaning of the policies because the subpoena was at a minimum a "similar document" to a "formal investigative order" that commenced a regulatory proceeding as stated in the policy.[21] This aspect of the decision also is significant for policyholders because in upholding coverage for costs incurred in responding to the NYAG subpoena, the court refused to "put[] form over substance" and recognized that a reasonable businessperson would view a regulatory agency's subpoena as a "formal or informal investigatory order" even if the policy definition of "Securities Claim" did not explicitly include a proceeding commenced by the service of a subpoena.[22]

The courts in the *Office Depot* and *MBIA* cases reached opposite results with respect to coverage for SEC investigations primarily due to the differences in the relevant policy language at issue and nature of the investigatory proceeding for which coverage was sought. In *Office Depot*, the insured sought coverage for costs incurred in connection with an SEC informal investigation of the company, but the policy at issue defined a "Securities Claim" as "an administrative or regulatory proceeding *against* an Organization." In contrast, in *MBIA*, the policyholder also sought

coverage for costs incurred in complying with the SEC's informal (oral) requests for documents, but not only were those requests connected to an earlier formal SEC order, but the policy language expressly provided coverage for informal investigative orders.

Questions to Ask After Office Depot and MBIA

The *Office Depot* and *MBIA* cases highlight the two most important factors in predicting whether a court will find coverage for an SEC investigation: (a) the specific nature of the investigatory action; and (b) the actual language of the policy, particularly the definition of "claim."

– (A) What is the Nature of the Investigatory Action?

The court will evaluate the specific regulatory action taken by the SEC against the insured. This part of the court's analysis generally will be fact intensive. Is the SEC investigation "formal" or "informal?" As can be observed in *Office Depot*, if the SEC inquiry takes the form of letters purporting to be voluntary requests for information, or indicating that the recipient should not construe the SEC's inquiry as an indication by the Commission that any violation of law has occurred, the court is less likely to find that a "claim" has been asserted against the insured. On the other hand, if the SEC issues a formal order directing an investigation of the insured and serves a subpoena on the insured corporation and/or its officers, directors, and employees, seeking documents and testimony, the court is more likely to conclude that a "claim" has been asserted against the insured.

In related fashion, is the insured a target of the investigation or simply a source of information? An investigative subpoena served on a company's custodian of records by the Department of Justice was held not to be a "claim" within the meaning of the company's D&O policy.[23] In finding no coverage for the attorney's fees the company incurred in responding to the subpoena, the court noted that there was no suggestion in the subpoena that the government was seeking anything other than information from the company, the company was not a target of the investigation, and the investigation did not result in the government bringing any charges against it.[24] However, a court found that a grand jury investigation constituted a "claim" under a bank's D&O policy and held that the insurer was obligated to pay the cost of legal expenses the bank incurred in complying with a subpoena that sought documents related to the time period a bank officer was president of the bank.[25] The court rejected the insurer's characterization of the investigation as a mere request for information, noting that later events proved the former bank president was the target of the investigation and the regulatory probe was "serious."[26]

– (B) What Is the Specific Language Used in the Policy?

The specific language used in the policy, especially the definition of "claim," is of critical importance because as a matter of black-letter law, if policy language is clear on its face, the court must look solely to the policy language to determine its plain and ordinary meaning. This prong of the court's inquiry is largely a matter of law as it involves construing policy language.

As noted above, policy language may differ from policy to policy and the devil is often in the details. For example, the SEC's issuance of an "Order Directing Private Investigation and Designating Officers to Take Testimony" was found to constitute a "claim" against the company where the D&O policy defined "claim" to mean a "formal administrative regulatory proceeding commenced by the filing of a . . . formal administrative order."[27] Accordingly, the court held that the insurer was liable for all costs incurred by the company on behalf of its officers and directors after receiving the formal investigative order.

However, policy language defining a "claim" as a "judicial or administrative proceeding initiated against any of the Directors and Officers in which they may be subjected to a *binding adjudication of liability* for damages or other relief. . . " was found not to encompass subpoenas issued in connection with a grand jury investigation by the Justice Department or an SEC investigation. The court reasoned that the function of the grand jury and the SEC proceedings was to investigate, not to determine guilt or innocence, and therefore neither proceeding could result in a "binding adjudication for liability for damages or other relief." [28]

Sometimes courts, construing nearly identical policy language, will reach diametrically opposite results. The U.S. District Court for the Northern District of Illinois, applying Illinois law, found an SEC subpoena requiring the insured corporation and its employees to provide deposition testimony and produce documents constituted a "claim" where the D&O policy defined "claim" to include "a written demand for monetary or non-monetary relief made against any Insured."[29] The court reasoned that the term "relief" is broad enough to include a demand for something due, including a demand to produce documents or appear to testify.[30] However, a New York federal court, applying New York law, rejected such a broad construction of the term "non-monetary relief," finding that the ordinary and accepted meaning of the word "relief" did not include investigative subpoenas.[31]

Conclusion

A company faced with an SEC investigation should pay close attention to the language of its D&O policy, particularly the policy's definition of "claim" (and if possible, at the underwriting stage, negotiate the broadest possible definition of the term). Depending on the nature of the SEC investigatory action and the precise language of the policy, the policy may provide coverage for the legal costs and expenses incurred in responding to a formal or informal SEC investigation.

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[1] *See, e.g.,* National Stock Exch. v. Federal Ins. Co., No. 06 C 1603., 2007 BL 209135 (N.D. Ill. Mar. 30, 2007)

[2] *See, e.g.,* MBIA Inc. v. Federal Ins. Co., 652 F.3d 152 (2d Cir. 2011).

[3] *See, e.g.,* Herley Indus., Inc. v. Federal Ins. Cos., No. 08-5377, 2009 BL 179695 (E.D. Pa. Aug. 21, 2009).

[4] *See, e.g.,* AT&T Corp. v. Clarendon Am. Ins. Co., C.A. No. 04C-11-167 (JRJ)., 2006 BL 53268 (Del. Super. Ct. Apr. 25, 2006).

[5] *See, e.g.,* Center for Blood Research, Inc. v. Coregis Ins. Co., 305 F.3d 38 (1st Cir. 2002).

[6] *See* 15 U.S.C. § 78u(b)

[7] 15 U.S.C. § 78u(c)

[8] No. 11-10814, 2011 BL 263691 (11th Cir. Oct. 13, 2011).

[9] *Id.* at *3.

[10] *Id.* at *6-*7 (emphasis supplied).

[11] *Id.* at *7-*8.

[12] Cooperating with SEC informational and document requests at an early stage in the investigative process also gives the company an opportunity to convince the SEC to terminate its investigation, a result which redounds to the benefit, not only of the policyholder, but its insurer as well.

[13] 652 F.3d 152 (2d Cir. 2011).

[14] *Id.* at 156.

[15] *Id.* at 157.

[16] *Id.* at 159.

[17] *Id.* at 158. The excess insurer paid nothing because the policy limits of the underlying Federal insurance policy were not exhausted. *Id.*

[18] *See* Brief for Defendant-Appellant Federal Insurance Company at *30, MBIA, Inc. v. Federal Ins. Co., 652 F.3d 152 (2d Cir. Apr. 26, 2010) (No. 10-0355-cv(L)).

[19] MBIA, 652 F.3d at 161-62.

[20] *Id.* at 161.

[21] *Id.* at 159-60.

[22] *Id.* at 160.

[23] Center for Blood Research, Inc. v. Coregis Ins. Co., 305 F.3d 38 (1st Cir. 2002).

[24] *Id.* at 42.

[25] Polychron v. Crum & Forster Ins. Cos., 916 F.2d 461 (8th Cir. 1990) (applying Arkansas law).

[26] *Id.* at 463. *See also* Richardson Elec., Ltd. v. Federal Ins. Co., 120 F. Supp. 2d 698, 701 (N.D. Ill. 2000), wherein the court noted that "characterizing a Justice investigation as involving a 'request' for information understates the seriousness of what such an investigation involves."

[27] National Stock Exch. v. Federal Ins. Co., No. 06 C 1603, 2007 BL 209135 (N.D. Ill., Mar. 30, 2007).

[28] JB Oxford Holdings, Inc. v. Certain Underwriters at Lloyd's, London, No. B141597 (Cal. App. Oct. 5, 2001). *Accord* Foster v. Summit Med. Sys., Inc., 610 N.W.2d 350 (Minn. Ct. App. 2000).

[29] Minuteman Int'l Inc. v. Great Am. Ins. Co., No. 03 C 6067, Memorandum Opinion and Order (N.D. Ill. Mar. 22, 2004).

[30] *Id.* at 17-18.

[31] Diamond Glass Cos., Inc. v. Twin City Fire Ins. Co., No. 06-CV-13105 (BSJ) (AJP),Order at 8-9 (S.D.N.Y. Aug. 18, 2008).