New York Law Journal

WWW.NYLJ.COM

An ALM Publication

VOLUME 246—NO. 57

WEDNESDAY, SEPTEMBER 21, 2011

CORPORATE INSURANCE LAW

Expert Analysis

Second Circuit Upholds Coverage For Investigation-Related Costs

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In today's economic climate, one of the most important issues concerning Directors' and Officers' (D&O) insurance is whether and to what extent the policy provides coverage for the costs of defending and responding to government investigations. Whether the investigation is commenced by a federal, state or local government agency, and whether it concerns financial, intellectual property, environmental or trade laws, the expense associated with properly responding can be very significant. There are often voluminous amounts of documents to review—both paper and electronic—and more often than not there are legal issues that require the retention of outside legal counsel.

D&O insurance policies vary considerably with regard to the scope of coverage for expenses associated with investigations. Some policies cover only formal investigative proceedings such as those commenced by a formal order of investigation. Others provide coverage as long as a target letter or subpoena has been issued to an individual. Still others provide even broader coverage, including costs associated with informal investigations.

In the recent case of *MBIA Inc. v. Federal Insurance Co.*,[1] the U.S. Court of Appeals for the Second Circuit determined that the policies at issue covered costs incurred to respond to investigations conducted by the U.S. Securities and Exchange Commission (SEC) and the New York Attorney General. The Second Circuit also held that MBIA was entitled to reimbursement of expenses incurred by two special committees formed to investigate derivative demands and derivative lawsuits related to these investigations. While the Second Circuit's ruling hinged in large part on the policy language and the specific fact pattern, policyholders can be expected to rely on *MBIA* to push for liberal interpretation of the scope of coverage for costs associated with investigations.

The Investigations of MBIA

MBIA is a Connecticut corporation, based in New York, which provides financial guarantee insurance for bonds or structured financial obligations. In 2001, the SEC issued a formal order of investigation, commencing an inquiry into certain companies' compliance with securities laws, financial recordkeeping, financial reporting and related matters. As part of that larger investigation, on Nov. 12, 2004, the SEC issued the first of a series of subpoenas to MBIA. These subpoenas did not identify specific transactions, but rather sought documents regarding transactions involving "Non-Traditional Product(s)."[2] A few days later, the Attorney General issued the first in a series of subpoenas to MBIA, mirroring the scope of the SEC subpoena.

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Ultimately, the SEC and the Attorney General focused their investigation on three MBIA transactions: (i) MBIA's purchase of reinsurance on its guarantee of bonds issued by Allegheny Health, Education and Research Foundation (AHERF) two years after AHERF had declared bankruptcy; (ii) MBIA's use of a subsidiary to guarantee securitization of certain liens purchased by Capital Asset Holdings GP, thereby transferring the risk of loss from MBIA's investment in Capital Asset to the subsidiary; and (iii) MBIA's guarantee of securities used to purchase airplanes for U.S. Airways, MBIA's subsequent foreclosure on U.S. Airway's airplanes following the airline's bankruptcy and the treatment of the transaction as an investment instead of an insurance loss. In May 2005, MBIA provided notice of claim to its insurers.

In the summer of 2005, with the SEC and New York Attorney General considering issuing additional subpoenas related to these transactions, MBIA, concerned with the impact additional subpoenas would have on its reputation, agreed to respond to informal document requests if the agencies would forgo formal subpoenas. The investigations proceeded in this informal manner and, in August 2005, the SEC and Attorney General advised MBIA that they would take action against it for violation of securities law in connection with the AHERF transaction.

In the fall of 2005, MBIA made a settlement offer which included retention of an independent consultant, paid for by MBIA, to complete the investigations into the Capital Asset and U.S. Airways transactions. In early 2007, the SEC and Attorney General agreed to a settlement which did include retention of that independent consultant. Ultimately, the independent consultant cleared MBIA of wrongdoing with regard to those two transactions.

As a result of these investigations, MBIA received two derivative demand letters from shareholders. In response, MBIA organized a Demand Investigation Committee (DIC) made up of independent directors to investigate the derivative claims. When the DIC failed to make a recommendation within the statutory time period, two derivative lawsuits were filed. In response, MBIA formed the Special Litigation Committee (SLC), also made up of independent directors, to investigate the claims. The SLC retained outside counsel to investigate the derivative claims. Ultimately, the SLC determined that pursuit of the derivative claims was not in MBIA's best interest and recommended their dismissal. The court dismissed the claims.

MBIA claimed that it incurred a total of $29.5 million in defense costs and expenses responding to the SEC and New York Attorney General investigations and investigating and defending against the derivative lawsuits.

Insurers' Position

MBIA had purchased $15 million in primary insurance from Federal Insurance Company and $15 million in excess coverage from ACE American Insurance Company. The insuring agreement of the primary policy provided coverage for "all Securities Loss for which [MBIA] becomes legally obligated to pay on account of any Securities Claim…."[3] The

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policy defined Securities Claim 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."[4] The policy provided coverage for defense costs incurred for Securities Claims. The policy also provided coverage for investigation into derivative demands from shareholders, but only up to a separate $200,000 sub limit.

Federal agreed to pay $6.4 million, including the costs incurred to respond to the SEC investigation of the AHERF transaction and the $200,000 sublimit for the DIC investigation into the derivative demands. Federal denied coverage for the (i) Attorney General investigation into the AHERF transaction; (ii) the SEC and Attorney General investigations into the Capital Asset and U.S. Airways transactions; (iii) the costs incurred to pay the independent consultant; and (iv) the SLC expenses. ACE refused to pay on the grounds that the primary policy was not exhausted.

The District Court's Ruling

MBIA and the insurers filed cross-motions for summary judgment before the Southern District. On Dec. 30, 2009, Judge Richard M. Berman issued a ruling granting summary judgment to MBIA on most but not all of the issues in dispute. Judge Berman held that MBIA was entitled to coverage for the costs incurred in connection with the SEC and Attorney General investigations of all three transactions as well as for the legal costs incurred by counsel to the SLC to investigate and defend against the derivative demands.

Judge Berman found, however, that the policies did not cover the costs associated with the independent consultant, because MBIA did not provide adequate advanced notice of its intent to retain the consultant to review the Capital Asset and U.S. Airways transactions in accordance with the settlement agreement.[5]

The Second Circuit's Ruling

On appeal, the Second Circuit affirmed most of the Southern District's ruling but further expanded the scope of coverage. In a decision authored by Chief District Court Judge Loretta A. Preska (sitting by designation), on July 1, 2011, the Second Circuit affirmed the portion of the ruling granting coverage to MBIA for the costs incurred to respond to the SEC and Attorney General investigations of the three transactions. In addition, the Second Circuit also held that MBIA was entitled to coverage for the fees paid to the independent consultant in connection with the Capital Asset and U.S. Airways investigation. Finally, the Second Circuit granted MBIA's request for coverage of the fees incurred by counsel to the SLC.[6]

Investigation Costs

The Federal policy language defining the scope of a Securities Claim is actually quite broad, including 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." As a result, it is not surprising that the Southern District and the Second Circuit had little trouble concluding that at least some of the costs incurred by MBIA in response to the SEC and Attorney General investigations were incurred to defend a Securities Claim.

The fact that both courts held that the costs incurred in response to the informal agency document requests, in lieu of subpoenas, were also covered may be of particular significance to policyholders. The Second Circuit first found that the Attorney General investigation into the AHERF transaction was, like the SEC investigation into AHERF, a Securities Claim, because the Attorney General's service of a subpoena constituted the commencement of an investigation or at minimum service of a document similar to a "formal or informal investigative order." Next, the Second Circuit held that the SEC and Attorney General investigations of the Capital Asset and U.S. Airways transactions, whether by subpoena or informal agreement, were within the scope of the formal investigations commenced by the SEC and the New York Attorney General.

There are relatively few reported cases addressing disputes over the scope of coverage for investigation-related costs under D&O policies. But in the current regulatory climate, disputes over these issues can be expected to become more prevalent.

Costs incurred to comply with informal agreements to produce documents are not likely to be covered in every situation. However, in *MBIA*, because of the broad scope of the definition of Securities Claim and because the informal agreements followed and were connected with the formal investigation, the Second Circuit concluded that those costs were covered. The same might not be true, even under MBIA's policies, if the formal order did not pre-date the voluntary compliance.

Consultant and Committee

The Second Circuit also found that the fees paid to the independent consultant were covered, reversing the District Court on this issue. The insurers argued that the appointment of the independent consultant in the course of settlement discussions breached the insurers' "right to associate" in the defense of the insured. The Second Circuit, however, held that MBIA gave the insurers sufficient notice of the claims and settlement discussions, early enough in the process, so that the insurers had the opportunity to associate in the defense if they so chose. The court held that it is not the insured's duty to "return to the nonparticipating insurer each time negotiations about the same claim take a new twist and ask if the insurer still wants to opt out."[7]

The District Court had determined that the SLC's costs were covered legal defense costs, relying in part on its finding that outside counsel that performed the investigation for the SLC also defended MBIA (and filed motions to dismiss) in the derivative action.[8] The Second Circuit took an even broader view, finding that the SLC's costs were covered because the SLC was not a separate entity from MBIA and was therefore an insured person under the policy.[9]

This is an interesting analysis because the SLC was comprised of independent directors and charged with investigating the derivative claims to determine whether there was alleged wrongdoing such that MBIA should pursue claims against certain directors and officers or whether the derivative claims lacked merit. As the SLC determined that the claims lacked merit, it recommended dismissal of the claims and the court dismissed the derivative actions. In that sense, the SLC costs do seem like defense costs. However, the Second Circuit's analysis does not explain whether the SLC's costs would have been covered even if the SLC determined that the derivative claims should be prosecuted by MBIA.

Looking Forward

There are relatively few reported cases addressing disputes over the scope of coverage for investigation-related costs under D&O policies. But in the current regulatory climate, disputes over these issues can be expected to become more prevalent. For example, the recent enactment of the whistleblower provisions under the Dodd-Frank Act is likely to provide incentives that may lead to an increase in regulatory investigations. Scrutiny of the financial services industry by the SEC, New York Attorney General and other government agencies continues. Recently, the New York Attorney General also commenced an investigation into certain companies in the gas exploration and production and hydraulic fracking industries.

Reportedly, at least one insurance company is considering issuing standalone coverage for government investigations. Unless and until such separate policy forms become the norm, however, cases like MBIA, concerning the scope of coverage for investigations under D&O policies, are likely to take on added significance.

1. *MBIA Inc. v. Federal Insurance Co.*, __F.3d.__, 2011 WL 2583080 (2d Cir. July 1, 2011).
2. "Non-Traditional Products" 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 of 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…." Id at *2.
3. Id at *5.
4. Id at *5.
5. *MBIA Inc. v. Federal Insurance Co.*, No. 08 Civ. 4313, 2009 WL 6635307 (SDNY Dec. 30, 2009).
6. *MBIA*, 2011 WL 2583080 at *12.
7. Id. at *14.
8. *MBIA*, 2009 WL 6635307 at *9.
9. *MBIA*, 2011 WL 2583080 at *10.

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