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Costs Relating to Regulatory Investigations, Derivative Lawsuits, and Independent Consultant's Investigations Are Covered Under Contracts for Directors' and Officers' Liability Insurance

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The authors discuss a United States Court of Appeals for the Second Circuit decision holding that a policyholder was entitled to coverage under a directors' and officers' liability insurance contract for costs associated with financial regulators' investigations.

In *MBIA Inc. v. Fed. Ins. Co.*[1] the U.S. Court of Appeals for the Second Circuit held that a policyholder was entitled to coverage under directors' and officers' liability insurance contracts for costs associated with financial regulators' investigations, including costs associated with the investigation of a derivative shareholder litigation and the cost of an independent consultant's investigation pursuant to a settlement with government regulators.

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BACKGROUND

MBIA, Inc. ("MBIA" or the "Policyholder"), a Connecticut bond insurer, purchased directors' and officers' insurance policies from Federal Insurance Co. ("Federal") and ACE American Insurance Co. ("Ace") (collectively the "Insurers"). The policies provided coverage for, among other things, "Securities Claims" and "Securities Defense Costs." Securities Claims were defined to be "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." Securities Defense Costs were defined as "costs incurred in defending or investigating Securities Claims."

On March 9, 2001, the Securities and Exchange Commission ("SEC") issued a formal order of investigation of MBIA. In 2004, as part of the investigation, the SEC issued several subpoenas to MBIA, seeking documents concerning its compliance with securities laws, financial recordkeeping and financial reporting. The New York attorney general ("NYAG") followed suit and issued a subpoena to MBIA in connection with a separate, but similar, investigation. Following the initial phases of the SEC and NYAG investigations, MBIA was targeted for three specific transactions: the AHERF transaction, the Capital Asset transaction, and the US Airways transaction.

In May 2005, MBIA informed its Insurers that it was the subject of a regulatory investigation by providing the SEC and NYAG subpoenas to the Insurers. The Insurers did not view the subpoenas as sufficient to trigger coverage; however, they accepted the subpoenas as notice of a potential claim under the policies. In the summer of 2005, when the SEC and the NYAG considered issuing additional subpoenas, MBIA negotiated voluntary compliance in lieu of the subpoenas to avoid further adverse publicity. The SEC and the NYAG accepted voluntary compliance concerning the Capital Asset and US Airways transactions.

In August 2005, federal and state regulators advised MBIA that they intended to take action against MBIA for securities law violations. MBIA sought consent from its Insurers to settle with the regulators. The Insurers contended the settlement was not covered by the policy, but, nevertheless,

agreed to waive lack of written consent to settlement as a defense to coverage. Accordingly, MBIA signed a preliminary offer of settlement with the SEC and the NYAG, which included, among other terms, that MBIA agreed to hire an independent consultant to review the Capital Asset and US Airways transactions, both of which were at issue in the investigation and alleged violations.

As a result of the investigations, MBIA's shareholders brought two derivative suits alleging financial wrongdoing by MBIA. In accordance with Connecticut law, MBIA was required to set up a committee of independent directors (the "Demand Investigation Committee" or "DIC") and a special litigation committee (the "SLC") to determine whether maintaining the suits was in the best interests of MBIA. The SLC ultimately determined that the lawsuits should be dismissed, but not before MBIA had incurred substantial costs.

MBIA agreed to pay $50 million in civil penalties for the AHERF transaction, and MBIA was exonerated of any wrongdoing for the Capital Asset and US Airways transactions. The Insurers, however, agreed to cover only $6.4 million in costs, refusing to cover costs associated with the NYAG investigation, the Capital Asset investigation or the US Airways investigations.

As a result, MBIA filed a lawsuit in the Southern District of New York to compel the Insurers to cover the costs of all three investigations. After review, the district court granted summary judgment in favor of MBIA regarding coverage for costs associated with all three investigations, as well as the costs incurred by the SLC. The district court awarded summary judgment to the Insurers with respect to coverage for costs associated with the independent consultant's investigation. Both parties appealed.

The Insurers argued that the district court erred in two ways. First, the Insurers argued that the NYAG investigation, the Capital Asset investigation and the US Airways investigations were not "Securities Claims," as defined by the policies. In support, the Insurers contended that the NYAG subpoena did not constitute a formal order, and the caption on the SEC order served to limit the scope of the investigation to a certain class of transactions, not to include the Capital Asset or US Airways investigations. The Insurers also argued that the Capital Asset and US Airways investigations

were not Securities Claims because MBIA voluntarily complied with the SEC's document requests rather than producing them through the subpoena process and because the SEC official making the requests was not named on the initial SEC order.

Second, the Insurers argued that the district court erred because costs incurred by the SLC either were not covered, since the SLC was not an "Insured Person," or they were subject to a $200,000 policy sublimit.

MBIA argued that the district court erred in denying coverage for the costs of the independent consultant.

HOLDING

Upon review, the Second Circuit affirmed the district court's ruling for MBIA concerning the costs associated with the three investigations and the costs incurred by the SLC. But, the Second Circuit reversed the district court concerning the independent consultant's costs and held that MBIA is also entitled to coverage for those costs.

According to the Second Circuit, the NYAG's subpoena came within the definition of a "Securities Claim" because the subpoena was "at least a similar document" to a "formal or informal investigative order" that commenced a regulatory proceeding. Thus, because the subpoena amounted to a Securities Claim, the investigatory costs associated with that subpoena were "Securities Losses" as defined in the policy.

The court also held that the SEC's investigations of the Capital Asset and US Airways transactions were covered "Securities Losses." The court looked to the nature and scope of the SEC's formal order, and not to the caption or persons named on the subpoena, as the Insurers had argued, to define the scope of the investigation. The court stated that the investigation need not be pursued by only individuals named on the formal order. The court also refused to attach significance to MBIA's voluntarily compliance with the regulators' document requests, explaining that a company may take steps to mitigate public relations damage and exposure without jeopardizing coverage that otherwise would be reasonably expected to apply.

Next, the Second Circuit held that MBIA could recover the costs associated with the SLC, thereby rejecting the Insurers' argument that the

SLC was not an "Insured Person" under the policy. The court reasoned that the SLC's independence was an "independence of judgment," rather than a new source of authority. The court also held that the Insurers failed to prove that the SLC costs fell within the $200,000 policy sublimit for shareholder demand investigations. The court reasoned that the $200,000 sublimit would apply only to pre-litigation demand costs and not to litigation-related costs of the SLC.

Finally, the Second Circuit determined whether the costs associated with the independent consultant were covered under the policies. The district court had found that MBIA could not recover the independent consultant costs because MBIA breached the policies' "right to associate" provision. But, the Second Circuit disagreed, finding that MBIA fulfilled its obligations under the right to associate clause when it provided notice to the Insurers of the claims involved in the settlement discussions. The court explained that "where the insured gives the insurers an invitation to associate with adequate information about the claim under consideration for settlement, the insured has done what is required under this clause." This is the case even if, as in *MBIA,* the policyholder simply informs the insurers of the proposed settlement, but fails to inform the insurers of any additional components, such as an independent consultant. Any other result, according to the court, would require the policyholder to revisit the claim with the nonparticipating insurer each time negotiations about the same claim "take a new twist." The court noted that independent consultants are not a "rare component of regulatory settlements" and should not be an unforeseeable component of the settlement discussions. Thus, where the Insurers were notified of the proposed settlement but failed to take part in settlement negotiations, the Policyholder was entitled to recover the costs of the independent consultant's investigation, particularly where the Insurers failed to object after they learned of the independent consultant component.

IMPLICATIONS

The *MBIA* decision is of particular significance to policyholders in today's economy, where lawmakers, governmental auditors and regulators are becoming increasingly suspicious of corporate dealings and transac-

tions, thereby requiring policyholders to incur substantial investigation and compliance costs. As illustrated in *MBIA*, the costs of such regulatory suspicion and investigation should be covered under contracts for Directors & Officers liability insurance.

The decision is also significant because it broadly interprets the definition of "Securities Claims" and "Securities Defense Costs," thereby suggesting that other fees and costs associated with a covered Directors & Officers liability claim likewise should be covered under contracts for Directors & Officers liability insurance.

Finally, the *MBIA* decision underscores the importance of keeping an insurer informed, even when the insurer denies coverage, defends under a reservation of rights or chooses to opt out of settlement negotiations. Although the policyholder ultimately prevailed on the independent consultant issue, the court stressed the importance of providing adequate notice to the insurer regarding the claim under consideration for settlement.

NOTE

[1] No. 10-0355-cv, 2011 U.S. App. Lexis 13402 (2d Cir. July 1, 2011).