Second Circuit Finds Broad Coverage for Investigative Costs Under D&O Policy

On July 1, 2011, the United States Court of Appeals for the Second Circuit issued an opinion finding broad coverage under directors and officers ("D&O") insurance policies for pre- and post-suit costs relating to investigations. *MBIA Inc.* v. *Federal Ins. Co.* (opinion by Chief Judge Preska, sitting by designation).

In applying New York and Connecticut law, the Court of Appeals specifically found coverage for: (i) costs incurred to respond to a subpoena from the New York Attorney General ("NYAG"), (ii) costs "voluntarily" incurred to respond to an oral request for information from the SEC, (iii) costs "voluntarily" incurred to respond to an oral request for information from the NYAG, (iv) costs incurred by a special litigation committee of the board of directors after initiation of derivative litigation to investigate the allegations made in such litigation, and (v) costs of independent consultants retained to investigate transactions which investigations were required in connection with a settlement with the SEC and the NYAG.

The policies in question provided "entity" (or "Side C") coverage to the company, MBIA, in respect of its own liability and defense costs arising out of securities claims (as distinguished from those of individual directors and officers). A "securities claim" was defined in the policy as encompassing "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." Slip Opinion at 13.

In finding coverage for the costs incurred to respond to the NYAG subpoena, the Court of Appeals found that such a subpoena "is at least a 'similar document' to a 'formal or informal investigative order' that commenced a regulatory proceeding." Slip Opinion at 14. The Court specifically rejected the insurers' argument that the omission of "subpoena" from the definition of "securities claim" meant that there was no coverage in respect of same. The Court noted that "a subpoena is the primary investigative implement in the NYAG's toolshed." Slip Opinion at 15.

The Court's finding that there was coverage for costs voluntarily incurred to respond to an oral request for information from the SEC is interesting in that it was premised on the existence of a formal SEC order of investigation which predated the policy period of the D&O policies by several years. The Court's opinion gives no indication that the argument was raised or considered that the insured's reliance on such order of investigation meant that the claim was first made prior to the policy period and, therefore, not covered. The Court explicitly found that the fact that the SEC made a follow-up oral request for information was no different than if the SEC had issued a subpoena or other formal process. The Court noted that the company in this case requested that the SEC not issue a formal subpoena and promised "voluntary" compliance, then reasoning, "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." Slip Opinion at 18-19. The Court distinguished other cases where the definition of a covered claim did not include "informal" investigations. Slip Opinion at 19, n.3.

The Court also found that there was coverage for costs voluntarily incurred to respond to an oral request for information from the NYAG. The Court's reasoning that no formal subpoena was required was similar to that described above as respects the SEC request for information, and the Court tied oral requests for information back to the earlier subpoena to establish a predicate that there was an "investigation." Slip Opinion at 20. It is not clear how the Court would have ruled had the initial request from the NYAG been oral instead of a formal subpoena. Although not stated in the Court's opinion, it is implicit that the Court viewed SEC practice differently from NYAG practice in looking to the SEC order of investigation as a necessary prerequisite for there being a

"securities claim" but not requiring anything other than a subpoena or, perhaps, an oral request for information as respects the NYAG.

The D&O policies at issue in the case contained an express sublimit (of $200,000) for derivative demand investigation costs. Slip Opinion at 21. The insured company, however, was seeking to recover costs in excess of this amount incurred by the special litigation committee after the institution of the derivative litigation. The definition of covered "loss" in the policy excluded "any amount incurred by [MBIA] (including its board of directors or any committee of the board of directors) in connection with the investigation or evaluation of any Claim or potential Claim by or on behalf of [MBIA]." Slip Opinion at 28. Nonetheless, the court found coverage for the costs incurred by the special litigation committee. The Court reasoned that "on behalf of" was equivocal in this context because MBIA was a nominal defendant and that the costs related to pending litigation, not investigation. Slip Opinion at 29.

Finally, the Court found coverage for the costs incurred for the independent consultant to investigate certain transactions as required by a settlement with the SEC and NYAG. The principal issue raised by the insurers in this context was that the company assertedly did not provide sufficient notice and cooperation to the insurers as respects this aspect of the settlement. The Court rejected these arguments finding sufficient the insured's notice of the original claims and after-the-fact notice that the independent consultant requirement was incorporated in the "preliminary" settlement (which was subject to a condition of regulatory approval). Slip Opinion at 35. The Court also relied upon the fact that the insurers did not object to the settlement upon being informed of the independent consultant feature. Slip Opinion at pp. 39-40.

Construing policy language susceptible of differing interpretations in favor of the insured seems at the heart of the Court's analysis.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Thorn Rosenthal at 212.701.3823 or trosenthal@cahill.com.