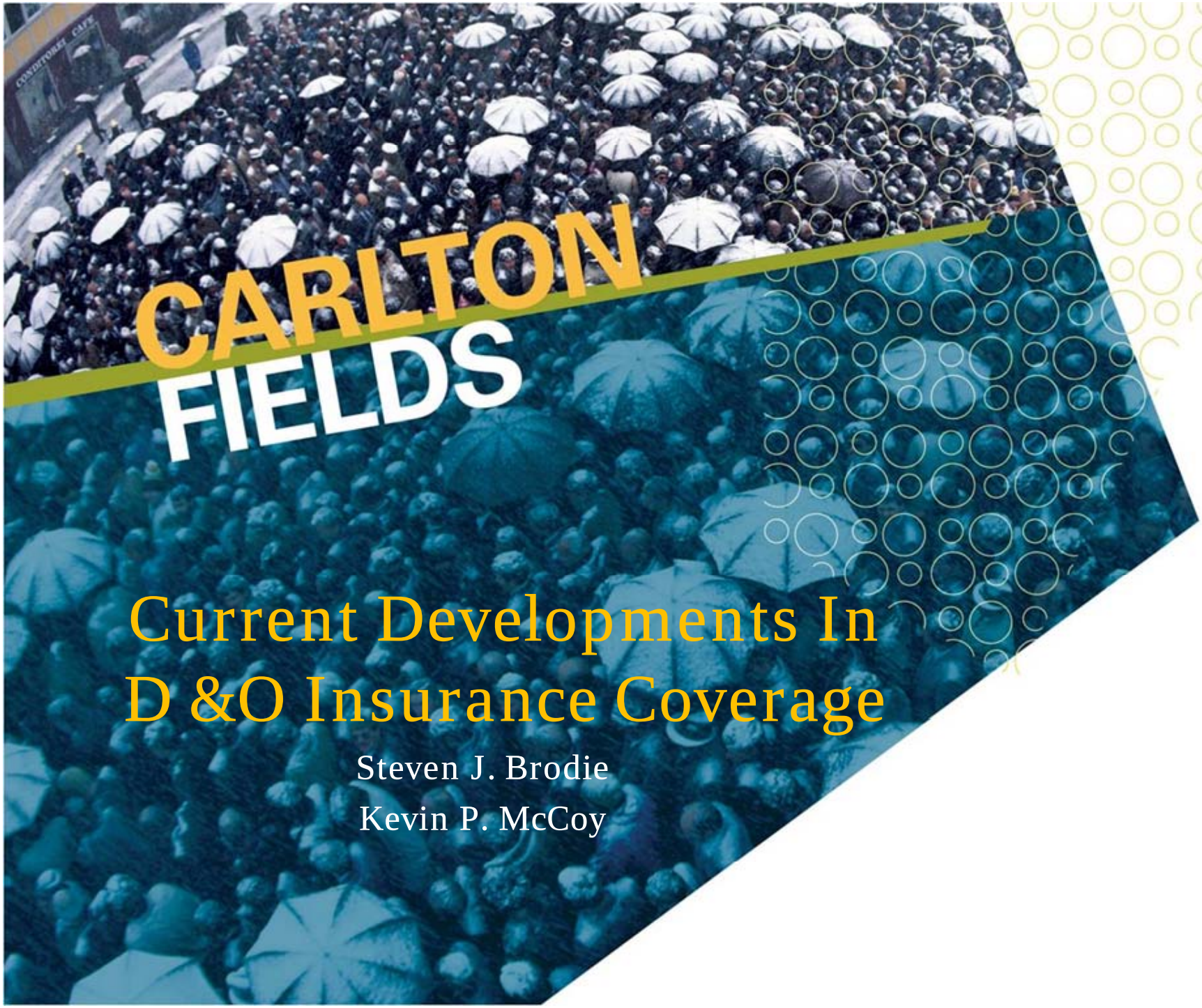

Current Developments In D &O Insurance Coverage

Steven J. Brodie

Kevin P. McCoy

Insuring the Predictable Aspects of Federal Securities Litigation

- The timing of government investigations and related shareholder derivative or class action litigation is fortuitous.

- Government investigations, however, follow a relatively predictable pattern. In fact, the SEC publishes a manual that lays out the steps in its investigation.
  - ***www.sec.gov/divisions/enforce/enforcementmanual.pdf***

- The information necessary for the insured and insurer to make an informed decision in the purchase of D&O insurance products is readily available. This purchase should be made with the costs associated with investigations and related litigation in mind.

CARLTON FIELDS

Insuring the Predictable Aspects of Federal Securities Litigation (cont.)

- For example, a typical investigation may include:
  - **Document preservation and litigation holds**
  - **Informal document production requests**
  - **Formal document production requests**
  - **Informal witness interviews**
  - **Testimony and document subpoenas following a Formal Order of Investigation**
  - **Wells Notices and white paper submissions**
  - **Enforcement proceedings**

- Allegations of misconduct often trigger internal investigations, Audit Committee reviews, shareholder derivative and/or class action lawsuits, and indemnification requirements for individual D&Os.

- An organization can incur tens of millions of dollars in costs before an investigation ever targets an individual, or meets the policy definition of an insured claim or securities claim.

- Four recent decisions highlight the differences in coverage depending on the plain language definitions of “Claims” and “Securities Claims” used in the policy.

Office Depot v. National Union Fire Insurance Company of Pittsburgh, PA

- Reported at 734 F. Supp. 2d 1310 (S.D. Fla. 2010) aff'd 2011 WL 484095 (11th Cir. Oct. 13, 2011).

- Outcome – The Eleventh Circuit *per curiam* affirmed the district court's summary judgment ruling that no coverage existed for the more than $25 million in costs Office Depot incurred in responding to the SEC's informal inquiry and later formal order of investigation of Office Depot's conduct. It also found no coverage for the costs Office Depot incurred for its internal Audit Committee's investigation of certain accounting irregularities.

- Why – The Policy covered "Claims" against the individual D&Os, but only "Securities Claims" against Office Depot. The SEC's document requests and informal and formal orders of investigation did not meet the plain language of the "Securities Claims" definition for Office Depot. The definition of "Securities Claim" excepted coverage for "an administrative or regulatory proceeding, or investigation of an Organization."

- Both the district court and Eleventh Circuit rejected Office Depot's argument that under the policy's claims-reporting provisions, all costs incurred once there was a covered "Claim" or "Securities Claim" related back to the date it gave a "Notice of Circumstances." The courts enforced the plain language of the definition of covered "Defense Costs" as limiting coverage to only those costs "resulting solely from" a covered "Claim" or "Securities Claim."

MBIA v. Federal Insurance

- Reported at 652 F.3d 152 (2d Cir. 2011).
- Outcome – Second Circuit held the policy covered the costs associated with investigatory subpoenas and the SEC's formal order of investigation.
- Why -- The policy defined "Securities Claim" to mean "a formal or informal administrative or regulatory proceeding or inquiry commenced by the filing of a . . . formal or informal investigative order or similar document."
- The court equated a subpoena to a "formal or informal investigative order" and agreed with the district court's "sensible intuition" that a businessperson would "view a subpoena as a 'formal or informal investigative order' based on the common understanding of these words." The court continued, "the subpoena is, at absolute minimum, a 'similar document' to those listed [in] the definition of a 'Securities Claim' because it is similar to other forms of investigative demands made by regulators."
- The Second Circuit also agreed that the costs associated with the SEC's formal order of investigation for a related transaction came within the policy definition a "Securities Claim."

CARLTON FIELDS

National Stock Exchange v. Federal Insurance Company

- Reported at 2007 WL 1030293 (N.D. Ill. Mar. 30, 2007).
- Outcome – The court held the policy covered the costs of the SEC's investigation beginning with the date the SEC issued a formal order of investigation. The court rejected the insured's argument for coverage for costs incurred before a defined "Claim" triggered coverage. The insured had argued these costs should be covered because they were useful to the defense of the later "Claim."
- Why – The policy defined a "Claim" to mean "a formal administrative or regulatory proceeding commenced by . . . [a] formal investigative order . . . ." The court viewed the SEC's formal order of investigation as a coverage trigger under the plain language of this definition.
- "If [the insurer] did not wish to include SEC investigations . . . [it] could have omitted the phrase "commenced by the filing of a . . . formal investigative order, or similar document."
- Similarly, if the insured wanted coverage for pre-Claim investigation costs, it should have insisted that the policy language extend to potential claims.

Employers' Fire Insurance v. ProMedica Health System

- Reported at 2011 WL 6937488 (N.D. Oh. Dec. 31, 2011).

- Outcome – The court ruled that the insured failed to give notice of a "Claim" within the policy reporting period. The insured's failure to give such notice relieved the insurer of the duty to indemnify ProMedica for the costs associated with an FTC investigation.

- Why – The policy defined "Claim" to mean "(1) a written demand for monetary, non-monetary or injunctive relief . . . ; or (2) a civil, criminal, administrative, regulatory or arbitration proceeding for monetary, non-monetary or injunctive relief commenced by: (a) the service of a complaint or similar pleading; (b) the return of an indictment, information or similar document . . . ; or (c) the filing of a notice of charges, formal investigative order or similar document against an Insured for a Wrongful Act . . . ."

- The court said the FTC's investigation order triggered coverage and should have been reported as a "Claim" within the policy period. In distinguishing the decisions in *MBIA* and *Office Depot* the court said, "th[is] case demonstrates that these inquiries largely turn on the terms of the policy and the specific underlying facts."

CARLTON FIELDS

Other Considerations – Insurer Consent to Defense Costs

Apart from the coverage accorded by the insuring clauses themselves, most D&O policies have provisions governing the costs that are, and are not, covered once a "Claim" exists. For example:

- Consent Clauses – Insureds should be aware that most D&O policies have consent clauses that require the consent of the insurer before costs are incurred. These clauses do not extend the coverage provided under the policy, but they can be a pitfall for unwary insureds that do not keep their insurer informed of the costs they are incurring by hiring outside counsel or otherwise. It is better to ask for permission rather than seek forgiveness concerning the insurer's consent to costs it will be expected to pay. Often insurers will agree to costs they otherwise would not have to pay if there is an informed, front-end discussion about the need for such costs.

- Definition of Defense Costs – Policies vary in their definition of covered "Defense Costs." This was a key definition in the *Office Depot* case, which the courts seized upon to reject Office Depot's claim for coverage prior to the existence of an actual Claim. Insureds need to understand what costs will fit within their policy's definition of "Defense Costs." They should not simply expect that all costs they incur relating to a covered "Claim" will be paid by their insurer.

Takeaways

- The different coverage outcomes in *Office Depot*, *MBIA*, *National Stock Exchange*, and *Employers' Fire* highlight the need to understand the definition of "Claims" and "Securities Claims" when purchasing D&O insurance.

- The policy in *Office Depot* expressly excepted out coverage for "an administrative or regulatory proceeding, or investigation of [Office Depot]." This carve out was fundamentally different than the coverage accorded for "Securities Claims" under different policies. Insureds cannot look to different policies with different terms, to prove coverage under their policy.

- Many aspects of an investigation and related securities litigation are predictable. Know these aspects, their costs, and what risk tolerance the insured is willing to accept *before* costs start rolling in.

- Know the conditions to payment of defenses costs once a covered "Claim" exists. Obtain insurer consent to costs before they are incurred. Communication is key.

- Shop the market – In response to demands for new approaches to coverage, carriers are offering new insurance products to cover costs traditionally excluded from coverage. One example is Chartis's new Executive Edge policy. It now provides coverage for certain categories of pre-Claim investigation costs.
  - http://www.chartisinsurance.com/us-executive-edge_295_253434.html