

When The Regulators Come Calling, Will Your Company Have The Right D&O Coverage?

*by Kali N. Bracey, Lorelie S. Masters, Matthew L. Jacobs, Jerry J. Burgdoerfer,
Ronald L. Marmer and Andrew Weissmann*

Introduction

In the wake of the economic meltdown, state and federal authorities are stepping up their investigations into alleged violations of the securities laws. While companies purchase Directors and Officers Policies ("D&O Policies") designed to cover such investigations and other types of claims, it can be difficult to get the insurers to defend or pay such claims. Recently, Judge Richard Berman of the United States District Court of the Southern District of New York gave D&O policyholders ammunition against insurers when he upheld coverage for MBIA, Inc., ("MBIA") under policies sold by Federal Insurance Company ("Federal") and ACE American Insurance Company ("ACE") (collectively, "Policies") for the costs MBIA incurred in responding to inquiries and subpoenas by the State of New York Attorney General ("NYAG") and the Securities and Exchange Commission ("SEC").¹ Significantly, Judge Berman also upheld coverage for MBIA's Special Litigation Committee's ("SLC") costs in investigating a shareholder derivative action.

The Insurance Policies

In 2004, MBIA purchased a primary insurance policy from Federal and an excess insurance policy from ACE. The Federal Policy provided "a \$15 million maximum aggregate limit of liability, inclusive of Defense Costs, for all claims and Securities Claims." The Federal Policy defined a "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" that arises from the purchase or sale of securities. ACE

provided \$15 million in excess coverage and covered the same losses as the Federal Policy.

Facts

In March 2001, the SEC issued a formal order against MBIA and a subpoena seeking information about loss mitigation products, a type of insurance product which transfers more limited risk to the policyholder than traditional insurance. Loss mitigation products often involve a retroactive insurance policy in which an insurer lends a policyholder money to pay for known losses in the first year of the policy and the "premiums" the policyholder pays in subsequent policy years are actually repayments on the loan. The SEC also issued subpoenas pursuant to the March 2001 formal order on November 17, 2004, and December 8, 2004. On November 18, 2004, and December 15, 2004, the NYAG issued subpoenas to MBIA for, among other things, all documents concerning "Non-Traditional Product transactions entered into by MBIA." MBIA complied with the SEC and NYAG subpoenas and produced documents related to the liability it incurred when the Delaware Valley Obligated Group of Allegheny Health, Education and Research Foundation ("AHERF") filed for bankruptcy ("AHERF Transaction"). In the spring of 2005, MBIA sought to minimize the negative publicity associated with multiple subpoenas and agreed to comply voluntarily with informal requests for documents from the SEC.

The SEC and NYAG investigations expanded when both agencies sought information related to two additional non-traditional product transactions ("Additional Transactions")

that were similar to the AHERF Transaction. The NYAG sought documents related to the Additional Transactions pursuant to oral requests for information while the SEC sought documents pursuant to its March 2001 formal order.

In October 2005, MBIA executed an “Offer of Settlement” with the SEC in which it undertook to retain and pay for an Independent Consultant to conduct a comprehensive review of MBIA’s accounting for, and disclosures concerning, the Additional Transactions. MBIA entered into a similar agreement with the NYAG in early 2007. Pursuant to the settlement agreements with both the SEC and NYAG, MBIA hired an Independent Consultant who began working in May 2006.

Shareholders filed two derivative actions in September and November 2005. MBIA formed the SLC which determined that maintaining derivative actions was not in the best interest of MBIA or its shareholders.

MBIA filed a declaratory judgment action against Federal and ACE seeking a determination that it had coverage for four events:

- (1) the investigation commenced by the issuance of a subpoena by the NYAG;
- (2) the SEC and NYAG investigations of the Additional Transactions ²;
- (3) the SLC’s work evaluating and defending two derivative actions brought by MBIA shareholders; and
- (4) the Independent Consultant’s investigation.

The parties filed cross-motions for summary judgment.

Court’s Ruling

Applying New York law, the Court granted MBIA’s motion for summary judgment on three out of the four grounds, upholding coverage for the bulk of the policyholder’s defense costs. First, the Court held that the NYAG subpoena was a formal or informal investigative order and therefore qualified as a “Securities Claim” under the Policies. Even if the NYAG subpoena did not constitute an order, the Court held that the NYAG subpoena was “sufficiently similar” to a Securities Claim under the Policies to be covered. The

Court enforced coverage for the costs of defending the subsequent NYAG oral request for documents related to the Additional Transactions. Second, the SEC and NYAG investigations into the Additional Transactions triggered coverage because those transactions had a similar goal – the avoidance of booking losses – as the AHERF Transaction.

Third, with respect to the derivative action, MBIA argued that the law firm representing the SLC also represented MBIA when it entered an appearance as “Counsel for Nominal Defendant MBIA.” Federal and ACE argued that an SLC must be independent of the company and cannot stand in the company’s shoes. Even if the law firm had represented only the SLC, the Court reasoned, the SLC was vested with the responsibility to determine whether the derivative action was in the best interest of MBIA. Therefore, the Court concluded that the costs of the SLC’s investigation into the pursuit of the derivative actions constituted costs for defending MBIA under the Policies.

Finally, the Court found that MBIA had not given the insurers the opportunity to “effectively associate” with MBIA in the settlement of the claim and, thus, failed to inform the insurers about the hiring of the Independent Consultant “until at least ten months” after his retention. Concluding that this conduct ran afoul of the Policies’ “cooperation clauses,” the Court held that the costs of hiring the Independent Consultant were therefore not covered.

Advice for Policyholders

The costs of defending and responding to state and federal securities investigations can be expensive, even apart from any fines or penalties Policyholders may have to pay. In this case, the total outlay for defending and responding to the regulatory investigations and the follow-on derivative litigation was nearly \$30 million. The insurers had paid \$6.4 million beyond MBIA’s deductible but refused to pay more. The court relied on MBIA’s broadly worded insurance policy to uphold coverage for the majority of those defense costs. Policyholders should examine their D&O policies to determine if their policies contain similar language to that in the MBIA policies which defined a “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.” If Policyholders discover that their D&O policies define “securities claims” more narrowly than the MBIA policies, they should consider purchasing policies that define “securities claims” with broader language. Of course, D&O insurance policies that contain broader language can be more expensive than those affording narrower coverage. Policyholders should purchase the most

coverage they can afford. Policyholders also should seek recovery for all of their defense costs, including the costs of an SLC, under this ruling.

Finally, Policyholders should keep their insurers informed, even if the insurers have denied coverage or are defending under a reservation of rights. In this case, MBIA was unable to recover the costs generated by the Independent Consultant because it failed to keep its insurers adequately informed.

Endnotes

1 *MBIA, Inc. v. Federal Ins. Co. and Ace Am. Ins. Co.*, No. 08 CIV 4313, slip op. (S.D.N.Y. Dec. 30, 2009).

2 Federal and ACE alleged that the compliance with the SEC’s formal order and subpoenas was covered by the Policies. They only contested coverage for the SEC’s investigation of the Additional Transactions.

For more information, please contact the following Jenner & Block attorneys:

Kali N. Bracey

Partner, Insurance Litigation and
Counseling Practice
Tel: 202 639-6871
Email: kbracey@jenner.com

Matthew L. Jacobs

Partner, Insurance Litigation and
Counseling Practice
Tel: 202 639-6096
Email: mjacobs@jenner.com

Ronald L. Marmer

Partner, Securities Litigation Practice
Tel: 312 923-26886096
Email: rmarmer@jenner.com

Lorelie S. Masters

Partner, Insurance Litigation and
Counseling Practice
Tel: 202 639-6076
Email: lmasters@jenner.com

Jerry J. Burgdoerfer

Partner, Securities Practice
Tel: 312 923-2820
Email: jburgdoerfer@jenner.com

Andrew Weissmann

Partner, White Collar Defense and
Investigations Practice
Tel: 212 891-1650
Email: aweissmann@jenner.com