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Second Circuit Holds That D&O Policies Cover Expenses Related to Voluntary Compliance with Agency Investigations and Costs of Special Litigation Committee

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In its July 1, 2011 opinion *MBIA, Inc. v. Federal Ins. Co. and ACE American Ins. Co.*, 10-0355-cv (2d Cir. July 1, 2011), the U.S. Court of Appeals for the 2nd Circuit rejected Insurers Federal Insurance Company's (Federal) and ACE American Insurance Company's (ACE)(collectively, the Insurers) appeals seeking to reverse a finding of coverage for (1) expenses associated with federal and state government investigations into the insured's accounting practices, and (2) a special litigation committee formed to investigate the shareholder derivative suits that followed the agency scrutiny. In an analysis heavily influenced by the facts, the 2nd Circuit swept aside the Insurers' arguments that their D&O policies did not cover expenses associated with what they argued were informal agency inquiries and investigations only loosely associated with written agency orders and subpoenas. The court also concluded that expenses incurred by the special litigation committee formed by the insured, MBIA, Inc. (MBIA), to investigate two derivative suits were "Defense Costs" covered under the Insurers' D&O policies. On close scrutiny, however, the impact of the decision may be limited based on the particular policy language at issue and the facts of the case.

The Policies

MBIA provides financial guarantee insurance for government bonds or structured finance obligations – essentially guaranteeing that bond holders would be paid with respect to MBIA's clients' bonds. MBIA purchased $15 million in primary D&O insurance from Federal covering the period of February 15, 2004 through August 15, 2004. ACE issued $15 million in excess coverage that followed form to the Federal policy in all respects relevant to the lawsuit (collectively, the Policies). The Policies' entity coverage section provided: "The Company shall pay on behalf of any Organization all Securities Loss for which it becomes legally obligated to pay on account of any Securities Claim first made against it during the Policy Period …." The Policies further covered "Defense Costs" for "Securities Claims." "Securities Claim" was defined 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 "in whole or in part, is based upon, arises from or is in consequence of the purchase or sale of, or offer to purchase or sell any securities issued by [MBIA]."

The Agency Investigations and MBIA's Claim

In 2001, the SEC issued an Order Directing Private Investigation and initiated an investigation into potentially unlawful accounting practices in the insurance industry. The SEC targeted MBIA in November 2004 as part of that larger investigation, issuing subpoenas compelling the company to produce documents concerning transactions involving "non-traditional products" – products that could be used to "affect the timing or amount of revenue or expense recognized." The New York attorney general (NYAG) followed suit, serving MBIA with similar subpoenas requesting similar documents in November and December 2004.

The federal and state investigations eventually focused on three separate MBIA transactions. In the first transaction, MBIA purchased reinsurance for its guarantee of bonds issued by a group of hospitals owned by the Allegheny Health, Education and Research Foundation (AHERF) after AHERF declared bankruptcy. The investigations sought to determine whether MBIA endeavored to disguise the impact of a $170 million loss from the transaction with AHERF.

In the summer of 2005, the SEC and NYAG began investigating two additional transactions. In the second such transaction, MBIA purchased an interest in Capital Asset Holdings GP, Inc. (Capital Asset), but soon found it necessary to provide additional, unanticipated funds to Capital Asset. MBIA made the payment through a subsidiary, thereby transferring the risk of the investment loss to the subsidiary and allegedly disguising a potential loss to the parent company. The third transaction involved MBIA's guarantee of securities used to purchase airplanes for US Airways.

MBIA foreclosed on the airplanes after US Airways declared bankruptcy and treated the transaction as an investment in airplanes rather than a loss.

MBIA forwarded the agency subpoenas to the Insurers in May 2005, informing them that it was the target of state and federal investigations. MBIA asked for the Insurers' consent to retain counsel. The Insurers denied that the subpoenas triggered coverage, but accepted the subpoenas as notice of a potential claim. MBIA hired counsel and responded to the agency inquiries.

The SEC and NYAG considered issuing additional subpoenas concerning the Capital Asset and US Airways transactions in the summer of 2005. Concerned about additional adverse publicity, MBIA requested that the agencies hold off on issuing more subpoenas, and instead accept MBIA's voluntary compliance with the agencies' demands. The SEC and NYAG agreed and, thereafter, MBIA complied with the agencies' informal, often oral, requests.

In October 2005, MBIA forwarded the agencies an offer of settlement concerning the AHERF transaction investigation. That offer included a payment of penalties and MBIA's proposal to retain an independent consultant to analyze the Capital Asset and US Airways matters. MBIA notified the Insurers of the settlement discussions in September 2005 and met with Federal in October 2005. At the time, however, MBIA did not advise the Insurers of its proposal to hire an independent consultant. The SEC and NYAG finalized settlements with MBIA in January 2007 in accords substantially similar to MBIA's October 2005 offer. The independent consultant later exonerated MBIA of any wrongdoing in the Capital Asset and US Airways transactions.

MBIA's shareholders followed the state and federal agency investigations with two derivative lawsuits. Upon receiving the shareholder plaintiffs' presuit demand letters, MBIA formed a Demand Investigative Committee (DIC) – a committee of independent directors tasked with investigating the shareholders' demand letter. The DIC retained an outside law firm, Dickstein Shapiro (Dickstein), to assist in the investigation. When the DIC failed to act on the shareholders' derivative demand within the time allotted by Connecticut law, the shareholders filed suit. MBIA reconstituted the DIC as a Special Litigation Committee (SLC), which again employed Dickstein to aid in the investigation of the derivative suit allegations. The SLC concluded that the suits were not in the best interests of the company and, consistent with Connecticut law, moved to dismiss the complaints.

MBIA submitted a claim with the Insurers seeking costs associated with the agencies' investigations of the three transactions, the cost of the independent consultant retained to investigate the Capital Asset and US Airways transactions, and expenses associated with the DIC and the SLC. Federal paid MBIA approximately $6.4 million out of its $15 million limit to cover losses from the SEC investigation of the AHERF transaction and related lawsuits. The payment included $200,000 for the DIC's investigation of the shareholder plaintiffs' presuit demand pursuant to the Federal policy's derivative investigation coverage sublimit. Federal denied MBIA's claim for losses associated with the NYAG investigation of the AHERF transaction, the SEC and NYAG investigations of the Capital Asset and US Airways transactions, the independent consultant, and the SLC. ACE denied that it had any obligation to pay for any of the losses based upon MBIA's non-exhaustion of the primary policy.

The Motions for Summary Judgment and Appeal

MBIA filed suit against the Insurers on May 7, 2008, asserting three claims for breach of contract and seeking a declaratory judgment. MBIA and the Insurers cross-moved for summary judgment on MBIA's claim for losses associated with the NYAG investigation of the AHERF transaction, the SEC and NYAG investigations of the Capital Asset and US Airways transactions, the independent consultant, and the SLC.

Judge Berman of the Southern District of New York granted in part and denied in part the parties' cross-motions for summary judgment. On balance, however, the Southern District found in MBIA's favor, holding that the Insurers owed coverage for the SEC and NYAG investigations of all three transactions, as well as for the expenses incurred by the SLC. The District Court determined that MBIA was not entitled to coverage for the costs associated with the independent consultant's review of the Capital Asset and US Airways transactions because MBIA had not provided the Insurers with adequate notice of its intent to retain the consultant. The Insurers appealed and MBIA cross-appealed.

The Insurers' appeal challenged the District Court's holdings that the Policies obligated the Insurers to cover losses associated with (1) the NYAG investigation of the AHERF transaction, (2) the SEC and NYAG investigations of the Capital Asset and US Airways transactions, and (3) the SLC.

On the first issue, the Insurers argued that the NYAG subpoena was a "mere discovery device" that did not meet the Policies' definition of "Securities Claim." The 2nd Circuit

disagreed, pointing out that a subpoena is the "primary investigative implement in the NYAG's toolshed," and that, at a minimum, it constituted a document similar to a "formal or informal investigative order," which was within the definition of "Securities Claim."

On the second issue, the 2nd Circuit rejected the Insurers' argument that the SEC and NYAG investigations into the Capital Asset and US Airways transactions were not within the scope of the SEC's formal order and the NYAG's similar AHERF investigation. The court found that the language of the SEC order and NYAG subpoenas evidenced a "broad but definitive investigatory scope" that included all three of the questionable transactions. It further observed that the SEC and NYAG investigations of the Capital Asset and US Airways transactions were connected to the SEC's formal order and the NYAG's AHERF investigation, and rejected the Insurers' argument that they were not obligated to cover MBIA's expenses associated with its voluntary compliance with informal requests made in the course of those related investigations.

The Insurers' main argument in support of its third issue on appeal was that the SLC costs were incurred solely by the SLC, and that the SLC was not an "insured person" under the Policies. The District Court found coverage for the SLC expenses primarily because the expenses at issue were owed to Dickstein, and Dickstein had entered its appearance on behalf of MBIA, a nominal defendant in the derivative suits. The District Court reasoned that because Dickstein represented MBIA in the derivative suits, Dickstein's fees were covered "Defense Costs." The District Court then suggested that the SLC expenses would have been covered even if the outside firm had not represented MBIA, because the SLC was not an entity independent of MBIA.

The 2nd Circuit broadened the District Court's reasoning and concluded that the SLC expenses were covered "Defense Costs" because the SLC was part of MBIA. After a brief analysis of Connecticut law on how and through whom corporations operate, the 2nd Circuit proclaimed that MBIA directed or acted through the SLC when the latter moved to dismiss the derivative suits and, as a result, the SLC was an "insured person" under the Policies. Unlike the District Court, the 2nd Circuit did not mention, much less rely upon the fact that Dickstein represented both the SLC and MBIA in the derivative suit. The 2nd Circuit further rejected the Insurers' arguments that coverage for the SLC would render superfluous the Policies' sublimit for investigation costs, and that the SLC expenses were excluded from coverage by operation of exclusions within the Policies' definition of "Loss." The court found that the investigation sublimit only applied to presuit investigations, not costs related to derivative suits, and that the Insurers had failed to establish that any exclusions applied to MBIA's claim for SLC expenses.

Turning to MBIA's cross-appeal, the court reversed the District Court's ruling in the Insurers' favor on the issue of coverage for costs associated with the independent consultant's investigation of the Capital Asset and US Airways transactions. In a lengthy analysis reciting what and when MBIA reported to the Insurers, the court concluded that MBIA did not breach the Policies' "right to associate" clause, because MBIA provided the insurers with sufficient notice of the settlement discussions with the SEC and NYAG "early enough in the process to allow the insurers to exercise their option to associate effectively."

MBIA's Affect on Future Claim Disputes

The 2nd Circuit's opinion touches on two types of expenses commonly disputed in D&O claims, expenses incurred in responding to state or federal subpoenas and special litigation committee expenses associated with the investigation of allegations in derivative suits. The court accepted the policyholder's arguments in support of coverage for both types of expenses.

With respect to the first category of expenses, *MBIA* interprets "Securities Claims" broadly, supporting the assertion that coverage extends to expenses associated with an insured's voluntary compliance with certain types of informal or quasi-formal agency investigations. Insureds undoubtedly will cite *MBIA* for the proposition that a company does not forfeit its D&O coverage when it volunteers to cooperate with investigative agency requests rather than await formal, legal proceedings and risk suffering potentially damaging publicity and harsher penalties.

The court's ruling on coverage for MBIA's voluntary cooperation with investigators, however, cannot be universally applied without regard to the court's view of the breadth of the investigations and the expansive language of the primary policy's insuring agreement. Both factors may provide bases for distinguishing *MBIA* from other cases. In *MBIA*, the policy at issue broadly defined "Securities Claim" to include any "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." A formal order of investigation and regulatory subpoenas already had been issued by both agencies before any voluntary compliance was offered or undertaken. Given the Federal policy's expansive definition of "Securities Claim," the 2nd Circuit had little difficulty concluding that coverage existed. This should be distinguished from situations involving voluntary disclosure in the absence of formal agency process or where a policy contains more limited language.

The most significant aspect of the 2nd Circuit's *MBIA* opinion is the seemingly blanket pronouncement that special litigation committee investigative costs incurred in response to a derivative suit are covered "Defense Costs." That holding, however, relies on two questionable propositions: (1) that the SLC was an agent of, and acted at the behest of, MBIA, and (2) that the SLC's actions were related to the defense of MBIA or insured directors.

On summary judgment, the District Court strained to find coverage for SLC expenses by noting that outside counsel retained by the SLC to investigate the shareholders' claims also represented MBIA as a nominal defendant in the derivative lawsuits. After linking the SLC's expenses to Dickstein's representation of MBIA in the derivative suits, the District Court decreed that the SLC costs were, in fact, "Defense Costs."

The 2nd Circuit abandoned the District Court's reliance on Dickstein's representation of both the SLC and MBIA, determining instead that the SLC was not a separate entity from MBIA and was, therefore, an "insured person" under the Policy. The court's analysis notwithstanding, there is no support for the proposition that MBIA directed the SLC. Rather, the SLC was comprised of independent directors uninvolved in wrongdoing alleged by the shareholder plaintiffs. Indeed, under Connecticut law, the SLC was required to operate independent of MBIA and its board in the SLC's investigation of the derivative suits. The decision to dismiss the derivative suits was the SLC's alone. MBIA did not, and legally could not, instruct the SLC to conclude that the derivative suit was not in the company's best interest.

More importantly, the SLC did not act in the defense of MBIA or the insured directors and its expenses should not have been categorized as "Defense Costs." The 2nd Circuit's opinion provides no analysis on this point, concluding simply that "the costs incurred by the SLC in terminating the derivative litigation were covered 'Defense Costs.'" But the very purpose of special litigation committees – to investigate allegations in shareholder derivative suits and determine whether the company should prosecute those claims against the defendant directors – is a corporate governance function. The board, through the SLC, has a fiduciary duty to investigate whether wrongdoing has occurred and whether to seek relief on behalf of the corporation. Thus, the SLC's investigative costs should be covered here only to the extent of the Federal policy's investigations sublimit.

Moreover, costs for appearing in a lawsuit are not necessarily defense expenses. The SLC, after all, was not defending itself or the corporation. It was, in this case, seeking the termination of claims against other directors on grounds that it was not in the company's interest to pursue those claims. This is the company's right as the true owner of the claims being prosecuted. Simply because targeted directors avoided adverse claims as a result of the SLC's investigation does not transform the SLC into a tool to defend target directors or defeat shareholder derivative claims. Had the SLC decided to take over the prosecution of the claims, also its right, no colorable argument for coverage could have been made. The 2nd Circuit overlooked this crucial analytical distinction.

MBIA is likely to be cited by policyholders both within and outside the 2nd Circuit in support of arguments for broad coverage with respect to agency investigations and Special Litigation Committee costs. Insurers need to be aware of the limitations of the 2nd Circuit's reasoning and the factual idiosyncrasies of the case.

To discuss any questions you may have regarding the opinion discussed in this alert, or how it may apply to your particular circumstances, please contact Richard J. Bortnick (rbortnick@cozen.com or 610.832.8357) or Micah J. M. Knapp (mknapp@cozen.com or 215.665.5564).

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