

# ALERT

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## GLOBAL INSURANCE GROUP

News Concerning  
Recent Insurance Coverage Issues



## Eleventh Circuit Rejects Office Depot's Claim for Defense Costs Incurred During Voluntary Compliance with an Informal SEC Investigation

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In an unpublished *per curiam* opinion, the U.S. Court of Appeals for the 11th Circuit affirmed that Office Depot's Executive and Organization Liability policy did not cover defense costs incurred in voluntarily responding to an informal Securities and Exchange Commission (SEC) inquiry, nor costs incurred in conducting an internal investigation and audit triggered by a whistleblower complaint over alleged accounting improprieties. *Office Depot, Inc. v. National Union Fire Ins. Co. et al.*, No. 11-10814 (11th Cir. Oct. 13, 2011) (on appeal from the Southern District of Florida). Relying entirely on the unambiguous terms of the primary and follow form excess policies, the 11th Circuit rejected Office Depot's arguments that the policy's definitions of "Securities Claim," "Claim," and "Defense Costs" contemplated coverage for legal fees it accrued in responding to the informal SEC inquiry into possible securities law violations.

### The Policies

Office Depot purchased a \$25 million primary Executive and Organization Liability policy from National Union Fire Ins. Co. of Pittsburgh, Pa., (National Union), and a \$15 million follow form excess policy from American Casualty Co. of Reading, Pa., (American Casualty) (collectively the insurers). The National Union policy was subject to a \$2.5 million retention. The policies afforded Office Depot and its directors and officers executive liability coverage (Coverage A), organization insurance for the entity's liability and for reimbursement of its indemnity obligations to its directors and officers (Coverage B), and outside entity executive liability coverage (Coverage C).

### The SEC Investigation and Office Depot's Claim for Defense Costs

In June of 2007, an article appeared on the *Dow Jones Newswire* suggesting that Office Depot violated federal securities laws. In

July, Office Depot forwarded a copy of the article to the insurers as "notice of circumstances" that a claim might be filed against it in the future. That same month, Office Depot received an internal whistleblower letter alleging various accounting irregularities. The letter prompted Office Depot to initiate an independent review by outside counsel and forensic accountants.

Also in July, the SEC wrote Office Depot advising it that the SEC would begin conducting an inquiry to determine whether Office Depot had violated any securities laws. In August 2007, the SEC asked Office Depot to produce any internal documents regarding the accounting irregularities that were the subject of the whistleblower letter. These requests were made prior to the SEC's commencement of any formal investigation and thus sought a voluntary response.

In October 2007, Office Depot's internal review identified problems with certain financial statements. In November, two shareholder derivative suits and two securities lawsuits were filed against Office Depot and various officers and directors. Finally, in January 2008 the SEC issued a formal order of investigation. The SEC then issued a series of subpoenas and "Wells Notices" recommending civil action against three Office Depot officers. Office Depot reached a settlement with the SEC in January 2009.

Office Depot requested reimbursement from National Union for more than \$23 million in legal fees and expenses that Office Depot incurred in responding to and settling with the SEC, indemnifying insured persons against defense costs, and conducting the internal investigation and audit triggered by the whistleblower complaint. National Union acknowledged its obligation under the terms of the policy to reimburse Office Depot for defense costs incurred by officers and directors served with SEC subpoenas and Wells Notices, and for the costs

incurred in defending the various securities lawsuits. However, it denied Office Depot's claim for reimbursement of earlier SEC response costs and the cost of its internal investigation and audit. Because National Union determined that the covered defense costs did not exceed Office Depot's \$2.5 million retention, the insurers paid Office Depot nothing on the claim.

### The Coverage Suit and Summary Judgment

Office Depot filed suit in the Southern District of Florida against the insurers for breach of contract and for a declaration of coverage for the investigatory costs incurred beginning in July 2007. The parties filed cross motions for summary judgment. In an October 15, 2010, opinion, the district court denied Office Depot's motion and granted the insurers' motion. The court held that, "the disputed investigatory costs do not fall within the subject policy's definition of loss 'arising from' a covered 'Securities Claim' made against Office Depot, or a covered 'Claim' made against one of its officers, directors or employees." Office Depot appealed.

### The 11th Circuit Opinion

Office Depot raised four arguments in its appeal to the 11th Circuit: (1) the policy's definition of securities claim did not exclude coverage for costs incurred after the first, informal SEC letter and, even if it did, a carve-back within the definition restored coverage for such costs; (2) the informal SEC letters constituted a covered claim under the insuring agreement regarding indemnification of insured persons; (3) the policy's definition of defense costs contained no temporal limitation barring coverage for costs of investigating an anticipated claim; and, (4) the policy's notice and claim reporting provisions allowed a claim to "relate back" to the date Office Depot notified the insurers of a potential claim.

The court first addressed Office Depot's assertion that the definition of securities claim included the SEC's informal investigation beginning in the summer of 2007. The policy defined securities claim, in part, as "a Claim, *other than an administrative or regulatory proceeding against, or investigation of an Organization, made against any Insured.*" (Emphasis added by the court.) The definition included a carve-back that provided that securities claim "shall include an administrative or regulatory proceeding against an Organization" if it was also maintained against an insured person. Office Depot argued that because the policy did not define what constituted an "administrative or regulatory proceeding," the terms should be read liberally to cover those costs incurred after the SEC's July 2007 letter.

Analyzing the operation of the definition as a whole, the court noted neither ambiguity, nor any support for Office Depot's restrictive interpretation of the exclusion within the securities claim definition. Specifically, the court noted that while the definition of securities claim excluded both "an administrative or regulatory proceeding against, or investigation of an Organization," the carve-back added to the definition only an "administrative or regulatory proceeding." The court concluded that the SEC's request for voluntary cooperation with its inquiry constituted an excluded "investigation" rather than a potentially covered "administrative or regulatory proceeding." The court therefore held that the SEC's informal inquiry was not a "Securities Claim" under the policy. Thus, there was no entity coverage for Office Depot's costs in responding to the SEC.

The court next addressed Office Depot's argument that the SEC's investigation was a covered claim under the policy's corporate reimbursement coverage. The policy definition of claim included regulatory investigations of insured persons identified as a person against whom a proceeding may be commenced, or, in the case of an SEC investigation, after service of a subpoena on the insured person. The court explained that the Wells Notices, which identified three Office Depot officers who might be charged with securities violations, met the definition of a claim. The court then contrasted the Wells Notices with the SEC's initial letters, which did not allege any violations or identify any targeted officers or directors. The court concluded that the SEC's letters notifying Office Depot of its informal inquiry and requesting Office Depot's cooperation did not "trigger a Claim under the relevant policy definition."

The court similarly rebuffed Office Depot's assertion that coverage was owed because the policy's coverage for defense costs contained no limitation barring coverage for investigation costs for potential claims. Again, the court looked to the plain language of the policy, which defined defense costs as "reasonable and necessary fees, costs, and expenses consented to by the Insurer ... *resulting solely from the investigation, adjustment, defense and/or appeal of a Claim against an Insured* ..." (Emphasis added.) The court reasoned that this "plain language demonstrates that the costs must 'result[] solely from' a Claim." Investigation of a claim necessitates that a claim exists to investigate. Because the SEC's informal investigation did not create a claim, Office Depot's costs associated with voluntarily responding to the SEC's requests and its internal investigation after receiving the SEC letter did not constitute covered defense costs.

In the last argument discussed by the court, Office Depot asserted that the policy's "Notice/Claim Reporting Provisions" allow a claim to "relate back" to the date Office Depot first notified the insurers of the potential claim. The subparagraph relied on by Office Depot provided that if an insured became aware of circumstances that may give rise to a claim and reported it during the policy period, "then a Claim which is subsequently made against such Insured ... shall be considered made at the time such notice of such circumstances was given." Analyzing the policy as a whole, the court concluded that the provision did not grant coverage. Rather, it merely created a notification process for claims filed before or after the expiration of the policy period. The court held that the cited provisions determined when claims are "considered made," but did not "expand coverage to the costs incurred before a claim is actually made." Accordingly, there was no coverage for the costs incurred in the informal SEC investigation or the company's internal investigation. The court affirmed the district court's order granting summary judgment for the insurers.

#### *Office Depot's Effect on Future Claim Disputes*

The 11th Circuit's opinion touches on two categories of expenses commonly disputed in D&O claims: (1) legal and accounting costs incurred in voluntarily responding to an informal SEC investigation, and (2) costs incurred in conducting an internal investigation and audit triggered by a whistleblower complaint over alleged accounting improprieties. The potential for such costs to run into eight-figure sums provides powerful economic incentive for policyholders and their counsel to press claims under D&O policies for coverage of such costs.

*Office Depot* demonstrates, however, that the issue of whether coverage exists for internal corporate or SEC investigations will usually turn on the facts of the case and the plain language of certain key policy provisions, such as the definitions of claim, securities claim, and defense costs. These factors will vary from case to case. Thus, a careful reading of the policy terms is essential and generalizations drawn from prior cases may be misplaced. *Office Depot* also demonstrates that attempts to tease meanings from policy provisions that are not supported by the plain language will be unavailing.

Given the dramatic increase in regulatory and corporate investigations in recent years, it is essential that policyholders determine whether they wish to purchase coverage for such investigations and, if so, the level of coverage they desire. Once those determinations are made, policyholders should negotiate with insurers to purchase the appropriate coverage to match their expected need. New products providing coverage for such investigations have become available and policy terms may be customized to suit a policyholder's needs and budget. The time to address these concerns, however, is before purchasing the policy and not after paying millions for investigations that are not within the scope of the policy.

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*To discuss any questions you may have regarding the issues discussed in this alert, or how they may apply to your particular circumstances, please contact Angelo G. Savino at 212.908.1248 or [asavino@cozen.com](mailto:asavino@cozen.com) or Micah J. M. Knapp at 215.665.5564 or [mknapp@cozen.com](mailto:mknapp@cozen.com).*