Insurance Coverage For Regulatory and Internal Investigations

By Joshua Gold and Toby Freund

The past several years have been marked by numerous, high-profile investigations by regulators and lawmakers investigating a variety of business practices and senior company executives. While certain types of investigations appear to have leveled off, others look poised for an expansion. Anyone embroiled in past regulatory investigations can attest to the enormous costs involved in dealing with an investigation.

Commercial-lines insurance coverage under a few different policy form types may help businesses cope with the enormous expenditures occasioned by addressing an investigation or inquiry. But, even with those insurance policies which expressly promise coverage for the costs attendant to investigations, insurance companies often contest such claims and seek to apply the most narrow interpretation possible of the coverage grants and terms. As such, it is critical that policyholders take an inventory of their commercial crime and liability insurance policies to determine what level of insurance coverage may be available should they become the target of an investigation or should they be required to perform an internal investigation. Policyholders should check their D&O, E&O, fiduciary liability, commercial crime, and computer crime insurance policies to determine the availability of insurance coverage.

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1133 21st Street, NW
Suite 700
Washington, D.C. 20036
202-775-0509
www.nacdonline.org

Director Summary: Regulatory and internal investigations can prove costly to businesses, and having D&O insurance is no guarantee of protection of coverage. The authors point to recent court rulings and insurance companies' denial of claims to urge policyholders to review their policies to determine the availability of coverage and to be prepared for narrow interpretations of coverage by the insurance companies.

Background

Historically, insurance companies have avoided indemnity obligations to policyholders for costs and payments incurred due to regulatory investigations. This is particularly troublesome as certain state attorney generals and federal authorities, including the SEC, have turned increasingly active in recent years. Consequently, how courts will construe D&O insurance policies in the context of these investigations has become a critical question.

Companies traditionally purchased D&O insurance to protect executives and senior management from liability in class-action and derivative shareholder lawsuits. When the cost for D&O insurance products was relatively modest, insurance companies were offering broader insurance policy provisions to entice insurance buyers. Some of those coverage enhancements promised coverage for civil and criminal investigations. Even with the "harder market" that existed some years back, many of the coverage grants for investigations remained in the insurance policies (albeit for a higher price). This coverage now has become more important with the increase in regulatory investigations and raises new questions for policyholders about what coverage applies to these investigations and when.

Unfortunately, the vagueness of policy language, coupled with SEC investigative processes, has at times allowed insurance companies to dodge liability based on a triumph of form over substance.

For example, some forms of D&O policy language recognize a claim where there is "a civil, criminal, administrative or regulatory investigation of an Insured Person." However, the SEC typically names the company as the express party on the notice of formal investigation, not individuals, and obtains probative information and data from management that can then be used against the officers as individuals during that investigation. As such, D&O insurance companies frequently insist that the company, not its officers, is the subject of the investigation and consequently D&O coverage does not attach. This maneuver sometimes allows insurance companies an excuse to dodge D&O liability, as the investigations are not

commenced, purportedly, against an "Insured Person." This defense, however, is highly dubious as many forms of SEC subpoenas received by witnesses expressly state that they are investigating whether individuals violated federal securities laws. As such, compelling arguments exist that such coverage is available to policyholders and other insureds.

Coverage For SEC Investigations In Federal Court

In 1990, *Polychron v. Crum & Forster Insurance Companies, ("Polychron")*, the Eighth Circuit held that viewing a grand-jury subpoena and investigations as "claims" was a reasonable construction of the D&O policy, but the coverage at issue was limited to legal expenses and did not address any question of indemnification for money paid in settlement.

Still, the holding in Polychron offers hope for policyholders: the "characterization of the grand-jury investigation as mere requests for information and an explanation underestimates the seriousness of such a probe. As later events proved, the plaintiff was the target of the investigation."

A District Court ruling in 2004 followed the holding in *Polychron* by recognizing at least some measure of D&O coverage for SEC investigations.

In *Minuteman International, Inc. v. Great American Insurance Co. ("Minuteman")*, the court construed Minuteman's D&O policy as providing coverage for legal expenses incurred during an SEC investigation. In *Minuteman,* the company and several of its officers entered into a cease-and-desist order with the SEC that made findings and imposed "undertakings" against *Minuteman* and its officers, without admitting or denying the findings contained therein. The policyholders sued their D&O carrier to indemnify them for defense costs during the investigation, and for coverage of an additional $420,000 necessary to pay external auditors as per the settlement with the SEC. The court sided with the policyholder for the legal expenses incurred during the probative phase of the investigation. The *Minuteman* court held: "an SEC subpoena is not a mere request for information, but a substantial demand for compliance by a federal agency with the ability to enforce its demand," and ruled that the SEC's investigation was a "claim" under the policy. However, like *Polychron,* the *Minuteman* court declined to construe the auditors' expenses as a "loss" covered under the policy.

The court in *Minuteman* identified the complexities of determining the extent of D&O coverage: "There is no case on point which decides whether an SEC investigation constitutes a Claim under the particular language of the Policy." Further, policyholders must be vigilant about insisting that insurance companies cover officers and directors from the moment an investigation of the company commences, pursuant to the holdings in *Polychron* and *Minuteman.*

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Coverage For the Costs of Internal Investigations

At a time of crisis, it is not uncommon for a corporation to have its counsel perform an internal investigation and report to senior management. Depending upon the circumstances, these internal investigations can turn out to be exhaustive and expensive. Under the terms of their insurance policies, commercial policyholders may have express insurance coverage for these costs.

Specifically, many D&O policies cover costs for the investigation and defense of a "claim." With such language included in an insurance policy, policyholders are in a position to recoup significant expenses for internal investigations that are incurred in connection with dealing with a claim, whether a private third-party claim or, alternatively a state, federal or regulatory investigation.

SEC Settlements Not Construed as Loss

Despite the clear promise of insurance coverage for certain regulatory matters, not all courts have found in favor of policyholders. For instance, a New York court ruling sets a bleak precedent for D&O policyholders and held that settlement payments to the SEC could not be construed as a "loss" under a D&O policy.

In 2004, in *Vigilant Insurance Co. v. Credit Suisse First Boston Corp. ("Vigilant"),* the policyholder entered a settlement agreement with the SEC and the agreement specifically denied any admission of wrongdoing. The policy language in question included in its definition of "Claim" any "regulatory, arbitration, governmental or administrative proceeding"; the policy defined "Loss" as "damages, awards, judgments, settlements… and the legal expenses of any plaintiff or claimant if the Insured(s) is legally liable for such expenses." Nevertheless, when the insurance company moved for declaratory judgment, the trial court held that the settlement was a "disgorgement of monies obtained improperly" which could not be construed as a "loss" under the policy. Not only did the court

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reject coverage, but its treatment of the settlement, entered into as an SEC uniform consent agreement that does not permit parties to either admit or deny liability, comes treacherously close to construing such settlements as de facto admissions of culpability. The *Vigilant* holding represents an alarming development for policyholders and raises serious concerns about how this holding may assist insurance companies in escaping coverage.

The particular issues in *Vigilant* and both courts' language in their decisions are precisely the cause for policyholder concern. Not only do the SEC's uniform consent agreements often not allow policyholders to admit or deny culpability, but both courts observed that "the Final Judgment is not the same as a final adjudication of the facts after a trial." Moreover, as the trial court recognized, the law encourages parties to settle. Indeed, the regulatory state depends upon the practice of allowing parties to settle without admitting their culpability. As such, it is particularly alarming that the court insisted that "the settlement with the SEC… represented the disgorgement of funds improperly acquired," and denied recovery entirely.

Also, in, *Foster v. Summit Medical Systems, Inc.*, (Minn. Ct. App. 2004) *("Foster")*, the appellate court ruled that an SEC investigation was not a "claim" under a D&O policy after the policyholder had won that issue at the trial court. In the case, Summit had registered with the SEC in order to have its stock publicly traded. Two years later, Summit announced that, due to accounting errors, its year-end revenue statement for the preceding years needed to be corrected downward from $10,000,000 to $6,000,000. The SEC commenced an investigation and the trial court construed the policy in favor of the policyholder, finding D&O coverage to attach to the investigation. The Court of Appeals of Minnesota reversed, and explicitly announced that an SEC investigation was not a claim under the D&O policy. Specifically, the court insisted that the investigation was not a "proceeding in which respondents 'may be subjected to a binding adjudication for… relief.'"

In the wake of decisions like *Vigilant* and *Foster,* policyholders should be exceedingly careful about the forms they use when settling with federal regulators or entering into uniform consent agreements, when there are either existing or potential related shareholder actions.

Looking Forward

Policyholders and other interested parties should pay careful attention to new developments in D&O coverage cases and in particular to how the *Vigilant* holding is interpreted by subsequent courts. For example, *National Union Fire Insurance Company of Pittsburgh, Pa. v. Xerox Corp.* ((N.Y. Sup. Nov. 10, 2004) *("National Union")*, was a case before the Supreme Court of New York, in New York County. In *National Union*, the insurance company brought an action against the policyholder company directors and officers seeking to rescind the D&O policy, or a court declaration that the insurance company was not obligated to provide coverage for securities fraud actions brought against the policyholders. The Supreme Court dismissed all but three of the insurance company's causes of action: one which alleged that Xerox did not cooperate with the insurance company in settling an action with the SEC, and two causes of action related to the disgorgement of funds to the SEC, as part of a settlement with the SEC. Citing *Vigilant,* the Supreme Court held that it was ripe for adjudicating whether "the individuals in the SEC actions… are barred by the improper profit exclusions in the Policy, or otherwise constitute ill-gotten gains, and are not covered as losses under the Policy." The court's ruling in *National Union* sheds some light on how *Vigilant* may be subsequently applied, and the scope of future coverage for D&O policyholders in certain forums.

Conclusion

Despite negative rulings in New York and Minnesota, policyholders should still review their insurance policies and determine whether they potentially have insurance coverage for the costs of internal investigations, external investigations and other related matters. Policyholders need to be aware that their insurance companies can be expected to take an exceedingly narrow view of insurance coverage for such claims and submit that even if coverage is triggered, the sequencing of claim events may cause them to argue for a denial or reduction in coverage. ■

Joshua Gold is a shareholder specializing in insurance recovery in the New York office of Anderson Kill & Olick, P.C. **Toby Freund** is an attorney practicing in Anderson Kill's New York office.