An ALM Publication

CORPORATE COUNSEL

OCTOBER 2011

Special Advertising Section

OUTSIDE PERSPECTIVES

When Government Investigators Come Calling, Give A Little Whistle For D&O Coverage

QUITE A LITTLE FINANCIAL CRISIS we had there. In its wake, the enforcers on the corporate beat are at least somewhat reinvigorated with new tools, powers and pressures to prevent malfeasance. That spells new liability risks for directors and officers and hence — new challenges in pursuing D&O insurance claims.

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Among the emerging risks that are likely to spur D&O claims in the near future are whistleblower claims under Dodd-Frank, the long reach of the U.K. Bribery Act 2010, pre-litigation governmental investigations, and shareholder derivative suits. The broad coverage writ for "Wrongful Acts" characteristic of D&O liability insurance should in most instances provide coverage or at least defense costs for these risks.

Investigation Costs May be Covered

On May 25, 2011, the Securities and Exchange Commission issued a press release (available at www.sec.gov) announcing the adoption of its Final Rule for the new "whistleblower" program under Section 922 of the Dodd-Frank Act. The program requires that any person providing "original information" that leads to successful enforcement can be awarded between 10 and 30 percent of the amount of any resulting sanction that exceeds $1,000,000. Observers believe that this program and the incentives it contains will lead to a significant number of new claims.

U.K. Bribery Act 2010

At virtually the same time, the United Kingdom's reach is extended by their new Bribery Act 2010, effective July 1, 2011. Since the Bribery Act has effect outside of the United Kingdom, it has implications for all businesses that carry on business or "part of a business" in the United Kingdom. Indications are that the intention is for very broad extra-territorial reach of the Bribery Act, which creates strict liability for the corporate "offense" of an organization that fails to prevent a bribe.

The Bribery Act might also be expected to give rise to potential follow-on civil lawsuits in the United States and elsewhere. It is a liability scheme similar to the U.S. Foreign Corrupt Practices Act, which has led to very significant enforcement efforts.

Pre-Litigation Investigation and Shareholder Derivative Suit Costs May be Covered

Many corporations face formal and informal investigations by the SEC as well as federal and state prosecutors. The costs associated with these investigations can be significant. While many courts have found that investigation costs are covered under D&O liability insurance policies, some courts have come to the opposite conclusion, and insurance companies will often fight to avoid covering these costs.

Most recently, in *MBIA Inc. v. Federal Ins. Co. et al.* (July 1, 2011), the U.S. Court of Appeals for the Second Circuit ruled that MBIA was covered for costs related to investigations by the New York Attorney General and the SEC government investigations and shareholder derivative lawsuits alleging accounting misstatements. The Second Circuit held that MBIA was covered for the costs of an independent auditor in settling the government's claims, as well as of a special litigation committee that MBIA formed to respond to the shareholder actions.

In *National Stock Exch. v. Fed. Ins. Co.* (March 30, 2007), an Illinois court held that an SEC-issued "Order Directing Private Investigation and Designating Officers to Take Testimony" was a "Claim" even though the order did not name any directors or officers, and the E&O insurance company was held liable for past and future costs in responding to administrative subpoenas from Texas and Maryland attorneys general. In *Minuteman Int'l, Inc. v. Great American Ins. Co.* (March 22, 2004), the same court found coverage for expenses related to an SEC investigation. Courts have also recognized that a policyholder faced with an investigation cannot simply ignore communications from regulators nor wait to investigate or incur defense costs until sued.

Typical Coverage Defenses

The corporate or individual insureds under a D&O policy often turn to their liability insurance when facing crushing claims. In such cases, policyholders should brace themselves to resist common coverage defenses, often first expressed in a reservation of rights letter sent in response to the filing of a claim. Below are some examples of coverage defenses that insurance companies often assert inappropriately when faced with a claim related to investigations.

"Insured vs. Insured" Exclusion

The so-called "insured vs. insured" exclusion, commonly found in D&O insurance policies, often purports to preclude D&O coverage for claims by an insured against another, though there are many forms of this exclusion. The exclusion originated in the early 1980s in response to collusive attempts to obtain D&O coverage for losses resulting from the acts of insureds. Thus, the exclusion is widely interpreted to prevent only collusive lawsuits by a corporation against its officials.

Policyholders should be aware of two instances where insurance companies have overreached in asserting this exclusion.

First, insurance companies have improperly argued that the exclusion precludes coverage when a regulatory agency or statutory receiver, such as the Federal Deposit Insurance Corp., sues a former director or officer. However, most courts have held that the exclusion does not apply in these situations because the exclusion is designed and intended to prevent collusive lawsuits between insureds. Regulatory agencies and receivers are sufficiently adverse parties to a corporation and its officials — not insureds — and thus lawsuits brought by them against directors and officers cannot be collusive in nature. Second, insurance companies have improperly asserted that the insured vs. insured exclusion precludes coverage for claims brought by a bankruptcy trustee or a creditors' committee against directors and officers on behalf of the corporation. Often, this view is simply incorrect under applicable law.

Regulatory Exclusions

The regulatory exclusion purports to deny coverage for suits brought by any governmental, quasi-governmental or self-regulatory agency. These exclusions proliferated in the wake of the savings and loan crisis of the 1980s and were often found in D&O policies issued to financial institutions. In recent years they have become much rarer as the D&O market softened and memory of the prior crisis faded. However, in the wake of the financial crisis of 2008–2009, policyholders should expect a resurgence of the regulatory exclusion and be prepared to defend against it.

If your policy does contain a regulatory exclusion, closely examine its wording. Policies may or may not name specific regulatory agencies. While some courts have upheld the applicability of regulatory exclusions, others have determined the language to be ambiguous and refused to preclude coverage. In the wake of the savings and loan crisis, government regulators themselves successfully defended against the regulatory exclusion against the public policy supporting federal regulators' ability to sue directors and officers who have committed wrongful acts.

Conclusion

The insurance available to cover management mistakes resulting in loss is often contested. The covered wrongful acts, under D&O and related insurance polices, nonetheless offer potentially valuable protection in a new liability environment with a number of new types of claims that should be covered. Risks, such as whistleblower claims under Dodd-Frank, subprime and credit crisis claims, and pre-litigation governmental investigations, will all help shape the new liability and insurance landscape.

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