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D&O Update: Court Addresses Coverage for Legal Costs Incurred by a Special Litigation Committee

On December 30, 2009, the United States District Court for the Southern District of New York in *MBIA, Inc. v. Federal Ins. Co. et al.*, Civ. No. 08cv4313 (S.D.N.Y. Dec. 30, 2009), held that, in certain instances, legal costs incurred by a special litigation committee in connection with a shareholder derivative litigation may be covered under a D&O policy.[1]

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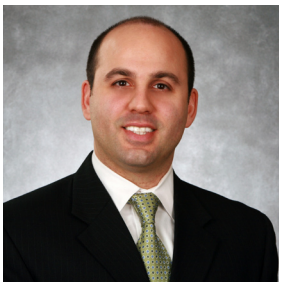

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There are several significant implications of the *MBIA* decision, which are discussed in detail below.

Coverage for Special Litigation Committee Investigations

When a corporation has reason to believe its directors or officers are engaged in wrongdoing, it is obligated to investigate and eliminate such misconduct. Commonly, companies form a "special litigation committee," which is composed of independent directors who are not implicated in the alleged wrongdoing, and task this committee with conducting an independent, fact-finding investigation. As such, special litigation committee investigations are a corporate activity essential to the corporation's proper and lawful functioning.

Special litigation committees also confer additional benefits. For one, government investigators look favorably on a company's efforts to identify and ferret out wrongdoing, thereby increasing the company's chances of receiving lenient treatment from the government in the event that wrongdoing indeed has occurred. Second, shareholder derivative litigations – a means by which a shareholder can force a corporation to take certain actions that its directors are actually or apparently unwilling to take – can often be deemed unnecessary and therefore subject to dismissal when the company's board of directors forms a special litigation committee to investigate those allegations. Specifically, shareholder derivative litigation can only be brought if the plaintiff can demonstrate that the board of directors is unable or unwilling to take action to investigate or correct the alleged wrongful conduct that is the subject of the derivative litigation. A company that has empanelled a special litigation committee to conduct an independent investigation may be able to obtain a dismissal of a shareholder derivative litigation by demonstrating either that the allegations in the shareholder derivative litigation are without merit or that the board – through the special litigation committee – already has sufficiently addressed and corrected any perceived wrongdoing.

As a general matter, D&O policies do not cover legal costs incurred by a special litigation committee because D&O insurers consider that such costs are not part of the defense of a claim made against an insured party. Rather, D&O insurers argue, such costs are to be deemed legal costs the insured company incurs in conducting an affirmative investigation into possible wrongdoing by directors or officers.[2] Under D&O policies with a broad definition

[1]The court also addressed other legal issues that are not discussed in this Client Advisory.

[2]Certain D&O policies include sublimits for demand investigation costs. These sublimits are affirmative grants of limited coverage treating such costs as "Loss" (but not as defense costs) given that such costs typically would not be covered under the D&O policy.

of "Claim," if a special litigation committee concludes that directors or officers engaged in wrongdoing and those individual insureds (i.e., directors or officers of the company) incur costs in responding to the special litigation committee's allegations, such costs generally would be excluded pursuant to the so-called "insured v. insured" exclusion found in most D&O policies that generally operates to exclude D&O claims brought by one insured against another insured.

Despite the fact that the legal fees and expenses incurred by a special litigation committee in its investigation are not incurred in the defense of a claim made against an insured party, some insureds argue that such costs are nonetheless covered when the efforts of counsel can be argued to also "benefit" the defense of a shareholder derivative litigation. Even if a well-conducted special litigation committee investigation results in the dismissal of a shareholder derivative litigation, that outcome should be unexpected and not the intended outcome of the investigation. Such arguments treat the special litigation committee investigation as one component of a defense strategy to thwart a shareholder derivative litigation and ignore the key principle of an objective special litigation committee investigation: such investigations are to be undertaken in an objective manner by disinterested directors and designed to obtain all relevant facts – regardless of whether those facts suggest D&O liability or otherwise.

The argument that special litigation committee investigation expenses should be considered incurred in the "defense" of a claim also confuses the parties whose interests are being protected. In a shareholder derivative litigation, the interests that require a defense are those of the defendant directors and officers alleged to have breached their fiduciary duties to the company. In this scenario, the corporation is the plaintiff, whose aggrieved interests are being asserted by a shareholder suing (derivatively) on the company's behalf. So if a special litigation committee investigation is being conducted to "defend" any interests, the only interests with liability at stake are those of the defendant directors and officers. Accordingly, it cannot reasonably be said to be the case that a special litigation committee investigation is created by the board of directors and staffed by disinterested, independent directors – all for the collective purpose of exonerating the defendant directors and officers alleged to have breached their fiduciary duties to the company.

Finally, any properly undertaken corporate activity, including thorough internal and external audits and legal compliance efforts, arguably may benefit the subsequent defense of litigation challenging corporate transactions and decisions. However, good corporate governance is not the same as defending a D&O claim challenging the conduct of directors and officers. Thus, this argument too appears to be without merit.

And yet, a federal court in New York held in the *MBIA* case that such legal fees and expenses should be covered under the relevant D&O policies. Below, we examine the decision and its stated rationale.

Background of the *MBIA* Decision

In 2001, the U.S. Securities and Exchange Commission (the "SEC") issued a formal order directing an industry-wide investigation into "loss mitigation products." The investigation concerned the sale of certain insurance products, including so-called "finite insurance," that allegedly were purchased by certain companies in order to manipulate their financial results. In November 2004, the SEC subpoenaed MBIA to produce "documents concerning all Non-Traditional Product transactions entered into by MBIA." Among other documents, MBIA produced documents relating to a transaction entered into between MBIA and the Allegheny Health, Education and Research Foundation ("AHERF").

In 2005, two MBIA shareholders demanded that MBIA investigate alleged wrongdoing committed by certain MBIA directors and officers in connection with the AHERF transaction. MBIA set up a "Demand Investigation Committee" to investigate this alleged wrongdoing. The Demand Investigation Committee retained as outside legal counsel the law firm of Dickstein Shapiro LLP. Subsequently, the two MBIA shareholders filed shareholder derivative litigations against certain of MBIA's directors and officers and MBIA as a nominal defendant. MBIA reconstituted the Demand Investigation Committee as a Special

D&O insurers should brace themselves for the likelihood that the MBIA *ruling will be cited by policyholder counsel and brokers in an effort to significantly expand the scope of coverage for these kinds of legal expenses and costs, as well as to cover other fees and expenses that an insured can argue were incurred "in connection with" a covered D&O claim.*

Litigation Committee (the "SLC"). The SLC also retained Dickstein Shapiro as its legal counsel.

Dickstein Shapiro conducted an independent investigation on behalf of the SLC and determined that the maintenance of the shareholder derivative litigation was not in the best interests of MBIA or its shareholders. On October 2, 2006, Dickstein Shapiro filed a motion to dismiss the shareholder derivative litigation on behalf of "Nominal Defendant MBIA, Inc. Through the Special Litigation Committee of the Board of Directors." Thereafter, MBIA sought coverage from its D&O insurers for the legal fees and expenses billed by the Dickstein Shapiro firm.

MBIA's primary D&O insurer, Federal Insurance Company ("Federal"), denied coverage for the amounts billed by Dickstein Shapiro as counsel for the SLC, on the ground that they were investigation costs, rather than costs incurred in the defense of a claim.[3] On May 7, 2008, MBIA brought a declaratory judgment action against Federal and MBIA's excess D&O insurer, Ace American Insurance Company ("Ace"), seeking, among other things, coverage for the legal fees and expenses incurred by Dickstein Shapiro as counsel for the SLC. MBIA moved for summary judgment on the issue of whether the SLC legal costs incurred in connection with the shareholder derivative litigation were covered under the D&O policies. Federal and Ace cross-moved for summary judgment on the ground that the SLC legal costs were not reimbursable because counsel for the SLC did not represent any Insured under the policies.

The *MBIA* Decision

The court held that the SLC's legal costs were covered because they were costs incurred "in connection with" the shareholder derivative litigation. In its opinion, the court rejected Federal and Ace's contention that Dickstein Shapiro could not have represented the Insured, MBIA, in the shareholder derivative litigation. The court noted that Dickstein Shapiro had appeared and filed motion papers on behalf of MBIA in the shareholder derivative litigation (in seeking to dismiss the shareholder derivative litigation following the conclusion of the SLC investigation). In addition, the court concluded that Dickstein Shapiro, by virtue of its representation of the SLC, necessarily also represented MBIA because the SLC governed MBIA's conduct with regard to the shareholder derivative litigation, stating that "the SLC was composed exclusively of members of [MBIA's] Board of Directors and was vested with full and exclusive authority . . . to determine whether pursuit of the litigation was in the best interest of MBIA." Finally, the court concluded that Dickstein Shapiro could represent both the SLC and MBIA (or MBIA "through the SLC") without undermining the SLC's ability to reach independent decisions. The court also noted that "[t]he SLC could readily reach independent decisions *without* being independent of [MBIA]." [*Emphasis ours*.]

Implications of the *MBIA* Decision

There are several significant implications of the *MBIA* decision.

- The court did not make a blanket ruling that special litigation committee investigative costs are covered defense costs; rather, on the facts presented, it simply held that the law firm retained to represent the SLC and MBIA as the nominal defendant in the shareholder derivative litigation *could have* represented MBIA in the shareholder derivative litigation "though its representation of" the SLC.
- By permitting MBIA to characterize special litigation committee investigation costs as "defense costs," the court potentially opened the door to the argument that any type of legal costs incurred by the corporation that incidentally benefits the defense of a litigation constitutes "defense costs" for purposes of insurance coverage. This is problematic given that it appears that the SLC investigation "benefited" the defense of the shareholder derivative litigation only incidentally (and primarily with respect to the individual defendants in that action), and in the way any corporate activity, properly undertaken, benefits a subsequent defense of corporate actions.
- In situations in which an insured party characterizes the legal costs incurred by its special litigation committee as defense costs rather than investigative costs, shareholder derivative litigation plaintiffs can now easily challenge the independence and objectivity of the special litigation committee investigation. It is one thing for a special litigation committee to conduct an independent investigation and, upon completion of the investigation, to then determine whether a pending shareholder derivative litigation should be maintained. It is another thing for a special litigation committee to conduct an independent investigation with the explicit purpose of "defending" a shareholder derivative litigation. This is essentially what MBIA argued in its motion for summary judgment: once the shareholder derivative litigation was filed, Dickstein Shapiro – counsel for the SLC – focused its work on the defense of the shareholder derivative litigation. One might speculate whether a special litigation committee investigation that has as its main purpose to thwart a shareholder derivative litigation could ever be deemed truly independent.
- The *MBIA* decision likely has no applicability to coverage disputes over legal fees incurred by special litigation committee investigations that are empanelled in connection with the allegations raised in government investiga-

[3]Federal advised MBIA that its policy's $200,000 sublimit for "demand investigation costs" would cover a portion of these investigation costs.

tions. In the context of a government investigation, it would be inherently contradictory to argue that a special litigation committee investigation is an objective investigation and, at the same time, a defensive effort on behalf of the directors and officers whose conduct is at issue. In government investigations (unlike in shareholder derivative litigations), the fact that the special litigation committee has conducted an objective investigation does not constitute a defense by itself.[4]

- Under the *MBIA* decision, even D&O policies with demand investigation cost sublimits could be exposed to demands for coverage in excess of those sublimits. Here, the Federal policy included a demand investigation cost sublimit as a non-defined component of "Loss," but the court accepted MBIA's characterization of the SLC's costs as "defense" costs, rather than as "investigative" costs, which brought the SLC costs outside of the demand investigation cost sublimit.
- Unless and until the D&O insurers in *MBIA* press a successful appeal of this ruling to the Second Circuit Court of Appeals, D&O insurers should brace themselves for the likelihood that the *MBIA* ruling will be cited by policyholder counsel and brokers in an effort to significantly expand the scope of coverage for these kinds of legal expenses and costs, as well as to cover other fees and expenses that an insured can argue were incurred "in connection with" a covered D&O claim.

[4]Special litigation committee investigations might benefit the defense of a government investigation to the extent that the government treats the company with leniency as a result of its efforts to identify and eliminate wrongdoing. However, such a benefit is clearly incidental and not the primary purpose of the special litigation committee investigation.

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