LOWENSTEIN SANDLER PC CLIENT ALERT

INSURANCE LAW

ATTORNEY ADVERTISING

SECOND CIRCUIT: D&O INSURANCE COVERS SUBPOENAS, SPECIAL LITIGATION COMMITTEES, AND INDEPENDENT CONSULTANTS

By Robert D. Chesler, Esq., Michael David Lichtenstein, Esq., Joseph D. Jean, Esq., and Rachel M. Wrightson, Esq. July 2011

Policyholders were recently granted a sweeping victory on critical issues of insurance coverage for subpoenas and securities-related costs in the Second Circuit's *MBIA Inc. v. Federal Insurance* July 1, 2011, opinion. Perhaps most importantly, the court resolved in MBIA's favor the long-standing dispute over coverage for subpoenas. The decision is entirely favorable to MBIA, and insureds in general, as regards coverage for costs incurred: (1) to respond to an SEC and New York Attorney General subpoena; (2) to respond to informal SEC and AG requests; (3) to retain independent consultants to investigate in connection with SEC and AG settlements, and (4) by a Special Litigation Committee formed to investigate allegations in a shareholder derivative litigation of wrongdoing by MBIA directors and officers.

The Subpoenas, the Investigations, the Lawsuits … the Coverage Denial

Two D&O policies were at issue: one $15M primary policy issued by Federal Insurance Company, and one $15M excess policy issued by ACE American Insurance Company. Generally speaking, terms in D&O policies differ, but *MBIA* concerned largely standard provisions. Specifically, the policies defined "Securities Claim" 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." The policies did not specifically mention coverage for subpoenas.

The MBIA investigation began after the SEC issued a formal order on March 9, 2001, ordering an inquiry into the practices of certain companies with respect to accounting in the insurance industry and compliance with securities laws. Pursuant to that investigation, the SEC issued a subpoena to MBIA on November 12, 2004, seeking documents related to accounting practices. The NYAG issued a similar subpoena on November 18, 2004. MBIA then agreed to cooperate with the investigations, to avoid adverse publicity from issuance of additional subpoenas. A preliminary settlement was reached, conditioned on MBIA paying for an independent consultant to review two of the transactions and report any misconduct.

On the heels of the investigation, shareholders sued MBIA, and MBIA's board received a demand letter asking that a suit be filed against the company's directors and officers. MBIA then established an independent director committee, which did not recommend suit against the officers and directors. The shareholders filed two derivative suits anyway. The SLC was then established, and retained counsel to evaluate the lawsuits. Ultimately, the SLC won dismissal of the lawsuits.

MBIA provided notice of the subpoenas to the insurers in May 2005. The insurers accepted the subpoenas only as "notices of circumstances that might lead to claims," not as claims. The insurers were also notified of each development from the issuance of the first subpoena but declined to participate in settlement negotiations or any stage of the investigations.

Lowenstein Sandler

ATTORNEYS AT LAW

Seeking Coverage in Court

MBIA filed suit against Federal and ACE in the Southern District of New York, seeking to recover costs associated with the regulators' investigations, the SLC, and the independent consultant's investigation (pursuant to the settlement). The District Court ruled that the D&O policies covered the investigations and the SLC work, but not the independent consultant costs. Both parties appealed, and the Second Circuit ruled in favor of MBIA on all three issues.

Investigation Costs: The Second Circuit Rejects "the insurers' crabbed view of the nature of a subpoena as a 'mere discovery device'"

On appeal, the insurers' basic argument was that the subpoenas did not meet the definition of "Securities Claims," but rather were simple discovery devices. The Second Circuit found that, at the least, the subpoenas were documents similar to "a formal or informal investigative order" that commenced a regulatory proceeding, noting that "a subpoena is the primary investigative implement in the NYAG's toolshed." Moreover, the court confirmed the District Court's finding "that a businessperson 'would view a subpoena as a 'formal or informal investigative order' based on the common understanding of these words.'"

While the AG's action was specifically aimed at MBIA, the SEC's formal order was entitled "In re Loss Mitigation Insurance Products," and the SEC issued subpoenas to MBIA pursuant to that order. The Second Circuit gave short shrift to the insurers' arguments as to why these subpoenas were not covered, and ruled that the SEC and NYAG subpoenas and subsequent investigations were within the scope of the Formal Order, and within the definition of "Securities Claim" covered by the policies.

Equally significant, the court found that MBIA's decision to cooperate with the investigation and voluntarily produce documents did not defeat their coverage. To this end, the court noted that Federal and ACE could not require MBIA to risk public relations damage in order to obtain coverage.

Special Litigation Committee and Derivative Suit Costs

The District Court and Second Circuit also found coverage for the costs associated with the SLC that MBIA established to investigate the shareholder derivative suits.

Significantly, the courts ruled that the costs incurred by the SLC were covered because, although the SLC was not an "Insured Person" identified in the policies, it was as an agent for MBIA, was formed by MBIA pursuant to applicable Connecticut corporate law, and was composed solely of independent directors. Although the court did not elaborate, presumably the SLC was considered an "Insured Person" rather than an insured entity.

The Insurers' "Right to Associate" and "Consent to Settle"

The appointment of an independent consultant was a component of the settlement between MBIA and the SEC, and the insurers argued vigorously that they did not receive sufficient notice of this issue, and that MBIA's agreement to a settlement with the SEC incorporating this component violated their right to associate and consent to settle. The District Court agreed with the insurers, and the Second Circuit reversed.

Generally, the Second Circuit found that MBIA had provided the insurers sufficient opportunity to associate, and that the insurers failed to avail themselves of the opportunity. The policies gave the insurers the right to associate with MBIA in the investigation, and required MBIA to notify the insurers of a Securities Claim and a proposed settlement and invite them to associate. The Second Circuit concluded that an insured can satisfy this obligation by giving notice and adequate information about the claim, and inviting the insurer to participate. If an insurer declines to participate, "it is not the insured's duty to return to the nonparticipating insurer each time negotiations about the same claim take a new twist and ask if the insurer still wants to opt out." Thus, MBIA was able to recover the consultant costs.

Conclusion

The *MBIA* decision will likely have important ramifications for insureds in many industries, and in the D&O insurance community. Companies have many reasons to cheer this decision, but it should also put them on guard. Under D&O policies, insureds must give notice of a claim within the policy period, or run the risk of forfeiting coverage. Thus, insureds, and the professionals who serve them, must be vigilant in recognizing the need to give timely notice of subpoenas and similar documents.

Please contact any of the following attorneys in Lowenstein Sandler's Insurance Law Practice Group with questions related to this alert or other insurance coverage issues:

Robert D. Chesler
973 597 2328
rchesler@lowenstein.com

Michael David Lichtenstein
973 597 2408
mlichtenstein@lowenstein.com

Joseph D. Jean
646 414 6906
jjean@lowenstein.com

Rachel M. Wrightson
646 414 6912
rwrightson@lowenstein.com

Lowenstein Sandler
ATTORNEYS AT LAW