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Don't Forget About D&O Insurance When That Government Subpoena Arrives

When an investigation is commenced by a federal or state government entity, whether by service of a subpoena or by less formal means, a company should have two standard operating procedures: first, hire excellent and experienced counsel to respond to the investigation or subpoena; and second, determine whether insurance coverage may be available to pay for what are frequently significant defense costs that may be incurred in connection with the investigation.

Securing insurance coverage for subpoenas and informal investigations, both civil and criminal, can be an arduous process, but policyholders who plan ahead and know the pitfalls can give themselves a significant advantage in securing timely coverage. Failing to secure coverage for an investigation can mean that there will be no coverage if the investigation leads to lawsuits or other legal proceedings.

Prompt Notice The most common pitfall is failing to give prompt notice to your insurance company. At the first indication of a government investigation, a company should consider whether it needs to give notice to its Directors' & Officers' ("D&O") insurance carrier. This is generally done through a broker. Failing to give prompt notice, which usually occurs because no one realized that government investigations might be covered by insurance, is the most frequent mistake policyholders make and it could be fatal to obtaining coverage. In some states, late notice is a complete defense to coverage even if the insurer has suffered no prejudice as a result. And if late notice blows coverage for an investigation, it likely will also blow coverage for any lawsuits or other legal proceedings that may follow. The question of whether insurance coverage is available for fees and costs incurred in connection with responding to subpoenas and informal investigations depends in large part on the language of the D&O insurance policy and the specific facts and circumstances surrounding the subpoena or investigation.

Is the Investigation a “Claim” The starting point for the analysis is whether or not the subpoena or investigation fits within the D&O policy’s definition of the term “Claim.”

Several different definitions appear in D&O policies; a typical one defines “Claim” as:

- Any civil proceeding in a court of law or equity, including any mediation or alternative dispute resolution ordered or sponsored by such court
- Any criminal proceeding in a court of law
- Any administrative or regulatory proceeding commenced by filing a notice of charges, formal investigative order, or similar document

Another definition of “Claim” includes “formal and informal government investigations.” Several courts also have held that a subpoena can be a Claim. In determining whether a subpoena constitutes a “Claim,” courts have looked to the nature of the particular subpoena in light of the policy language. Thus, an SEC “Order Directing Private Investigation and Designating Officers to Take Testimony” has been held to be a Claim for the purpose of coverage under a D&O policy. Where a subpoena is served on a policyholder in its capacity as a “custodian of records,” however, it is unlikely to qualify as a Claim that would trigger payment of defense costs.

In a recent case, *MBIA Inc. v. Federal Ins. Co., et al.*, No. 08 CIV 4313, slip op. (S.D.N.Y. Dec. 30, 2009) (“MBIA”), the MBIA was hit with “inquiries” and subpoenas by the New York State Attorney General and the SEC. The definition of Claim in MBIA’s D&O policy included “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,” that arose from the purchase or sale of securities. The court held that the subpoenas and inquiries fit within the definition of Claim in the policies and, therefore, the defense costs incurred in responding to them were covered.

Is the Claim Covered Under the Policy In addition to the definition of the term “Claim,” the investigation must also relate to something that is covered under the policy. The typical D&O policy provides coverage for loss arising from a “Claim” based on an “actual or alleged Wrongful Act.” Thus, whether or not a subpoena represents a “Claim,” there may still be a question regarding whether an actual or alleged Wrongful Act is involved.

An insurance company may argue that there are no allegations of any Wrongful Act in the subpoena, thus negating the duty to defend. Most subpoenas and government investigations, however, have either explicit or implicit suggestions of wrongdoing that should satisfy this requirement, at least where the company or its directors or officers are a target of the investigation. The insurance company

may also contend that so-called “personal conduct” exclusions relating to fraud, illegal profits, and intentional violations of law, may preclude coverage. Such exclusions should not, however, deprive the policyholder of its right to a defense, since in most D&O policies, they are only triggered by a “final adjudication” of the wrongful conduct. The policy language may allow the insurance company to seek reimbursement of the amounts paid toward the defense if one of the exclusions is triggered. But in that event, at least the policyholder will have been able to mount a proper defense to the charges with the insurance company paying the bill in the first instance.

Reporting Potential Claims Even if a subpoena or government investigation does not qualify as a Claim under the policy, a company may still want to report it to its D&O insurer. D&O policies almost always give the insured the option of reporting potential claims—normally called “circumstances that may give rise to a claim”—in order to secure coverage for the potential claim within the policy period in effect when the potential claim is reported. So if the investigation is reported as a potential claim in policy period A, but does not blossom into a Claim (e.g., a lawsuit) until policy period B, it will be covered under policy period A. The main caveat is that policies normally require potential claims to be reported with a great deal of specificity, so attention must be paid to this requirement.

One reason to report an investigation as a potential claim is that the company may be required to disclose the investigation anyway in connection with an application for new insurance, because non-disclosure may carry the risk that the carrier later will try to rescind the policy. But disclosing potential claims in connection with new insurance runs the risk that the investigation and any resulting claims will be excluded from coverage under the new insurance, so it is important to secure coverage under the expiring policy instead. Reporting potential claims also may have the advantage of parking claims in an expiring policy period and leaving the new policy untouched for fresh potential claims (D&O policies typically have one-year policy periods).

A Note on E&O Insurance In some cases, a government investigation might be covered under a company’s Errors & Omissions (“E&O”) insurance policy rather than its D&O policy. For example, if a company is being investigated in connection with professional services it has provided to the government pursuant to a government contract, the E&O policy may be implicated (and the matter may be excluded from coverage under the D&O policy). Issues regarding notice under an E&O policy are very similar to notice issues under a D&O policy. If it is unclear whether an investigation will be covered under a company’s E&O or D&O policy, notice may be given under both.

Conclusion Government investigations can be both time-consuming and hugely expensive. A target of such an investigation that has purchased D&O or E&O coverage may, depending on the wording of the policy and the type and tenor of the investigation, have coverage to pay for the defense and cost of responding to such an investigation. Policyholders should think of insurance when the investigation begins, analyze their potential coverage with the assistance of an attorney, and give prompt notice of any potentially covered claim.