

SEC Formal Investigation of Company Is a "Claim" Against an Insured Person; But No Coverage for Informal Investigation

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The United States District Court for the Northern District of Illinois, applying Illinois law, has held that an SEC "Order Directing Private Investigation and Designating Officers to Take Testimony" constituted a "Claim" against an insured person for a wrongful act even though the order did not specifically name any directors or officers as targets. *National Stock Exch. v. Fed. Ins. Co.*, 2007 WL 1030293 (N.D. Ill. March 30, 2007). The court also held that fees and costs incurred in connection with the SEC's earlier, preliminary investigation were not covered defense costs.

The policy at issue provided coverage for "Loss" incurred on account of a "Claim" alleging a "Wrongful Act" made against the stock exchange's directors and officers. The policy defined "Claim" to include "a formal administrative or regulatory proceedings commenced by the filing of a . . . formal investigative order or similar document." The policy defined "Wrongful Act" to include "any error, misstatement, misleading statement, act, omission, neglect, or breach of duty committed, attempted, or allegedly committed or attempted, by an Insured Person." The policy defined "Loss" to include costs "defending or investigating Claims."

The stock exchange first received notice of a preliminary investigation by the SEC on October 16, 2003. After obtaining certain documents and information, the SEC issued an "Order Directing Private Investigation and Designating Officers to Take Testimony" on February 5, 2004. An attachment to this order indicated that the stock exchange may have violated certain securities laws and regulations. On May 19, 2005, the SEC filed an administrative cease-and-desist proceeding against the stock exchange, and also filed a civil lawsuit in federal court against one of the insured officers.

The insurer first argued that there was no Claim prior to the May 19, 2005, administrative proceedings and civil suit. Pointing to the phrase "formal investigative order" in this definition of "Claim," the court stated, however, that "[i]t is clear from this language that a formal investigation was intended to be included in the definition of 'Claim.'" The court then identified the February 5 order, which directed the SEC to conduct a private investigation and take testimony, as a formal investigation. The court, therefore, held that a Claim

existed as of February 5, 2004.

The court rejected the insurer's argument that the February 5 order was not a Claim for a Wrongful Act against an insured person. The court explained that although the investigation named the corporate entity rather than any individual insured, the order referred to an attachment that defined the corporate entity to include its "present and former officers and directors." The court stated that, "[c]ontrary to the [insurer's] assertions, the policy does not require the SEC to name specific individuals as the target of its proceedings." It reasoned that the broad reference in the SEC attachment to the company's officers and directors was sufficient to make the SEC order a "Claim" under the policy.

The court then addressed the separate issue relating to defense costs incurred in connection with the informal investigation. The stock exchange sought all costs incurred throughout the SEC investigation, including those costs incurred in connection with the preliminary investigation prior to the February 5 order. The court ruled, however, that costs incurred in connection with the preliminary investigation were not covered defense costs because "[c]ommon sense dictates that a Claim must first exist in order for a plaintiff to defend or investigate it."

The court then considered the stock exchange's bad faith Claim under 215 ILCS 5/155. The court observed that under Illinois law, "an insurer's conduct does not constitute [bad faith] if there is a *bona fide* dispute concerning the scope or application of the coverage." Further, an insurer is insulated from such a Claim so long as its coverage position was not "baseless." The court then held that despite its determination that there was coverage, the insurer's arguments to the contrary were not baseless and did not support a Claim for bad faith under the Illinois statute.