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NEWSLETTER

D&O Policy Does Not Cover Costs of SEC Investigation of Insured Entity or Audit Committee Investigation

November 2010

The United States District Court for the Southern District of Florida has determined under Florida law that no coverage is available under an office supply company's directors and officers liability insurance policies for costs incurred in connection with an internal audit committee investigation or with the company's response to an investigation by the Securities and Exchange Commission (SEC). *Office Depot, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 2010 WL 4065416 (S.D. Fla. Oct. 15, 2010). Wiley Rein LLP represented the first-layer excess insurer in the case.

The insured sought coverage under its D&O policy for costs incurred in connection with numerous matters: securities and derivative lawsuits against the company and insured directors and officers, an SEC investigation against the company itself, voluntary responses by directors, officers and employees to the SEC requests for documents and testimony, responses by insured persons to subpoenas and "Wells notices" issued by the SEC, and an internal investigation conducted by the audit committee of the insured's board of directors arising from an internal whistleblower complaint. The insured contended that the policy's entity coverage for "Securities Claims" should extend to the SEC's investigation of the insured company itself, that the SEC's voluntary requests for information constituted covered claims against insured persons and that the audit committee's investigation costs were part of covered "Defense Costs" incurred in connection with these purported claims. In the alternative, the insured contended that all of these matters "related back" to a notice of circumstances provided shortly before the SEC began its informal inquiry and that the costs incurred in connection with these matters therefore constituted covered "Defense Costs" starting on the date of the notice of circumstances.

The company's primary and first excess D&O insurers contended that, under the primary policy's clear terms, the policies afforded coverage solely for the securities and derivative lawsuits and for the SEC investigation of insured persons once subpoenas or Wells notices had been issued to such persons. Although the primary policy afforded limited coverage for administrative proceedings against the insured entity, the insurers argued that such coverage was not available for an investigation of the company, which was excepted from the definition of "Securities Claim." The insurers also contended that responses by insured persons to requests by the SEC for voluntary cooperation did not constitute "claims," nor did the policy afford coverage to an audit committee investigation that the company asserted was useful to its defense efforts in the parallel securities

litigation and should therefore be deemed "Defense Costs."

The court agreed with the insurers, granting their motions for summary judgment and denying the insured's motion. The court determined that the SEC's investigation was not a "Securities Claim" against the insured entity because the primary policy's definition of "Securities Claim" clearly excepted "an administrative or regulatory proceeding against, or investigation of an Organization." The court rejected the insured's contention that the phrase "administrative or regulatory proceeding" was ambiguous and could include an investigation of the insured entity. According to the court, the use of the disjunctive "or" in the quoted provision demonstrates that the parties understood "proceedings" to be distinct from "investigations." It is logically presumed, according to the court, that the parties did not intend for a "proceeding against" the entity to encompass an "investigation of" the entity. Otherwise, the court reasoned, it would be "pointless to distinguish between these terms."

The insured also relied upon a policy provision stating that, after a notice of circumstances is submitted, a "Claim which is subsequently made against [the] insured . . . arising out of . . . any Wrongful Act alleged in or contained in such circumstances, shall be considered made at the time such notice of circumstances was given." The court rejected the insured's contention that costs incurred in connection with SEC's informal and formal investigation were covered because the investigation "relates back" to a notice of circumstances the insured submitted to the insurers. The court determined that the so-called "relation back" provision "simply defines when a 'Claim' is 'considered made' . . . it does not create coverage for matters that do not constitute 'Claims' in the first instance." According to the court, the provision "does not operate to expand the Policy definition of a 'Claim' to absorb any allegations of wrongdoing which happen to be related or similar to the wrongdoing described in the insured's original Notice of Circumstance." Because the SEC investigation was not a "Claim," except to the extent that insured persons were issued subpoenas or Wells notices, the court held that the primary policy's "relation back" clause did not create any additional coverage.

Similarly, the court rejected the insured's argument that costs incurred in connection with its audit committee investigation and the company's response to the SEC were covered because they purportedly were costs that "related to" and were "beneficial to" the defense of covered securities lawsuits. The court determined that, although these lawsuits may well constitute "subsequent Claims" under the primary policy's so-called "relation back" clause, "it does not follow that any pre-suit investigation costs which may have related to and benefited the defense of those suits . . . are transformed into a covered 'loss' which 'arises from' that securities litigation under the operation of the Policy's 'relation back' provision or otherwise."

The policies afforded no coverage for pre-suit investigation costs, according to the court, because coverage existed only for loss "arising from" a Claim. Loss that "arises from" a claim is loss that "grows out of" or "flows from" and therefore follows the claim sequentially in time. "It does not include related pre-suit or pre-claim investigation costs, regardless of how 'related' or 'beneficial' those costs may have ultimately proved to be in defending against the claim which ultimately materialized." The court also agreed with the insurers' argument that such costs were not "Defense Costs," as defined by the primary policy, because they did not "result *solely from* the investigation . . . [or] defense . . . of a Claim against an Insured." Accordingly, the costs associated with the insured's audit committee investigation, which resulted in the first instance from a whistleblower

complaint and later as a part of the insured's voluntary interface with the SEC, could not have "resulted solely" from the investigation and defense of the securities lawsuits and were therefore not "Defense Costs."