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NEWSLETTER

Second Circuit Deems Subpoenas and Oral Requests "Securities Claims" and Treats Amounts Incurred by Special Litigation Committee as Defense Costs

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The United States Court of Appeals for the Second Circuit has held that subpoenas issued by the Securities and Exchange Commission (SEC) and a state attorney general constitute "Securities Claims," defined to include informal proceedings commenced by an investigative order "or similar document," and that oral requests from the same authorities constitute "Securities Claims" when made pursuant to investigative orders. *MBIA Inc., v. Federal Ins. Co.*, 2011 WL 2583080 (2d Cir. July 1, 2011). The court also held that costs incurred by a special litigation committee formed to terminate derivative litigation are covered "defense costs" under the policy. The court further determined that the insurers were liable for the costs of an independent consultant retained by the insured as part of a settlement with the regulators.

The policyholder provided financial guarantee insurance to municipalities and other government entities for their bonds and structured finance obligations. The SEC issued a formal order of investigation in 2001 regarding practices by many companies, and, in 2004, it began serving subpoenas on the policyholder to "produce all documents concerning Non-Traditional Product(s)" but did not identify any specific transactions. The New York Attorney General (NYAG) issued similar subpoenas shortly thereafter. Later in 2005, the SEC and NYAG indicated that they were going to issue additional subpoenas, but, at the policyholder's request, accepted voluntary compliance. The investigations ultimately focused on three separate transactions.

The policyholder notified its insurers of the investigations and requested that the insurers consent to incur defense costs in spring of 2005. The insurers indicated that the subpoenas were insufficient to trigger coverage and deemed them "notice of a potential claim." Later in 2005, the policyholder notified the insurers that it wished to attempt to settle with both regulators in connection with one of the three transactions under investigation for $75 million in penalties and disgorgement. Because the investigation as to the other two transactions remained ongoing, the policyholder agreed to fund an "independent consultant" to review those transactions and propose remedies if necessary. The consultant determined that no wrongdoing occurred in these two matters, and the investigation closed in 2007.

During the investigations, two shareholders separately demanded that the policyholder file suit against its directors and officers; the policyholder set up an independent committee to investigate the demands but did not act on them. When the shareholders filed derivative actions, the insured reconstituted the investigative committee as a Special Litigation Committee (SLC). After determining that the suits were not in its best interest, the policyholder successfully moved to dismiss the derivative suits.

The primary insurer agreed to pay $6.4 million for losses related to the SEC's investigation of the first transaction and initial investigative costs incurred in connection with the shareholder demands, but it declined to cover losses related to the other two transactions or the NYAG investigation. The excess carrier declined coverage because the primary policy had not been exhausted. The policyholder filed suit to "compel the insurers to cover costs related to (1) both regulators' investigations of all three transactions, (2) the independent consultant's investigation pursuant to the settlement, and (3) the work of the SLC."

The appellate court affirmed the district court's holding that the NYAG's investigation of the first transaction and related subpoena constituted a "Securities Claim," which the policy defined 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 court observed that New York law allowed the NYAG to "commence an investigation when, in his discretion, he believes it to be in the public interest that an investigation be made" and "the outward-facing form that investigation takes is the service of a subpoena, which, on its face, commands the production of documents and threatens criminal penalties for noncompliance." The court concluded that it agreed with the district court "that a businessperson would view a subpoena as a 'formal or informal investigative order' based on the common understanding of these words" and rejected the insurers' argument that a subpoena was a "mere discovery device . . . not even similar to an investigative order."

Next, the court considered "whether the SEC's investigation of [the other two] transactions was within the scope of its formal order and whether the NYAG's similar investigation was within the scope of its [first] investigation." The court held that they did, as "the three transactions at issue all involved MBIA's attempts not to report or to delay reporting a loss," and "[a]lthough the mechanics MBIA employed in each of the three transactions differed somewhat . . ., there can be no doubt that all of them involved efforts to delay, reduce, or eliminate the reporting of a loss, precisely as described in the subpoena." In so holding, the court rejected the insurers' arguments that that the caption of the SEC's formal order limited the scope of the investigation. The court next rejected as "meritless" the insurers' objection that "these investigations were conducted by way of oral request rather than subpoena or other formal process," observing that "[t]he investigation, oral or by way of subpoena, was connected to the formal order." In the court's view, "[t]he insurers cannot require that as an investigation proceeds, a company must suffer extra public relations damage to avail itself of coverage a reasonable person would think was triggered by the initial investigation."

Next the court held that the policies provided coverage for costs incurred by the SLC in the derivative litigation. The court rejected the insurers' arguments that the SLC constituted an entity separate from the company or its directors and therefore did not qualify as an Insured. Noting that Connecticut law empowered

the company to create the SLC to exercise the board's authority over management of the corporation, the court concluded that the SLC was simply "one way MBIA exercised its powers." While acknowledging the insurers' contention that the SLC needed to be "independent," the court determined that "[i]ndependence of judgment does not generate a new source of authority to terminate derivative litigation; that authority is still exercised by the corporation, which can act only through its agents." The court then held that the policy's $200,000 sublimit for "Investigation Costs . . . on account of all Shareholder Derivative Demands" did not apply to the SLC. Noting that the sublimit clearly applied to investigations of the pre-suit shareholder demands, the court determined that the sublimit's applicability "is less obvious" once demand is rejected and suit is brought because "[a]t that stage," the other insuring agreements afford coverage for costs incurred in "investigating" Securities Claims. The court also determined that a carveout from Loss for "any amount incurred by [the insured] (including its board of directors or any committee of the board of directors) in connection with the investigation or evaluation of any Claim or potential Claim by or on behalf of [the insured]" did not apply. The court reasoned that although the company was a nominal plaintiff in the derivative litigation, it also was a defendant and therefore "the insurers' reliance on the 'on behalf of' language provides only equivocal support for their position." Moreover, the court questioned the carveout's applicability to SLC costs "because those costs were, at least to some extent, related to litigation, not investigation."

Finally, the court held that the policies provided coverage for the independent consultant funded by the policyholder as per the terms of the settlement agreement. The Second Circuit determined that the insurers were adequately notified by the general notice of a proposed $75 million settlement but had declined to participate in the settlement process. Accordingly, the court held that, "because [the insured] gave the insurers the opportunity to exercise meaningfully their option to participate in settlement discussions and adequately informed them of the nature and amount of claims under consideration for settlement, it did not breach its contractual obligation under the association clause." Similarly, the court held that the company had given sufficient notice to the insurers of the independent consultant provisions so to enable them to exercise their consent rights.