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A COVERED BRIDGE TOO FAR: THE SECOND CIRCUIT WEIGHS-IN WITH AN EXPANSIVE VIEW OF D&O COVERAGE FOR INVESTIGATION-RELATED COSTS IN *MBIA v. FEDERAL*

by William G. Winget and Maureen Godfrey

Bill Winget *is a founding partner of Winget, Spadafora & Schwartzberg, LLP and* **Maureen Godfrey** *is a Senior Associate at the firm who concentrates on insurance coverage and complex litigation. They can be reached at their respective e-mails, winget.w@wssllp.com and godfrey.m@wssllp.com; the firm's telephone is 212-221-6900.*

In the July 2011 PLUS *Journal*, Catherine Asaro and Britt Eilhardt published a very topical article drawing a distinction between "formal" and "informal" investigations by government authorities, warning that the latter still can impose an extreme financial burden on a corporate insured and noting that each may be treated differently for coverage purposes under a directors and officers liability ("D&O") policy. The authors went on to discuss several cases analyzing the availability of coverage for investigative expenses, including a federal district court's opinion in *MBIA, Inc. v. Federal Insurance Company and ACE American Insurance Company.*[1]

Just before the long Independence Day weekend, the Second Circuit issued a comprehensive decision on the appeal of *MBIA v. Federal* by way of addressing the extent to which a D&O policy and a companion excess policy covered certain costs and expenses associated with regulatory investigations directed at MBIA, Inc.[2] Articulating a number of novel interpretive protocols in lieu of strict application of the policy language, the Circuit found entirely in MBIA's favor, holding that coverage was available for the costs of complying with informal requests for documents, conducting an investigation through a special litigation committee, and retaining an independent consultant per the terms of a settlement that was not consented to by the insurers.

Setting aside any misgivings about the Circuit's logic, the *MBIA* decision warrants careful analysis by the professional liability community as a potentially influential source of precedent from a highly respected federal court.

BACKGROUND AND CLAIM FACTS UNDERLYING THE MBIA DECISION

MBIA is in the business of providing financial guaranty insurance to municipalities and other public authorities for their bonds and structured financial obligations.

For a policy period incepting in 2004, MBIA purchased a $15 million primary D&O Policy and a $15 million companion excess policy.[3] By the end of 2004, MBIA received subpoenas concerning certain aspects of its business from both the Securities Exchange Commission ("SEC") and the New York Attorney General's Office ("AG"). The subpoenas requested virtually identical information and reflected ongoing, industry-wide investigations of "non-traditional" insurance products dating back to a 2001 SEC Order of Investigation (the "2001 Order"). In response to the subpoenas, MBIA produced documents concerning its purchase of reinsurance for guarantees it sold on bonds issued by an affiliate of Allegheny Health, Education and Research Foundation ("AHERF").

As the investigations continued, the regulators agreed not to issue new subpoenas in exchange for MBIA's voluntary compliance with further document requests. In response to informal document requests by the SEC and AG, MBIA responded with additional documents and information centered on two more transactions, one being MBIA's acquisition of an interest in Capital Asset Holdings GP, Inc. ("Capital Assets"), the other MBIA's guarantee of securities used to purchase airplanes for US Airways.

As the investigations continued, MBIA conducted intensive settlement negotiations with the SEC and AG for over a year, with discussions initially contemplating a deal based on disgorgement and penalties of up to $75 million. After being informed of those initial discussions in September 2005 and receiving MBIA's request for consent to the settlement as it was then structured, the insurers chose not to participate in the settlement negotiations and expressed the belief that the settlement would not be covered; at the same time, the insurers agreed that they would not raise the lack of consent to such settlement as a coverage defense.

In October of 2005, MBIA made an offer of settlement to the SEC and the AG that proposed, unbeknownst to the insurers, the retention of an Independent Consultant ("IC") to investigate the Capital Assets and US Airways transactions, adding a potentially covered expense to the settlement package. Nevertheless, as the protracted settlement negotiations continued MBIA did not inform the insurers of the new proposal until at least 10 months later, in September 2006, at which point the IC had

already begun work and the settlement was nearing completion.

The SEC and AG investigations led to two derivative actions against the company, in response to which a Special Litigation Committee ("SLC") was formed to evaluate the merit of the claims. After determining the suits were not in MBIA's or its shareholders' interest, the SLC successfully moved for their dismissal.

MBIA ostensibly expended $29.5 million in connection with the regulatory investigations, including the costs of producing documents, retaining the IC, investigating the derivative claims, and challenging the derivative claims in court. The primary carrier agreed to reimburse MBIA in the amount of $6.4 million for costs incurred producing documents concerning the AHERF transaction, presumably concluding that the original SEC subpoena had been issued pursuant to the 2001 Order and thereby qualified as a *Securities Claim*. The carriers otherwise would not cover expenses associated with the initial AG subpoena that resulted in production of the AHERF materials. They further declined to provide coverage for any of the subpoenas and document requests relating to the Capital Asset and US Airways transactions; and for costs incurred by the IC or the SLC in conducting their investigations.

Litigation ensued in the United States District Court for the Southern District of New York. The District Court determined that all of the claimed expenses were covered under the policies with the notable exception of amounts paid for the IC. With respect to the IC costs, the District Court determined that MBIA breached the so-called "right to associate" clause in the policies whereby the insurers were entitled to "effectively associate" in the "investigation, defense and settlement" of any claim. Each side appealed.

SECOND CIRCUIT'S DECISION—COVERAGE CONFIRMED AVAILABLE FOR COSTS OF COMPLYING WITH ALL SUBPOENAS AND DOCUMENT REQUESTS

In determining whether coverage was available for the costs incurred in responding to the SEC and AG subpoenas and the subsequent document requests, the Circuit focused on the definition of a *Securities Claim* under the policies, being in pertinent part, "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." In this context, the Circuit recognized that coverage was potentially available for a *Securities Loss* incurred by MBIA as a result of a *Securities Claim*.

The Circuit started its analysis with the original AG subpoena, which the insurers very plausibly argued was a "mere discovery device" that was in no way analogous to an "order of investigation" so as to qualify as a *Securities Claim,* much less to a "notice of charges." In this regard, any securities lawyer or executive seemingly would recognize an "order of investigation" as a document that officially authorizes an investigation, typically identifying the statute or regulation that may have been violated and memorializing the known facts warranting investigation, the overall objectives of the investigation, the investigative procedures contemplated to realize those objectives, and the persons or agencies authorized to preside over, and participate in, the investigation. While a subpoena might well be a *tool* of such an investigation, a subpoena generally contains only a straightforward request for testimony or documents, and the insurers' distinction between the two kinds of instruments seems entirely rational.

The Second Circuit disagreed, very broadly viewing the subpoena as the natural starting point of the investigation so that it qualifies as a "formal or informal investigative order," or at minimum a "similar document" that falls within the above definition of *Securities Claim*. Contrary to this writer's perception that any professional in the securities industry would distinguish a "subpoena" from an "order of investigation," the Circuit agreed with the District Court that a business person naturally would equate the two as a matter of "common usage," and held that the AG subpoena in and of itself manifested a *Securities Claim* so that coverage was available for the resulting expenses incurred by MBIA.

With regard to the document requests directed at the Capital Asset and US Airways transactions, the Circuit also found that coverage was available, reasoning that the SEC requests related directly to the 2001 Order qualifying as a *Securities Claim* and that the AG requests corresponding to the AHERF subpoena likewise qualified as such. In addressing the SEC requests, the Circuit extensively analyzed the terms of the 2001 Order, concluding that the overall focus of the investigation was directed at "non-traditional insurance products" that potentially were intended to manipulate or avoid loss recognition in any given quarter, rather than at any specific transaction. The Circuit went on to observe that the Capital Assets and US Airways transactions both were related to loss recognition strategies, and that the costs of complying with the informal document requests from the SEC were squarely connected to a covered *Securities Claim*.

For the AG document requests, the Circuit did not have an underlying order of investigation as a frame of reference. Instead, it simply "switched gears" and looked to the initial subpoena issued by the AG, noting that it mirrored the language of the SEC subpoena and its reference to non-traditional insurance products. Since it had concluded that the AG subpoena manifested a covered *Securities Claim* as discussed above, the Circuit readily concluded that the informal requests pertaining to Capital Assets and US Airways should likewise be characterized.

SECOND CIRCUIT'S DECISION—REVERSING THE DISTRICT COURT, COVERAGE HELD AVAILABLE FOR THE COSTS OF AN INDEPENDENT CONSULTANT

The insurers declined coverage for costs associated with the IC (Independent Consultant) because, *inter alia*, MBIA delayed over ten months before informing them that the settlement contemplated retention of the IC, during which time the IC actually started work and settlement negotiations proceeded to their final stages. As such, the insurers asserted, and the District Court agreed, that MBIA had breached the insurers' "right to associate" in the "investigation, defense and settlement" of any claim. Implicit in the District Court's ruling was the sensible notion that a liability insurer would have no reason to "associate" with settlement discussions that did not contemplate any covered settlement expense—recall that the initial notification received by the insurers advised only of proposed disgorgement and penalties—and that withholding information about the IC while negotiations proceeded for over ten months violated an express policy provision and prejudiced MBIA's insurers.

The Circuit, however, found that MBIA did not breach the "right to associate" clause since the purpose of that clause is only to provide the insurer with an "option to intervene," which MBIA accomplished merely by informing the insurers that settlement negotiations were ongoing. The Circuit found that "it is not the insured's duty to return to the nonparticipating insurer each time the negotiations about the

same claim take a new twist and ask if the insurer still wants to opt out."

The Circuit also rejected the insurers' position that the settlement exceeded the bounds of their 2005 agreement not to raise lack of "consent" since they were never informed of material settlement terms. The Circuit decided that the insurers had sufficient time to "voice an objection or lack of consent," and that, "the insurers' agreement to waive lack of consent to settlement in 2005 was, by their silence and inaction, reasonably perceived by MBIA to be a continuing waiver of that defense as they learned more about the contours of the final settlement being considered, without expressing any objection to the additional provisions of the evolving settlement."

SECOND CIRCUIT'S DECISION—COVERAGE CONFIRMED AVAILABLE FOR EXPENSES ASSOCIATED WITH COMMITTEES INVESTIGATING DERIVATIVE CLAIMS

Regarding the costs of the SLC and a predecessor committee appointed before the derivative suits were actually filed (the "Committees"), the Circuit affirmed the District Court's determination. Relying on Connecticut corporate law, the Circuit found that the directors sitting on the Committees were authorized to exercise the power of MBIA to investigate the derivative claims and to seek dismissal of the derivative actions, and it rejected the insurers' position that the Committees were independent bodies and hence not an "Insured Person" entitled to coverage under the Policy.

The Circuit also rejected the insurers' reliance on a time-honored principle of contract interpretation, namely being that the scope of one contractual provision should ***not*** be construed in a manner that renders another provision meaningless or ineffectual. More specifically, the insurers observed simply that the existence of a separate Insuring Agreement No. 4, potentially covering the costs of investigating a derivative demand and having a $200,000 sublimit, militated against the availability of coverage for costs associated with the SLC under a separate insuring agreement with a much larger limit, the seemingly airtight logic being that the Committees were empanelled to investigate derivative claims/suits and that the attendant costs would be covered under Insuring Agreement No. 4, if at all. The Circuit did not necessarily reject the validity of that observation, but it did rule that this analysis was tantamount to invoking an exclusion under the policy with the concomitant burden of proof being on the insurer; and that this burden was not met.

CONCLUSIONS

In retrospect, the *MBIA* decision embraces a kind of interpretive license in a number of respects, all seemingly intended to buttress the Circuit's perception that coverage should be available even if that position did not always seem to reflect strict adherence to the policy language. A subpoena is deemed to be the equivalent of a "notice of charges, formal or informal investigative order, or similar document;" the "right to associate" is deemed an "option" that must be exercised promptly even if vital information is withheld about the nature of the settlement; and any effort to interpret the policies so as to reconcile all of the insuring agreements—a fundamental methodology recognized under contract law—is viewed as the equivalent of invoking an exclusion so as to require an unattainably high burden of proof.

D&O insurers should pay particular attention to the Circuit's analysis of the "right of association" clause and its finding of a continuing waiver of the "consent to settlement" clause. In both, the Circuit took hard stances against the insurers based on their relative inactivity regarding the settlement process. To be sure, from this writer's perspective such inactivity merited no significance whatsoever since the insurers had no reason to think the settlement entailed any covered costs; in fact, an insurer under such circumstances would likely be concerned about waiving coverage defenses if it insisted on participating in settlement negotiations when it had no intention of funding any of the attendant costs.

Obviously, the Second Circuit's perspective will trump this writer's misgivings anytime. In the aftermath of *MBIA v. Federal*, D&O insurers wishing to protect their "right to associate" and their right to "consent to settlement" must consider a more proactive approach to monitoring settlement negotiations and affirmatively demanding information from an Insured on an ongoing basis. The Circuit's interpretation here in essence puts the onus on the insurer to make continual inquiries as to the status of settlement. While the *MBIA* court cautioned that the right to associate was not a "one-shot opportunity," it also made clear that the insured has no duty to return to a "nonparticipating" insurer once the settlement negotiations veer into costs for which the insurer may be responsible under the policy.

FOOTNOTES

1 See *MBIA, Inc. v. Federal Ins. Co.*, 08-cv-4313 (RMB), 2009 U.S.Dist. Lexis 124335 (S.D.N.Y. Dec. 30, 2009).

2 See *MBIA, Inc. v. Federal Insurance Co.,* 10-3555-CV(L), 2011 U.S.App. Lexis 13402 (2d Cir. July 1, 2011).

3 For purposes of the issues appealed, the Circuit found that the excess policy followed the form of the primary and/or to extent the language varied, did not affect the Circuit's finding.