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ENTITY INVESTIGATION COSTS COVERAGE

One of the most frequent coverage disputes under D&O policies in recent years is the existence of coverage for costs incurred by a Company in connection with regulatory and other governmental investigations. Many companies assume there is full coverage for any investigation costs incurred by the company and are surprised when the D&O insurer denies coverage for some or all of those costs.

In reaction to these frequent disputes, D&O policy terms and court rulings have evolved with respect to entity investigation cost coverage. Consistent with insurers' intent, most ABC D&O policies today afford full coverage for investigation costs incurred by insured persons (whether or not the person is a target of the investigation), but afford no coverage for investigation costs incurred by the company.

Subject to a few exceptions, courts have generally based their investigation cost coverage rulings on the clear language of the applicable policy. However, the intended lack of entity coverage has been subverted by some courts under various situations. More recently, some D&O insurers are now offering for an additional premium entity investigation cost coverage.

I. Investigation Costs: A Rising Tide

In recent years, investigation costs have grown exponentially due to an increase in the number of investigations and the rising cost of responding to those inquiries. In 2015, 18% of organizations worldwide identified regulatory and investigatory matters as among the most numerous they face.[1] This percentage has increased within the United States almost every year since 2012, across all company sizes and industry groups, though the increase has been most pronounced within the financial, energy, and life sciences and healthcare industries.[2] Tellingly, 39% of organizations worldwide now identify regulatory and investigatory matters as the legal disputes of greatest concern to their companies.[3]

The two most active enforcement authorities are the DOJ and the SEC. Not only are the number of investigations by these authorities at or near record levels, the size and scope of the investigations are often large and broad, thus requiring unprecedented costs to defend.

Due to lack of comprehensive public reporting, it is difficult to precisely measure the number of DOJ investigations commenced annually. Nevertheless, the DOJ has been the primary enforcement body with respect to the Foreign Corrupt Practices Act (FCPA), an area which has exploded since 2005. Approximately 57% of all FCPA enforcement actions since 2005 have been brought by the DOJ. In 2013 and 2014, the DOJ brought twice as many FCPA enforcement actions as the SEC, although this trend ended in 2015, when both agencies brought

10 actions each.[4] The average settlement value of such matters also increased between 2005 and 2014 from $7.3 million to $156.6 million.[5] In addition to FCPA matters, D&O insurers receive notice of a multitude of DOJ civil investigations relating to other corporate wrongdoing, including antitrust violations, financial fraud, and violations of the False Claims Act.

Investigation statistics reported by the SEC are sobering. The SEC reported that in fiscal year 2014, it filed a record 755 enforcement actions (a 10% increase from 2013) and obtained orders totaling $4.16 billion in disgorgement and penalties (a 22% increase).[6] In fiscal year 2015, these figures continued to increase, with 807 enforcement actions filed and $4.2 billion in penalty and disgorgement orders.[7] These increases may be due in part to the SEC's renewed focus on investigating and taking enforcement action against individuals responsible for securities law violations, not just the companies they work for, as well as the revived use of Section 20(b) of the Exchange Act. Under Section 20(b), the SEC can pursue persons who, directly or indirectly, do anything "by means of any other person" that would be unlawful for them to do on their own, but who may not be liable under *Janus* because they are not the "makers" of challenged statements.[8] The increases are also attributable to the SEC's push for greater policing of accounting fraud through the use of innovative computerized tools and the creation of a task force to investigate financial-reporting misconduct, which resulted in the SEC opening more than 100 accounting fraud probes in fiscal year 2014.[9]

In contrast, some regulators appear to be opening fewer investigations, but are still recovering record amounts in the investigations they pursue:

- In recent years, the Commodity Futures Trading Commission (CFTC) has reported a decrease in the number of enforcement actions (from 102 in 2012, to 67 in 2014 and 69 in 2015) and investigations (from 290 in 2013, to 240 in 2014), even while it recovered record sanctions of $3.7 billion and $3.2 billion in 2014 and 2015, respectively.[10]

- Likewise, the number of disciplinary actions brought by the Financial Industry Regulatory Authority (FINRA) decreased by approximately 9.3% from 1,541 in 2012 to 1,397 in 2014, but the fines and restitution recovered by FINRA over the same period increased from $102 million to $166.3 million.[11]

- The Federal Energy Regulatory Commission (FERC) reports that it opened only 17 investigations in 2014, as compared to 24 in 2013, even while the total penalties and disgorgement damages assessed and/or recovered through settlement increased to $559.2 million in 2014.[12] However, as these assessments increase, so too does litigation arising out of FERC's assessments, with seven litigation proceedings reported in 2015.[13] As a likely result, FERC opened 19 new investigations in 2015, but only reached settlements of $26.26 million and assessed civil penalties and disgorgement of $111.7 million the same year.[14]

The costs associated with defending these investigations continue to soar, largely because of ever-expanding e-discovery. For example, 62% of U.S. companies report that they were required to preserve or collect data from a mobile device in connection with litigation or an investigation in 2014.[15] Because companies and their employees maintain immense amounts of data, discovery costs can total millions (and sometimes tens of millions) of dollars.

Not surprisingly, many companies retain outside counsel to assist in defending investigations, thereby further increasing costs.[16] Directors and officers often request separate counsel to represent them in interviews and to respond to document requests. As such, the cost of responding to regulatory investigations may approach or even exceed the sanctions ultimately imposed. For example, in 2008, Office Depot spent over $23 million to defend SEC allegations that the company and two of its officers violated the federal securities laws. Office Depot ultimately agreed to pay a $1 million civil penalty and the officers paid separate $50,000 penalties to resolve the allegations.[17] That same year, Siemens reportedly spent $1 billion on its internal investigation into violations of the FCPA, for which it ultimately paid $1.6 billion in regulatory fines.[18] As shown by these extreme examples, the existence or lack of investigation cost coverage can be critically important for Insureds.

II. Evolving Coverage for Entity Investigation Costs

As with many coverage issues, whether a policy affords entity coverage for an investigation often begins and ends with the definitions of "Claim" and "Securities Claim" in the policy. D&O policies typically contain a definition of "Claim" that includes one or more of the following potentially applicable prongs:

- A written demand for monetary or non-monetary relief against an Insured;
- A civil, criminal, administrative, regulatory or arbitration proceeding against an Insured that is commenced by (i) service of a complaint or similar pleading, (ii) return of an indictment, information, or similar document, or (iii) receipt or filing of a notice of charges; or
- A formal criminal, administrative, or regulatory investigation against an Insured Person.

The definition of "Securities Claim" in turn typically includes certain "Claims" alleging a violation of securities laws, but frequently excludes regulatory or administrative proceedings against the company.

Historically, D&O insurers have not intended to afford entity coverage in connection with regulatory and governmental investigations. Entity investigation costs are viewed by insurers as a highly volatile exposure and an ordinary cost of doing business. The following discussion summarizes how insurers have tried to implement that intent and how insureds have tried to circumvent that intent.

A. "Investigations" Prong of Claim Definition

To avoid entity investigation cost coverage, the "investigation" prong of the definition of "Claim" usually limits coverage for investigations only to Insured Persons. That seemingly clear coverage limitation is not always followed by courts, though. For example, in *Millennium Laboratories Inc. v. Allied World Ins. Co.*, 2015 U.S. Dist. LEXIS 13353 (S.D. Cal. Sept. 30, 2015), the court held that DOJ subpoenas issued to the insured entity satisfied the "investigation" prong of the definition of Claim in the D&O policy even though that prong only referred to investigations of an Insured Person. The court based its holding on a corresponding letter from the DOJ, which stated that the DOJ was conducting a joint criminal and civil investigation of the insured entity and its officers, employees and agents.

B. "Proceeding" Prong of Claim Definition

Because the "investigation" prong of the definition of "Claim" does not expressly grant entity coverage, some Insureds argue that the "proceeding" prong of the definition triggers entity investigation cost coverage. However, investigations often do not rise to the level of a "proceeding." For example, in *Emplr's Fire Ins. Co. v. Promedica Health Sys.*,[19] the Sixth Circuit Court of Appeals held that the issuance of an investigative subpoena to the insured entity did not commence a "proceeding," but merely permitted "the use of compulsory process in connection with [an] ongoing investigation." The Eleventh Circuit reached a similar conclusion with respect to the SEC's requests for documents and testimony from the corporate entity in *Office Depot, Inc. v. Nat'l Union Fire Ins. Co.*[20] Such a result is particularly appropriate where the definition of "Claim" requires that a proceeding be commenced by the filing or service of a complaint, indictment, or notice of charges, all of which being documents not typically filed until an investigation concludes.[21]

But, in *MBIA Inc. v. Federal Ins. Co.*,[22] the Second Circuit held that subpoenas issued by the New York Attorney General pursuant to an investigation commenced a "proceeding or inquiry" as used in the definition of Claim because that definition referred to a proceeding commenced by an "investigative order." Likewise, in *Biochemics, Inc. v. Axis Reinsurance Co.*, the U.S. District Court for the District of Massachusetts held that subpoenas issued to the insured entity pursuant to an SEC formal order of investigation constituted a "civil, arbitration, administrative or regulatory proceeding against any Insured commenced by…the filing of a notice of charge, investigative order, or like document."[23]

C. "Demand for Relief" Prong of Claim Definition

Even when the "investigation" and "proceeding" prongs of the definition of "Claim" do not apply, some companies seek investigation cost coverage by arguing that the investigation is a "demand for non-monetary relief" under the definition of "Claim." A majority of the jurisdictions that have considered this argument have rejected it, primarily based on the court's view that "relief" (a term not defined by D&O policies) does not include compliance with discovery requests or the provision of testimony.

For instance, in *Diamond Glass Cos., Inc. v. Twin City Fire Ins. Co.*,[24] the Southern District of New York held that a subpoena and search warrant did not constitute a "demand for non-monetary relief," based in part on Black's Law Dictionary definition of "relief," which includes "redress or benefit…that a party asks of a court." The First Circuit also articulated this "ordinary meaning" approach in *Ctr. for Blood Research, Inc. v. Coregis Ins. Co.*,[25] holding that "an objectively reasonable insured would have…understood that its expenses for attorneys to represent it in response to the subpoena…would not be covered." The Sixth Circuit, as well as courts in California, Illinois, and Minnesota, has also adopted this view.[26]

To rebut this majority view, insureds frequently rely on *Syracuse Univ. v. Nat'l Union Fire Ins. Co.*,[27] in which the appellate court held that a grand jury subpoena is a "demand for non-monetary relief" because "a subpoena is a grand jury's means of preventing or redressing a wrong by enforcing the public's right to 'every man's evidence.'" However, several courts have discounted *Syracuse* as relying on distinguishable authority that construed policies which did not contain a definition of "Claim."[28] A few other courts, though, have found a subpoena to be a

"demand for relief" and thus a Claim.[29] Thus, whether an investigation is a "demand for relief" may vary from policy to policy and from jurisdiction to jurisdiction.

D. "Reasonably Related" Defense Costs

Even where investigations of the company are expressly excluded from or not included within the definitions of "Claim" and "Securities Claim," Insureds may argue that the entity's investigation costs should be covered because they are "reasonably related" to the defense of another covered Claim, such as an investigation of Insured Persons or a securities class action against the Company. A number of courts apply the "reasonably related" test when allocating between covered and non-covered defense costs and conclude that all or virtually all of the jointly incurred defense costs are covered.[30] However, those rulings arguably do not apply under most D&O policies today because of the allocation provisions in those policies, which adopt a more even-handed allocation methodology.[31] Likewise, courts have rejected arguments that a Company's investigation costs should be covered because such costs benefited the Insureds' defense of covered lawsuits.[32]

E. Express Entity Investigation Cost Coverage

A few insurers today now offer express entity investigation cost coverage in D&O policies. This coverage, which is typically only available for a substantial additional premium, applies to costs incurred by the insured company in connection with regulatory investigations. One can debate whether this expanded entity coverage is wise from both the insurer's perspective and the insureds' perspective.

A primary insurer may be benefitted from this coverage because it generates additional revenue and in many instances does not increase the primary insurer's loss payments because the coverage is likely triggered in situations where the primary policy's limit of liability will be exhausted by other covered claims even without this coverage. However, excess insurers will more likely be harmed by the coverage because their additional revenue from the coverage will be more modest even though they bear the vast majority of the additional covered loss exposure.

From the insureds' perspective, this additional entity coverage certainly benefits the insured company. However, this entity coverage dilutes the amount of coverage available for the insured persons. As a result, prudent risk management may result in companies purchasing this entity investigation cost coverage in the first few layers of the ABC D&O program but not adding this coverage to a large portion of the ABC layers, thereby protecting those higher ABC layers (and any Side A layers) from erosion by reason of this expanded entity coverage.

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[1] Norton Rose Fulbright, *2015 Litigation Trends Annual Survey* (the "2015 Litigation Trends Survey"), p. 8 (2015), http://www.nortonrosefulbright.com/files/20150514-2015-litigation-trends-survey_v24-128746.pdf.

[2] *Id*. at p. 9; *see also* Norton Rose Fulbright, *2014 Litigation Trends Survey Report*, p. 8 (2014), http://www.nortonrosefulbright.com/files/20140415-norton-rose-fulbrights-10th-annual-litigation-trends-115113.pdf.

[3] 2015 Litigation Trends Survey at p. 10.

[4] Gibson, Dunn & Crutcher LLP, *2014 Year-End FCPA Update* (the "2014 FCPA Update"), p. 2 (Jan. 5, 2015), http://www.gibsondunn.com/ publications/documents/2014-Year-End-FCPA-Update.pdf; Gibson, Dunn & Crutcher LLP, *2015 Year-End FCPA Update*, p. 2 (Jan. 4, 2016), http://www.gibsondunn.com/publications/documents/2015-Year-End-FCPA-Update.pdf.

[5] *See* 2014 FCPA Update at p. 2. However, in 2015, the average FCPA settlement dropped to $12.5 million. *See* Jones Day, *FCPA 2015 Year in Review*, p. 3 (Jan. 2016), http://www.jonesday.com/files/Publication/9a38cc48-0c4b-404d-8e0f-891f0a93d321/Presentation/PublicationAttachment/43ffd904-bef5-41ef-ab88-a6c26ed86da2/FCPA_2015_Year_in_Review.pdf.

[6] Press Release, U.S. Securities & Exchange Commission, *SEC's FY 2014 Enforcement Actions Span Securities Industry and Include First-Ever Cases* ("2014 SEC Enforcement Report") (Oct. 15, 2014), https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543184660.

[7] Press Release, U.S. Securities & Exchange Commission, *SEC Announces Enforcement Results for FY 2015* (Oct. 22, 2015), http://www.sec.gov/news/pressrelease/2015-245.html; *see* 2014 SEC Enforcement Report.

[8] Mary Jo White, Speech at the NYC Bar Association's Third Annual White Collar Crime Institute: *Three Key Pressure Points in the Current Enforcement Environment* (May 19, 2014), www.sec.gov./news/speech/2014-spch051914mjw.html.

[9] Jean Eaglesham & Michael Rapoport, *SEC Gets Busy With Accounting Investigations*, WALL STREET JOURNAL, Jan. 20, 2015, http://www.wsj.com/articles/sec-gets-busy-with-accounting-investigations-1421797895. (Data for fiscal year 2015 is not yet available.)

[10] Press Release, U.S. Commodity Futures Trading Commission, *CFTC Releases Annual Enforcement Results for Fiscal Year 2014* (Nov. 6, 2014); Press Release, U.S. Commodity Futures Trading Commission, *CFTC Releases Annual Enforcement Results for Fiscal Year 2015* (Nov. 6, 2015), http://www.cftc.gov/PressRoom/PressReleases/pr7274-15.

[11] Financial Industry Regulatory Authority, *Oversight – Enforcement*, http://www.finra.org/industry/enforcement.

[12] Federal Energy Regulatory Commission, *2014 Report on Enforcement*, p. 21 (Nov. 20, 2014), http://www.ferc.gov/legal/staff-reports/2014/11-20-14-enforcement.pdf (noting that a majority of these amounts are the subject of pending appeals).

[13] Federal Energy Regulatory Commission, *2015 Report on Enforcement*, p. 6 (Nov. 19, 2015), https://www.ferc.gov/legal/staff-reports/2015/11-19-15-enforcement.pdf.

[14] *Id*. at pp. 3, 9.

[15] 2015 Litigation Trends Survey at p. 40.

[16] *Id.* at p. 34 (approximately 64% of larger companies report that they retain outside counsel to assist with investigations, as compared to 44% of mid-sized companies and 17% of small companies).

[17] Edward Wyatt, *Office Depot to Pay $1 Million to Settle SEC's Fair Disclosure Charge*, NEW YORK TIMES, Oct. 21, 2010, http://www.nytimes.com/2010/10/22/business/22sec.html.

[18] Eric Lichtblau & Carter Dougherty, *Siemens to Pay $1.34 Billion in Fines*, NEW YORK TIMES, Dec. 15, 2008, http://www.nytimes.com/2008/12/16/business/worldbusiness/16siemens.html?_r=1&.

[19] 524 Fed. Appx. 241, 251 (6th Cir. 2013).

[20] 453 Fed. Appx. 871, 876 (11th Cir. Fla. 2011).

[21] *Diamond Glass Cos. v. Twin City Fire Ins. Co.*, 2008 U.S. Dist. LEXIS 86752, *10 (S.D.N.Y. Aug. 18, 2008).

[22] 652 F.3d 152 (2d Cir. 2011).

[23] *Biochemics, Inc. v. Axis Reinsurance Co.*, 2015 U.S. Dist. LEXIS 896, *6-*7 (D. Mass. Jan. 6, 2015).

[24] 2008 U.S. Dist. LEXIS 86752 at *11.

[25] 305 F.3d 38, 43 (1st Cir. 2002).

[26] *Emplr's Fire Ins. Co. v. Promedica Health Sys.*, 524 Fed. Appx. 241, 250-52 (6th Cir. 2013) ("The subpoenas [and civil investigative demands] sought information related to the FTC's investigation, not a remedy provided by a court.… Therefore, they did not demand "relief" as required by the second element of a 'claim.'"); *St. Paul Mercury Ins. Co. v. RMG Capital Corp.*, 2012 U.S. Dist. LEXIS 80034, *9 (C.D. Cal. June 7, 2012) (relying on the analysis from *Diamond Glass* and *Ctr. for Blood Research* to hold that a demand for "return correspondence" did not constitute a demand for "non-monetary relief"); *Federal Ins. Co. v. Illinois Funeral Director's Ass'n*, 2010 U.S. Dist. LEXIS 129747, *13-*14 (N.D. Ill. Dec. 8, 2010) (a subpoena did not constitute a "written demand for monetary damages or non-monetary relief"); *St. Paul Mercury Ins. Co. v. Foster*, 268 F. Supp. 2d 1035, 1048 (C.D. Ill. 2003) (a letter requesting information or documents regarding an ERISA plan did not seek "other relief" as used in the policy's definition of a Claim); *Foster v. Summit Med. Systems, Inc.*, 610 N.W.2d 350, 355 (Minn. App. 2000) ("The SEC's ability to compel production of documents does not fit any reasonable reading of the term "relief.").

[27] *Syracuse University v. Nat'l Union Fire Ins. Co.*, 40 Misc. 3d 1205(A) (N.Y. Sup. Ct. Mar. 7, 2013), *aff'd* 112 A.D.3d 1379 (N.Y. App. Div. Dec. 27, 2013).

[28] *McCalla Corp. v. Certain Underwriters at Lloyd's*, 2014 U.S. Dist. LEXIS 60309 (D. Kan. May 1, 2014); *RSUI Indem. Co. v. Desai*, 2014 U.S. Dist. LEXIS 122068 (M.D. Fla. Sept. 2, 2014).

[29] *Minuteman Int'l, Inc. v. Great Am. Ins. Co.*, 2004 U.S. Dist. LEXIS 4660 (N.D. Ill. Mar. 18, 2004); *Agilis Benefit Services LLC v. Travelers Cas. And Sur. Co. of Am.*, 2010 U.S. Dist. LEXIS 144491 (E.D. Tex. Apr. 30, 2010).

[30] *See, e.g., Continental Cas. Co. v. Board of Education*, 302 Md. 516, 489 A.2d 536 (1985).

[31] *See, e.g., Dobson v. Twin City Fire Ins. Co.*, 2012 U.S. Dist. LEXIS 93823, *53 (C.D. Cal. July 5, 2012), *reversed on other grounds* 590 Fed. Appx. 687 (9th Cir. 2015) ("[T]his Court rejects Plaintiffs' argument that the default ['reasonably related'] rule applies because the allocation provision clearly requires allocation and some of the Claims are not covered.").

[32] *Office Depot, Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 734 F. Supp. 2d 1304, 1322 (S.D. Fla. 2010) ("However, it does not follow that any pre-suit investigation costs which may have related to and benefitted the defense of those suits [now operating as 'subsequent Claims'] are transformed into a covered 'loss' which 'arises from' that securities litigation under operation of the Policy's 'relation back' provision or otherwise."); *Telxon Corp. v. Federal Ins. Co.*, 309 F.3d 386, 391-92 (6th Cir. 2002) (costs incurred by individual insureds for coordinated defense of non-covered entity did not constitute loss which the officers were "legally obligated to pay").