Does Your D&O Policy Cover Informal SEC Investigations?

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Among the most frequently recurring directors and officers insurance coverage issues is the question of the carrier's obligation to pay for costs incurred in connection with an informal U.S. Securities and Exchange Commission investigation. Indeed over the years, numerous policy revisions have been adopted in various forms by various carriers to address certain aspects of this issue. Yet the issues continue to arise, as shown most recently in District of Colorado Judge Robert E. Blackburn's Aug. 4, 2016, opinion in MusclePharm Corp. v. Liberty Insurance Underwriters Inc., in which he held that the D&O policy at issue did not provide coverage for the insured company's expenses incurred in responding to an informal SEC investigation. The opinion raises a number of issues, as discussed below.

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Background

On May 16, 2013, MusclePharm Corp. received a letter from the SEC's Division of Enforcement advising that the agency was conducting an inquiry into the company's operations and requesting the voluntary production of a number of different categories of documents. The letter did not specify any actual or suspected violation of the securities laws, nor implicate any specific individual officer or director. The letter did state that the inquiry "should not be construed as an indication that the Commission or its staff believes any violation of law has occurred, nor should you consider it an adverse reflection on any person, entity, or security."

On July 8, 2013, MusclePharm received from the SEC an "order directing private investigation and designating officers to take testimony." The order stated that the SEC had "information that tends to show" various "possible violations" of the federal securities laws by MusclePharm and/or its directors and officers. The order authorized a private investigation to "determine whether any person or entities have in engaged in, or are about to engage in" any prohibited acts.

On Feb. 13, 2015, two former MusclePharm officers were served with Wells notices.

MusclePharm submitted all of these various matters to its D&O insurance carrier and sought to have its defense expenses and other costs incurred in responding to be paid for by the insurer. The insurer denied coverage for all of the expenses except the expenses of the two individuals incurred after they were served with the Wells notices. MusclePharm filed an action against the insurer for breach of contract and statutory and common law bad faith, seeking reimbursement for the more than $3 million the company had incurred in complying with the two orders preceding the issuance of the Wells notices. The parties filed cross-motions for summary judgment.

The policy defined "claim" as, among other things: "(c) a formal administrative or regulatory proceeding against an Insured Person; or (d) a formal criminal, administrative, or regulatory investigation against an Insured Person when such Insured Person receives a Wells Notice or target letter in connection with such investigations."

The policy defines the term "wrongful act" to mean "any actual or alleged error, misstatement, misleading statement, act, omission, neglect, or breach of duty, actually or allegedly committed or attempted by the Insured Persons in their capacities as such or in an Outside Position or ... by the Insured Organization."

The Aug. 4, 2016 Order

In an Aug. 4, 2016, order, Judge Blackburn, applying Colorado law, granted the insurer's motion for summary judgment and denied MusclePharm's motion for summary judgment.

The insurer had argued both that the investigation did not constitute a "claim" and that the

investigation did not allege a "wrongful act." Because Judge Blackburn concluded that the investigation did not allege a "wrongful act," he did not reach the question of whether or not the investigation constituted a "claim."

In concluding that the SEC investigation did not involve an actual or alleged "wrongful act," Judge Blackburn examined the dictionary definition of the term "alleged." He said that in light of the definitions, "an alleged error or omission must involve a positive assertion that the implicated error or omission is believed to have actually occurred, even if still subject to proof." This, Judge Blackburn said, was not the case with the SEC's July 8 order, which stated only that the commission has information which "if true tends to show" various "possible violations" of the securities laws that "may have" occurred." Indeed, Judge Blackburn noted, the very purpose of the order was to investigate further and to determine whether these hypothetical violations in fact did occur. Every page of the document contained a legend stating that the commission has not determined whether any person or companies mentioned in the order may have violated the law.

The disclaimers in the document "plainly evidence" that the SEC "was not averring violations had occurred; it sought only to determine whether they had." Given all the contingencies, the July 8 order "cannot be construed to constitute an allegation of wrongdoing sufficient to invoke coverage under the Policy." He concluded that the July 8 order "did not allege a 'Wrongful Act' within the meaning of the Policy," and therefore that the insurer had no duty to reimburse MusclePharm for the fees and costs it incurred prior to the issuance of the Wells notices.

Discussion

The fact that the amount of fees for which MusclePharm was seeking reimbursement was as much as $3 million underscores how important these issues are for the companies involved. The determination of whether or not the investigation presented all of the elements necessary to trigger D&O insurance coverage can have a material financial impact on the concerned companies. Because of the magnitude of the issues involved, the question of insurance coverage for the costs of responding to an informal investigation recurs frequently.

Many of these disputes resolve around the question of whether or not the investigation at issue meets the policy's definition of the term "claim." For example, in a high-profile case involving Office Depot (Office Depot Inc. v. National Union Fire Insurance Co. of Pittsburgh, Pa., et al.), a district court and subsequently the Eleventh Circuit concluded that the informational SEC investigation in which the company was involved did not satisfy the definition of "claim" in the company's D&O insurance policy.

In this case, by contrast, Judge Blackburn did not address the question of whether or not the informal SEC investigation met the policy's definition of the term "claim" — although it should be noted that the definition of "claim" issue could have represented a separate and different hurdle to coverage for MusclePharm.

Rather, Judge Blackburn held that the investigative documents that the SEC had presented to MusclePharm did not involve an actual or alleged Wrongful Act. The absence of an actual or alleged Wrongful Act is always going to be a potential barrier to coverage when investigative matters are in their earliest stages and the investigative process has not yet ripened into actual charges.

Many public company D&O insurance policies these days have provisions providing "pre-claim inquiry" coverage. While this type of coverage is intended to try to provide protection for investigative costs that arise before an investigation has ripened into actual charges, it likely would not have helped this company, or at least not very much. The "pre-claim inquiry" coverage typically is available just to an "insured person" (that is, the individual directors and officers) and not the company itself. In this instance, it appears that the investigative documents and orders prior to the Wells notice were directed to the company itself rather than to the individuals, so the pre-claim inquiry coverage might have afforded only little or even no additional protection in this circumstance.

There are now products available in the marketplace providing investigative cost coverage for the company itself. These insurance products are sold either as stand-alone policies or as accessories to the primary D&O insurance policy. Under either of these arrangements, the policy or extension are underwritten and priced separately from the cost of the D&O insurance itself. These policies tend to be perceived as expensive, particularly in light of the hefty retentions that the carriers typically require for the policies. But as this case shows, while these investigative cost products may be costly, the cost of not having the coverage can be substantial as well.

It should be noted that there is additional case authority as well from which policyholders can seek to have their costs of responding to investigations reimbursed by their insurer. Although it is a very fact-specific opinion, the Second Circuit's 2011 holding in MBIA Inc. v. Federal Insurance Co. can support an argument that a D&O insurer must reimburse its policyholder's costs incurred in voluntarily responding to an SEC investigation. There are, however, numerous differences between the circumstances involved in the MBIA case and the MusclePharm case, including the fact that MBIA's costs of voluntarily responding to the SEC followed after the SEC has issued a broad formal investigative order. For a detailed analysis of the differences between the MBIA and Office Depot cases, please refer to this interesting memo from Kilpatrick Townsend & Stockton LLP, available here.

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