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Articles

An Overview of Offshore Oil Drilling Risks, Legislation and Offshore Physical Damage Insurance Policies

by Rina Carmel and Ashkan Yekrangi

Insurance coverage for offshore oil drilling operations has recently come to the forefront of public attention in the United States, with the Deepwater Horizon blowout in April 2010 in the Gulf of Mexico and the three months that elapsed before the well was capped in July 2010.[1] According to media reports, British Petroleum was self-insured for spills, but some of the entities involved had at least some potentially applicable insurance coverage.[2]

Offshore oil drilling began in the late 19th century, with the first offshore wells in the United States drilled off the coast of Santa Barbara County, California in 1896.[3] With the advent of offshore oil drilling came the risk of offshore oil spills. Between 1964 and the Deepwater Horizon blowout, there were seventeen marine well blowouts in United States waters alone.[4] Although blowouts are relatively rare, experts and environmentalists predict

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Insurance Coverage for SEC Investigations

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I. Introduction

In several recent cases, policyholders have obtained coverage for substantial costs incurred defending investigations by the Securities and Exchange Commission (SEC) or other regulatory bodies under Directors and Officers liability policies ("D&O Policies") and/or Errors and Omissions liability policies ("E&O Policies")(collectively "Professional Liability Policies"). Because there is wide variation in policy terms afforded by different insurers, these opinions necessarily turn on the facts of each case and the specific policy language at issue. In certain cases, policyholders have obtained coverage for substantial costs responding to SEC subpoenas and, depending on the facts and circumstances, may have strong arguments to obtain coverage prior to the entry of a Formal Order of Investigation.

Several recent cases have turned on the application of commonly applied canons of construction, including that courts should interpret policy language in a manner that is consistent with the reasonable expectations of the policyholder and that ambiguities should be construed against insurers. Based on such canons, courts have rejected insurer defenses that were inconsistent with well-known policies and practices of the SEC. In addition, courts have reasoned that if insurers continue to sell policies that are potentially ambiguous in the context of the policies and practices of the SEC, which continue to evolve over time, then such ambiguities should be construed against the insurer in order to promote a finding of coverage.

In certain cases, policyholders have obtained coverage for substantial costs responding to SEC subpoenas and, depending on the facts and circumstances, may have strong arguments to obtain coverage prior to the entry of a Formal Order of Investigation

In sum, if a company or individual is currently the target of an SEC investigation, then they should analyze whether they have coverage under their existing Professional Liability Policies and whether they should take steps (such as providing notice) in order to preserve their rights to coverage. In addition, given the wide variation in coverage offered by insurers, companies and individuals that are in the process of purchasing or renewing coverage should carefully evaluate their options to obtain appropriate coverage.

II. Discussion

A. Background on D&O and E&O Policies

There is great variation among D&O Policies and E&O Policies available in the market, including with respect to coverage for regulatory investigations. In addition, insurers frequently are willing to negotiate the specific terms of coverage. Historically, many insurers simply offered policies that covered certain "Claims" alleging "Wrongful Acts," but

the term "Claim" was either undefined or defined generally to include any "demand for monetary or non-monetary relief." Courts were often left to grapple with questions of whether various actions taken by regulators constituted a "Claim." Many insurers now include more specific definitions of the term "Claim" and, indeed, many policies now include specific provisions addressing regulatory investigations. Merely to illustrate, the following bullets describe a range of such provisions:

- At one extreme, some policies afford coverage only for lawsuits that are "commenced by service of a complaint."
- At the other extreme, some policies broadly afford coverage for "any investigations into possible violations of law or regulation initiated by any governmental body."[1]
- Many policies lie between these two extremes such that coverage is triggered when a regulator takes certain steps, such as issuing an "investigative order." Some policies are triggered not only by the issuance of an "investigative order," but also by the issuance of other "similar documents."[2]
- Some policies afford coverage for "formal investigations," but do not define the term "formal."
- Some policies afford coverage when a regulator identifies the insured in any "writing" as a person against whom an otherwise covered proceeding "may be" commenced.[3]
- Other policies afford coverage when a regulator issues a Wells notice, subpoena, target letter, or other similar document.
- And some policies expressly afford coverage when a regulator requests a Tolling Agreement relating to a potential Claim.
- In 2010, certain insurers expressly started to include "informal investigations" and "pre-claim inquiries."[4]

B. Canons of Construction and Reasonable Expectations with Respect to SEC Investigations

When resolving coverage disputes, courts often rely on well-established canons of construction for insurance policies. For example, ambiguities in an insurance policy should be construed against the drafter in order to promote a finding of coverage.[5] In addition, numerous courts have held that (1) every term in an insurance policy should be given some independent meaning,[6] and (2) terms should be interpreted in accordance with the reasonable expectations of the policyholder.[7]

With respect to disputes on coverage for SEC investigations, courts should consider the "reasonable expectations" of the insured. Such "expectations" arguably may be based on existing policies and practices of the SEC, which are well known to insurers when they draft and issue policies. In that regard, the SEC's Enforcement Manual provides a general description of the SEC's policies with respect to the "investigation of the potential violations of the federal securities laws."[8] In addition, given that SEC practices are evolving rapidly in the post-Madoff environment, consideration must be given to new practices and policies that are adopted by the SEC over time.

The SEC Enforcement Manual describes certain types of investigations, including: (1) Matters Under Inquiry (MUIs), (2) Investigations, and (3) Formal Orders of Investigation (also referred to as "Formal Orders"). The Enforcement Manual distinguishes between MUIs and Investigations as follows: while the "threshold for opening a MUI is relatively low, determining whether the MUI should be converted into an investigation or whether to open an investigation is typically a more detailed evaluation that is based on additional information," such as whether "the investigation has the potential to address violative conduct."[9] The Enforcement Manual requires that the Staff take nine separate steps to open an Investigation, including consulting with and obtaining the approval of the Associate Director, completing an "investigation opening form" and "Opening Narrative Form," processing of such forms by a Case Management Specialist, review and approval by the Deputy Directors, etc.[10]

The Staff also may issue a "Formal Order of Investigation." According to the Enforcement Manual,

> the formal order serves two important functions. First, it generally describes the nature of the investigation that the Commission has authorized, and second, it designates specific staff members as officers for the purpose of the investigation and empowers them to administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of documents and other materials.[11]

As a practical matter, after the entry of a Formal Order, the Staff's focus may evolve to address issues and persons that are not expressly identified in the Formal Order, but the Staff is not required to, and will not necessarily elect to, update the Formal Order.

Either prior to or after the entry of a Formal Order, the SEC Staff may issue a Wells notice which, in part, informs a "person involved in an investigation that ... the Division is considering recommending or intends to recommend that the Commission file an action or proceeding against them" and identifies

"the potential violations at the heart of the recommendation."[12]

While the Staff cannot issue subpoenas prior to the issuance of a Formal Order, the Staff often conducts complete investigations without obtaining this subpoena power. For example, in certain cases, it is not necessary for the Staff to obtain a Formal Order in order to compel the production of documents or testimony. The federal securities statutes require certain regulated entities (such as broker-dealers and certain advisers) to produce documents to the SEC upon request.[13] The SEC Staff frequently exercises this power in the context of an investigation (as opposed to a routine examination) to obtain documents from regulated entities prior to the entry of a Formal Order. The Staff also frequently "requests" interviews or other information from regulated entities or persons. While technically no subpoena has been issued, regulated persons may not be in a position to refuse to provide the requested information and, indeed, as discussed below, may face more severe penalties if they ignore the Staff.[14]

Similarly, with increasing frequency, SEC Staff in the Examination Division will work with Staff in the Enforcement Division, such that the line between a routine examination and an enforcement investigation is blurred. In that context, with respect to regulated entities such as funds and advisers, the SEC Staff may invoke the federal securities laws to require the production of documents rather than taking the step of obtaining a subpoena which they do not need in order to obtain the documents or information.

In addition, with regulated entities and non-regulated entities, the SEC has adopted policies and practices designed to encourage cooperation with the Staff with respect to investigations and to facilitate harsher sanctions on persons or entities that do not cooperate. Specifically, in 2001, the SEC issued the so-called Seaboard Report, which set forth a non-exclusive list of criteria that the SEC would consider "in determining, whether, and how much to credit self-policing, self-reporting, remediation, and cooperation."[15] After issuing the Seaboard Report, the SEC repeatedly sent the message in public pronouncements that

> cooperation and remediation will be considered when the Commission determines whether to authorize an enforcement action against a person or entity, and, if so, the contours of the action and the sanctions sought in that action. Conversely, the Commission has imposed severe sanctions in cases where it has determined that the party's conduct during the investigation reflected a lack of cooperation.[16]

The SEC Enforcement Manual further expands and explains such policies designed to encourage cooperation and/or punish non-cooperation. For example, the Enforcement Manual states that "there is a wide spectrum of tools available to the Commission and its staff for facilitating and rewarding cooperation by individuals, ranging from taking no enforcement action to pursuing reduced charges and sanctions in connection with enforcement actions."[17] The Manual further describes certain tools, including Proffer Agreements, Cooperation Agreements, Deferred Prosecution Agreements, Non-Prosecution Agreements, and Immunity Requests.[18]

Thus, under the threat of increased sanctions, the Staff "may request the voluntary production of documents" and may "request that witnesses agree to voluntary interviews and testimony."[19] In certain cases, the Staff also may indicate that they will obtain a Formal Order if a person or entity does not "voluntarily" cooperate with their requests. Insureds must take such threats seriously; in August 2009 the SEC amended its rules to facilitate the ability of Staff to issue subpoenas. In announcing this new rule, the Director of the Division of Enforcement stated that

> the Commission has approved, subject to certain exceptions, an order that delegates to the Division Director the authority to issue formal orders of investigation, with their accompanying subpoena power. I in turn intend to delegate that authority to senior officers throughout the Division. Thus, staff will no longer have to obtain advance Commission approval in most cases to issue subpoenas; instead, they will simply need approval from their senior supervisor.[20]

The Director made the purpose of the rule clear: "[t]his means that if defense counsel resist the voluntary production of documents or witnesses, or fail to be complete and timely in responses or engage in dilatory tactics, there will very likely to be a subpoena on your desk the next morning."[21]

The SEC may take testimony under oath prior to the issuance of a Formal Order. Whether or not a Formal Order has been issued, the SEC typically requires a witness providing testimony to sign (or acknowledge on the record) Form SEC 1662 (5-04)("Form 1662"), which informs the witness about the potential uses of the testimony, warns that he or she faces criminal charges for providing false testimony under oath, and advises the witness of his or her right to counsel, etc. Form 1662 further reflects that, prior to the issuance of a Formal Order, the Staff may "advise such persons [who become involved in investigations] of the general nature of the investigation, including the indicated violations as they pertain to them."[22]

As such, an investigation conducted prior to the entry of a Formal Order may be similar to an investigation conducted pursuant to a Formal Order in many ways. In both cases, the Staff must comply with procedures to open a file and obtain approval of their superiors. In both cases, the Staff may take testimony under oath and collect documents. With respect to regulated entities, the Staff may obtain documents and information pursuant to the federal securities laws. In both cases, the Staff may advise entities or individuals of potential charges.

It would be incorrect to suggest that the SEC Staff automatically or routinely issues a Formal Order if the Staff concludes there is evidence of wrongdoing. To the contrary, the SEC may conduct investigations, issue Wells notices, make enforcement decisions, and settle cases without ever issuing a Formal Order.

As illustrated below, courts have and should interpret policy language in a manner that is consistent with these well-known policies and practices.

C. Case Law Developments

As noted above, many insurers historically issued policies that did not define the term ''Claim'' or that generally defined ''Claim'' to include all demands for monetary or non-monetary relief. Courts grappled with coverage issues related to SEC investigations and similar regulatory investigations. In one leading case, *Minuteman International, Inc. v. Great American Ins. Co.*,[23] the policy covered certain ''demands for relief.'' The court held that an SEC subpoena triggered coverage, reasoning that a ''demand for 'relief'' is a broad enough term to include a demand for something due, including a demand to produce documents or appear to testify. ''Moreover, . . . an SEC subpoena is not a mere request for information, but is a substantial demand for compliance by a federal agency with the ability to enforce its demand.''[24]

Based on specific facts and policy language, courts reached mixed results addressing policies that did not expressly address regulatory investigations. This article, however, focuses on more recent cases that interpret policy provisions that expressly address coverage for regulatory investigations. Although insurers now often include specific provisions that address coverage for investigations, many insurers continue to use general language that does not track the language used in the SEC Enforcement Manual and related federal regulations. For example, rather than explicitly restricting coverage to investigations after the SEC has issued a Formal Order, many insurers agree to provide coverage when the regulator issues a document that is ''similar'' to an investigative order or when the regulator takes other actions—such as discussing potential claims that might be filed—which can take place at various stages of an SEC investigation. Courts have and should interpret such language broadly consistent with the reasonable expectation of policyholders.

1. "Investigations" Are Proceedings for Purposes of Triggering Coverage.

In *National Stock Exchange v. Federal Ins. Co.*,[25] a federal district court held that the policyholder was entitled to coverage for costs related to an SEC investigation after the issuance of a Formal Order. The policy at issue defined ''Claim'' to include ''a formal . . . regulatory proceeding commenced by the filing of a . . . formal investigative order.'' Although the policy covered ''proceedings . . . commenced by a formal investigative order,'' the insurer argued that coverage was not triggered until the SEC filed a proceeding in court, arguing that an investigation (even if conducted pursuant to a Formal Order) was not a ''proceeding.''[26]

> ***[C]ourts have rejected attempts by insurers to deny coverage on the grounds that a Formal Order did not expressly address each and every aspect of the SEC's ultimate "Claim" against the insured. Certain courts have rejected such arguments as form over substance, recognizing that in practice Formal Orders are often drafted at the outset of an investigation, often do not include specific details about the investigation, and often are not updated when the SEC's investigation evolves to focus on other issues and/or other insureds***

The court rejected that argument, holding that the policyholder was entitled to coverage for all defense costs incurred after the SEC issued the Formal Order. In sum, the court rejected the insurer's argument because it ignored the undisputed practices of the SEC, reasoning as follows:

> It is clear from this language that a formal investigation was intended to be included in the definition of ''Claim.'' If a formal investigative order did not commence a formal administrative or regulatory proceeding, then the term ''formal investigative order'' would have no meaning. Thus, a formal investigation must be deemed to qualify as a formal administrative or regulatory proceeding and, therefore, as a ''Claim'' as defined by the contract language.[27]

Consistent with the canon that any ambiguity should be construed in order to promote a finding of coverage, the court further emphasized that, ''if the

[insurer] did not wish to include SEC investigations, defendant, as drafter of the policy, could have omitted the phrase 'commenced by the filing of a . . . formal investigative order.' "[28]

2. Given that SEC Investigations May Evolve Over Time, Coverage Does Not Necessarily Turn on the Specific Language in the Formal Order.

As noted above, the SEC may elect not to include detailed information in a Formal Order and may elect not to update a Formal Order to reflect the progress of an ongoing investigation. Recognizing this reality, courts have rejected attempts by insurers to deny coverage on the grounds that a Formal Order did not expressly address each and every aspect of the SEC's ultimate "Claim" against the insured. Certain courts have rejected such arguments as form over substance, recognizing that in practice Formal Orders are often drafted at the outset of an investigation, often do not include specific details about the investigation, and often are not updated when the SEC's investigation evolves to focus on other issues and/or other insureds.

For example, in *MBIA, Inc. v. Federal Ins. Co.,*[29] the policy defined "Securities Claim" to include a "formal or informal . . . regulatory proceeding or inquiry commenced by the filing of a notice of charges, formal or informal investigative order or similar document."[30] The insurer did not dispute that coverage was triggered when the SEC issued a Formal Order. But the insurer denied coverage because the SEC's Formal Order focused on certain "Loss Mitigation Insurance Products" (Issue A), whereas the SEC in part later focused on other "traditional reinsurance issues" (Issue B). In other words, the insurer argued that the "loss" at issue (arguably related to Issue B) did not arise from the Formal Order (focusing on Issue A) and that there was no coverage because the Formal Order "was never amended to include" Issue B. The district court for the Southern District of New York squarely rejected this argument, reasoning that SEC investigations evolve over time, finding that Issues A and B were sufficiently related, and stating that the insurer had "offered no persuasive evidence to support their argument that the SEC ran a series of separate concurrent investigations."[31] In so holding, the *MBIA* court cited several cases for the proposition that the SEC performs a function similar to a grand jury and that the "identity of the offender" and "precise nature of the offense" typically are developed at the conclusion of the investigation, not at the outset.[32] The court also noted that the Cease and Desist Order issued as part of the settlement of the matter "confirms that the SEC included [Issue B] as part of the investigation commenced by the Formal Order [focusing on Issue A]."[33]

With respect to the SEC investigation, the insurer in *MBIA* also contested coverage on the grounds that the insured provided documents to the SEC in response to "informal requests . . . that do not amount to 'Securities Claims.' "[34] In *MBIA*, the SEC first issued a Formal Order and then issued several subpoenas; to avoid negative publicity, the insured then "asked regulators to forgo issuance of further subpoenas" and agreed to "comply voluntarily with further requests for documents."[35] While the court did not address the insurer's argument, its holding in favor of coverage for the SEC defense costs implicitly rejects the insurer's argument.

Similarly, in *National Stock Exchange*, the insurer attempted to deny coverage for defense costs incurred in responding to a Formal Order on the grounds that the Formal Order did not specifically name any Insured Persons. But prior to the entry of the Formal Order, the SEC had sent a letter requesting documents and information and stating that they were investigating the insured's officers and directors. In rejecting the insurer's defense based on the specific language in the Formal Order, the court stated that it was proper to consider the "SEC's previously defined scope of investigation."[36]

Several courts have rejected this argument and held that a subpoena alleges a "Wrongful Act" for purposes of triggering coverage

3. For Purposes of Triggering Coverage, Subpoenas and Formal Orders Allege Wrongful Acts.

As noted above, Professional Liability Policies generally cover "Claims" alleging "Wrongful Acts." Even assuming the definition of "Claim" is satisfied, insurers have attempted to deny coverage for investigations on the grounds that, during an investigation and prior to the filing of an enforcement action, the SEC has not alleged a Wrongful Act. In other words, the insurers argue that there could be no coverage until the SEC formally accuses an insured of wrongdoing, which in practice often does not take place until a settlement is reached and the SEC simultaneously files a Complaint and a Consent Decree.

Several courts have rejected this argument and held that a subpoena alleges a "Wrongful Act" for purposes of triggering coverage. For example, in *National Stock Exchange*, the court held that references in the Formal Order that certain Wrongful Acts

"may have occurred" was sufficient to satisfy any requirement in the policy of an alleged Wrongful Act.[37] Indeed, it would defeat the reasonable expectations of an insured if a policy expressly provided coverage for certain investigations, but that coverage was then implicitly taken away by a requirement of a formal allegation of wrongdoing in a complaint.

Similarly, courts have rejected insurer arguments that the SEC subpoenas do not trigger coverage because the subpoenas merely request documents or testimony, but do not allege that the insured has committed wrongdoing. For example, in *Jemmco Partners, LP v. Executive Risk Indemnity, Inc.*,[38] a New Jersey state court considered whether an SEC subpoena related to market timing alleged "wrongful acts" for purposes of triggering coverage. In *Jemmco*, the policy defined "Claim" to include proceedings commenced by a "formal investigative order," and the insured provided an affidavit stating that the SEC had obtained a Formal Order. Notwithstanding the Formal Order, the insurer argued that "on the face of the subpoenas the court can determine that no wrongful acts were alleged [because] subpoenas do not in themselves allege wrongful acts."[39] While recognizing that subpoenas do not literally "allege wrongful acts," the *Jemmco* court rejected the insurer's argument, reasoning as follows:

> This court is not prepared to rule that the insurance policy clearly indicates that some kind of formal accusing document is necessary in order for [there] to be a claim under the policy. In my view, certainly, a subpoena with a target letter would be sufficient to allege wrongful acts and if a target letter would be sufficient it may be that there are other circumstances such as some other kind of notice to the insured that its wrongful acts may be the subject of an investigation that would permit coverage.[40]

Similarly, in *ACE American Ins. Co. v. Ascend One Corp.*,[41] a federal district court in Maryland held that a subpoena issued by a state attorney general and a Civil Investigative Demand issued by the Texas Attorney General were "Claims for Wrongful Acts" that triggered coverage. The *ACE American* court held that "although the law is not settled as to whether any subpoena or investigative demand is considered an 'investigation' for insurance purposes, subpoenas and investigative demands have been found to constitute a claim where the insured was required to produce testimony and documents pursuant to an ongoing investigation of its activities."[42] The court gave "weight to the seriousness of government subpoenas in considering whether they constitute an investigation," in particular when it was clear that the insured was the target of an investigation, rather than a source of information.[43]

4. Coverage May Be Available for Investigations Prior to the Entry of a Formal Order.

In certain cases, policyholders may be able to obtain coverage prior to the issuance of a Formal Order. First, as noted above, some policies expressly cover "all" investigations, investigations after an insured has been identified as someone that "may be" the subject of an enforcement proceeding, Wells notices, requests for tolling agreements, etc. As discussed above, the SEC Staff may inform insureds of potential charges at various stages of an investigation, including prior to the entry of a Formal Order. *See, e.g.*, Form 1662 (the Staff may "advise such persons [who become involved in investigations] of the general nature of the investigation, including the indicated violations as they pertain to them."). In addition, the SEC Staff may issue a Wells notice or request a tolling agreement prior to the entry of a Formal Order.

Second, in some policies, the definition of "Claim" includes not only a sub-part that specifically addresses coverage for regulatory investigations, but also a sub-part that continues to define "Claim" in a very general way, such as any demand for relief. Certain courts have held that, in order to obtain coverage, a policyholder must only show that one part of the "Claim" definition has been satisfied.[44] Similarly, other courts have rejected insurer arguments that the inclusion of a specific sub-part addressing investigations somehow negates other more general sub-parts of the definition of "Claim."[45] In other words, even assuming for the sake of argument that an investigation does not trigger coverage under the sub-part addressing regulatory investigations, policyholders may be able to obtain coverage under other, more general sub-parts.

Third, some policies expressly cover investigations commenced not only by a Formal Order, but also by a "similar document" or "similar pleading." There is limited case law addressing the meaning of a "similar document." To illustrate, the court in *MBIA* considered whether a subpoena issued by the New York Attorney General was a "Securities Claim," which was defined to include a "notice of charges, formal or informal investigative order or similar document." With respect to the New York subpoena, the insurer argued that there was no coverage because the definition of "Claim" required some sort of "order" (and because the subpoena was not an "order"). The court disagreed, holding that (1) a subpoena was an "order," and (2) even if a subpoena was not an "order," it was a "similar document." With respect to its holding that a "subpoena" was an "order," the court relied on dictionary definitions defining "order" broadly to include any "command."[46] In addition, *MBIA* adopted a

broad, pro-policyholder interpretation of "similar document," reasoning that a subpoena has "characteristics in common" with an "investigative order" in that it is also a document that "may be said to commence a regulatory investigation."[47] The court held that, when a policy does not define "similar document," it must be "given its plain meaning that comports with the interpretation given by the average person."[48]

Notably, *MBIA* further held that the insured was entitled to coverage for defense fees incurred by counsel to a Special Litigation Committee created to investigate a derivative demand.[49]

Other courts have reached mixed results with respect to the meaning of "similar document." For example, in *National Stock Exchange*, the policy defined "Claim" to include in part "a formal . . . regulatory proceeding commenced by the filing of a notice of charges, formal investigative order, or similar document." The court was asked to decide what phase of an SEC investigation triggered coverage: a request for voluntary production of documents, the issuance of a Formal Order, the issuance of a Wells notice, or the filing of an enforcement proceeding. As noted above, the court in *National Stock Exchange* held that the insured was entitled to coverage for defense costs incurred after the SEC issued the Formal Order, but was not entitled to coverage for defense costs incurred in responding to the SEC's initial request for the voluntary production of documents. *National Stock Exchange* reasoned that "prior to the issuance of a formal investigative order, an SEC investigation is considered preliminary, and no process is issued or testimony compelled."[50]

If insurers wanted to limit coverage to SEC investigations that are commenced by a Formal Order, it arguably would not be difficult to do so, but many insurers continue to provide coverage pursuant to broad, less precise terms

That holding is debatable and has not been cited with approval. Initially, to the extent the holding of *National Stock Exchange* turns on its observation that the SEC investigation was "preliminary" (and, based on the court's summary of the facts, there is no suggestion that any testimony had been taken prior to the entry of the Formal Order or that the SEC Staff had threatened to obtain a Formal Order and/or impose harsher sanctions), the holding might be limited to its facts. Similarly, to the extent the holding of *National Stock Exchange* turns on its observation that no testimony had been "compelled," that holding arguably should not apply to regulated entities who face penalties under the federal securities laws if they do not respond to requests made by Enforcement Staff.

In any event, in other cases, courts may be called upon to address the meaning of "similar documents." If insurers wanted to limit coverage to SEC investigations that are commenced by a Formal Order, it arguably would not be difficult to do so, but many insurers continue to provide coverage pursuant to broad, less precise terms. When a policy covers SEC investigations commenced by Formal Orders and similar documents, a court should not adopt an interpretation of "similar document" that renders that language superfluous. Rather, the court should adopt an interpretation of "similar document" that provides independent meaning to such term and that is consistent with the reasonable expectations of the insured. As explained by the *MBIA* court, any suggestion that the phrase "formal order and similar document" includes only formal orders is "unpersuasive because, among other reasons, if only 'orders' trigger coverage . . ., the phrase 'similar document' would appear to be superfluous. . . . An interpretation of a contract that has the effect of rendering at least one clause superfluous or meaningless . . . is not preferred and will be avoided if possible."[51]

Under the *MBIA* test, courts may be called upon to decide what "similar documents" the SEC Staff can issue that have "characteristics in common" with a Formal Order, *e.g.*, documents that "may be said to commence a regulatory investigation." For example, does the execution of a form by a witness to provide sworn testimony subject to penalties for perjury commence an investigation, in particular if the witness has been advised of "indicated violations"; does the execution of a Cooperation Agreement and/or Deferred Prosecution Agreement commence an investigation; does a Wells notice that expressly informs the target of contemplated charges commence an investigation; does a letter to a regulated entity demanding the production of documents pursuant to the federal securities laws commence an investigation, when for all practical purposes there is no need for the SEC Staff to obtain subpoena power in order to conduct an exhaustive investigation of a regulated entity?

Similarly, it remains to be seen how courts will address questions such as the following: has a "Claim" been made when the SEC Staff expressly states that they will seek a Formal Order if an insured does not produce documents or give testimony on a voluntary basis? In the environmental coverage battles in the 1980s and 1990s, numerous courts held that Potentially Responsible Party letters issued by the EPA ("PRP Letters")—in which the EPA

requested voluntary cooperation in resolving disputes on liability for contaminated sites—constituted ''suits'' triggering coverage under general liability policies. Although some courts disagreed, many courts held that the term ''suit'' was ambiguous and, therefore, should be interpreted broadly to include PRP Letters. In part, some courts based this holding on public policy reasons, reasoning that early involvement by an insured in the EPA process was crucial to protect their interests, to create an accurate record, and to mitigate damages.[52]

Putting aside potential coverage issues, it may often be in the insurer's financial interest to provide coverage in such circumstances, given that non-cooperation by a policyholder likely would result in the Staff obtaining a Formal Order and the policyholder (and ultimately the insurer) facing increased exposure due to its lack of cooperation. But even if coverage disputes arise, policyholders may have persuasive arguments to demand coverage depending on the facts and policy language at issue.

5. Insurers Should Not Withhold Reimbursement of Defense Costs Prior to a Judicial Ruling on Potential Coverage Defenses.

In addition to issues related to the definition of ''Claim,'' insurers may attempt to rely on other policy terms to attempt to deny coverage for SEC investigations, such as exclusions related to Fraud, Improper Profits, Money Laundering, etc. A recent case from the Fifth Circuit—*Pendergest-Holt v. Certain Underwriters at Lloyd's of London*[53]—reaffirms that an insurer should advance defense costs until there is an appropriate judicial determination that the insurer has met its burden in establishing that an exclusion applies to bar coverage. In that case, certain executives of companies founded by Allen Stanford—who were accused of orchestrating a Ponzi scheme—sought coverage for an SEC lawsuit and a parallel criminal case. The insurer initially agreed to advance defense costs pending a final coverage determination, but expressly reserved the right to deny coverage at any time based on certain exclusions, such as the Fraud exclusion and the Money Laundering exclusion.

The Fraud exclusion applied only after a ''final adjudication'' that the fraudulent conduct had occurred. In contrast, the Money Laundering exclusion barred coverage for Loss ''in connection'' with Money Laundering (as defined in the endorsement), but required the insurer to advance defense costs until ''it is determined that the alleged act or alleged acts did in fact occur.''[54] The Money Laundering exclusion also expressly provided the insurer with the ability to claw back reimbursed funds.

After advancing defense costs for a period of time, the insurer subsequently reversed course and advised the executives that they would no longer provide coverage because they (the insurer) had determined that ''Money Laundering'' (as defined in the exclusion) had ''in fact'' occurred.

The court rejected the insurer's position and ordered the insurer to continue to advance defense costs for the time being. The court considered in part the following question: ''who may make the 'in fact' determination?''[55] The insurer argued that the insurer could make the ''in fact'' determination, subject to judicial review after the fact. The policyholders argued that the ''in fact'' determination must be made in the first instance by a court (''in other words, that the [insurer's] duties continue until they have a court judgment in hand, decreeing that Money Laundering was 'in fact' committed'').[56]

The court held in favor of the insured, ordered the insurer to continue to advance defense costs, and remanded for a judicial determination of whether ''Money Laundering'' in fact occurred. In so holding, the court noted that the Money Laundering exclusion was ''silent'' on the issue of who could make the determination, but construed this ambiguity against the insurer. The court reasoned as follows:

> The [insurer]—as drafters of the policy—could have unambiguously reserved a unilateral right to determine that the alleged acts in fact occurred. . . . The parties' word choice—''it is determined''—leaves us guessing, but it hardly seems a drafting error, at least not an inadvertent one. . . . [If] an insurer ''wants the unilateral right to refuse a payment called for in the policy, the policy should clearly state that right.'' . . . While there is nothing remarkable about an insurer reserving the right to make a unilateral coverage decision, it is similarly unremarkable to require an insurer to be explicit when doing so, rather than leaving the reader to ponder the word ''it.''[57]

The court also contrasted the ''in fact'' test in the Money Laundering exclusion to the ''final adjudication'' test in the Fraud exclusion. The insurer conceded that the Fraud exclusion did not apply at that juncture of the case, given that ''courts have consistently held that the adjudication must occur in the underlying D&O proceeding, rather than in a parallel coverage action or other lawsuit.''[58] The court further stated that ''read this way, a final adjudication limits the insurer's recourse if the parties settle—the most likely outcome—or if the insured is otherwise absolved of liability or guilt in the underlying action.''[59]

While the *Pendergest-Holt* opinion addressed coverage for an SEC lawsuit, the same principles

should apply in the context of an SEC investigation, namely that insurers should have a broad duty to advance defense costs until the appropriate judicial determination is made that the insurer has met its burden of proof on the application of an exclusion.

III. Conclusion

In sum, insureds that are facing SEC investigation should carefully evaluate whether they have coverage under existing Professional Liability Policies. In addition, insureds that are in the process of renewing policies and/or persons that are in the process of buying new coverage should attempt to obtain appropriate coverage for SEC investigations.

[1] *See* ICI Mutual Insurance Company, Directors and Officers / Errors and Omissions Liability Insurance (9/03), § III(B).

[2] *See* ACE American Ins. Co. v. Ascend One Corp., 570 F. Supp. 2d 789, 793 (D. Md. 2008)(quoting policy issued by ACE that defined "Claim" to include in part a "civil, administrative, or regulatory investigation against any Insured commenced by the filing of a notice of charges, investigative order or similar document").

[3] *See* Chubb Form 14-02-8919 (11/2003 ed.)(defining "Claim" to include in part "a civil, criminal, administrative or regulatory investigation of an Insured Person for a Wrongful Act, once such Insured Person is identified in writing by such investigating authority as a person against whom a proceeding described in paragraph (b) may be commenced").

[4] *See* S. Sclafane, "D&O Coverage Expands to Address Informal Regulatory Investigation Costs," P&C National Underwriter, Aug. 2, 2010.

[5] National Stock Exchange v. Federal Ins. Co., 2007 U.S. Dist. LEXIS 23876 (N.D. Ill. 2007)("[W]here the language of a policy is susceptible to more than one reasonable meaning, it is considered ambiguous and the policy language must be interpreted against the insurer who drafted the policy.").

[6] MBIA, Inc. v. Federal Ins. Co., No. 08 Civ. 4313 (RMB) (S.D.N.Y.) (Order dated Dec. 31, 2009), at 12 n.6 ("An interpretation of a contract that has the effect of rendering at least one clause superfluous or meaningless . . . is not preferred and will be avoided if possible.").

[7] *See* generally Roland v. Georgia Farm Bureau Mut. Ins. Co., 462 S.E.2d 623, 625 (Ga. 1995)("a contract of insurance should be strictly construed against the insurer and read in favor of coverage in accordance with the reasonable expectations of the insured"); *MBIA*, Order dated Dec. 31, 2009, at 10 (construing language according to understanding of "ordinary business person" and relying on dictionary definitions to interpret terms in policy).

[8] *See* SEC Enforcement Manual, § 1.1 (2008).

[9] *See* SEC Enforcement Manual, § 2.3.2.

[10] *See* SEC Enforcement Manual, § 2.3.2.

[11] *See* SEC Enforcement Manual, § 2.3.4.

[12] *See* SEC Enforcement Manual, § 2.4.

[13] *See* The Securities Enforcement Manual: Tactics and Strategies (2d Ed.), Kirkpatrick & Lockhart Preston Gates Ellis LLP (ABA Section of Business Law)("Securities Enforcement Manual"), at 82 (citing Exchange Act §§ 17(a) and 17(b), 15 U.S.C. § 78q (a) and (b) (2006), and Exchange Act Rules 17a-3, 17a-4 and 17a-4(j), 17 C.F.R. §§ 240.17a-3 and 17a-4 (2006); Advisers Act § 204, 15 U.S.C. § 80b-4 (2006), and Advisers Act Rule 204-2, 17 C.F.R. § 275.204-2 (2006); Investment Company Act § 30, 15 U.S.C. § 80a-30 (2006)).

[14] *See* Securities Enforcement Manual, at 82.

[15] *See* Exchange Act Release No. 44969, 2001 SEC LEXIS 2210 (Oct. 23, 2001).

[16] *See* Securities Enforcement Manual, at 55.

[17] *See* SEC Enforcement Manual, § 6.1.1.

[18] *See* SEC Enforcement Manual, §§ 6.2.1, 6.2.2, 6.2.3, 6.2.4, and 6.2.5.

[19] *See* SEC Enforcement Manual, § 3.2.3.

[20] *See* Speech Before SEC Staff: Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement, August 5, 2009, available at http://www.sec.gov/news/speech/2009/spch080509rk.htm.

[21] *See* Speech Before SEC Staff: Remarks Before the New York City Bar: My First 100 Days as Director of Enforcement, August 5, 2009, available at http://www.sec.gov/news/speech/2009/spch080509rk.htm.

[22] *See* SEC Enforcement Manual, § 3.2.3.

[23] *See* Minuteman International, Inc. v. Great American Ins. Co., 2004 U.S. Dist. LEXIS 4660 (N.D. Ill. 2004).

[24] *See Minuteman*, 2004 U.S. Dist. LEXIS 4660, at 22.

[25] *See* National Stock Exchange v. Federal Ins. Co., 2007 U.S. Dist. LEXIS 23876 (N.D. Ill. 2007).

[26] *See National Stock Exchange*, 2007 U.S. Dist. LEXIS 23876, at 12 (noting that the insurer "argues that the SEC defines investigations differently than administrative proceedings").

[27] *See National Stock Exchange*, 2007 U.S. Dist. LEXIS 23876, at 11–12.

[28] *See National Stock Exchange*, 2007 U.S. Dist. LEXIS 23876, at 11–12.

[29] *See MBIA, Inc. v. Federal Ins. Co.*, No. 08 Civ. 4313 (RMB) (S.D.N.Y.) (Order dated Dec. 31, 2009).

[30] *See MBIA*, Order dated Dec. 31, 2009, at 3.

[31] *See MBIA*, Order dated Dec. 31, 2009, at 12–13.

[32] *See MBIA*, Order dated Dec. 31, 2009, at 12–13.

[33] *See MBIA*, Order dated Dec. 31, 2009, at 12–13.

[34] *See MBIA*, Order dated Dec. 31, 2009, at 2.

[35] *See MBIA*, Order dated Dec. 31, 2009, at 5.

[36] *See National Stock Exchange*, 2007 U.S. Dist. LEXIS 23876, at *14.

[37] *See National Stock Exchange*, 2007 U.S. Dist. LEXIS 23876, at *14.

[38] *See* Jemmco Partners, LP v. Executive Risk Indemnity, Inc., No. SOM-L-486-07 (N.J. Super. Ct., Somerset County)(Transcript of Motion to Dismiss, Oct. 12, 2007).

[39] *See Jemmco*, Transcript dated Oct. 12, 2007, at 40.

[40] *See Jemmco*, Transcript dated Oct. 12, 2007, at 41. *See also* Polychron v. Crum & Forster Ins. Co., 916 F.2d 461 (8th Cir. 1990)(holding that grand jury investigation and questioning by Assistant United States Attorney "amounted, as a practical matter, to an allegation of wrongdoing" against the insured, and stating that insurer's "characterization of the grand-jury investigation as mere requests for information and an explanation underestimates the seriousness of such a probe"); Richardson Electronics, Ltd. v. Federal Ins. Co., 120 F. Supp. 2d 698 Shepardize (N.D. Ill. 2000)(subpoena and grand jury investigation "amount[s], as a practical matter, to an allegation of wrongdoing").

[41] *See* ACE American Ins. Co. v. Ascend One Corp., 570 F. Supp. 2d 789, 793 (D. Md. 2008).

[42] *ACE American*, 570 F. Supp. 2d 789, 796–97.

[43] *ACE American*, 570 F. Supp. 2d 789, 796–97.

[44] *See Minuteman*, 2004 U.S. Dist. LEXIS 4660 at *11 ("As long as the SEC proceedings constitute a Claim, there is coverage regardless of whether the Claim also falls into the subcategory of being a Securities Claim.").

[45] *See* Onvoy, Inc. v. Carolina Casualty Ins. Co., 2006 U.S. Dist. LEXIS 47198 (D. Minn. 2006), at **10–11 (definition of "Claim" included criminal indictments and "any proceeding brought by a . . . governmental agency"; although insured was never indicted, court held that a grand jury subpoena triggered coverage under the more general language for governmental proceedings; court rejected insurer argument that language specifically addressing criminal proceedings took precedence over more general language).

[46] *See MBIA*, Order dated Dec. 31, 2009, at 10–11.

[47] *See MBIA*, Order dated Dec. 31, 2009, at 11. In *ACE*, the definition of "Claim" included investigations commenced by the "filing of a notice of charges, investigative order or similar document." Although the court did not expressly address this point, the implication of its holding is that the court viewed the "subpoena" as a "similar document."

[48] *See MBIA*, Order dated Dec. 31, 2009, at 11.

[49] *See MBIA*, Order dated Dec. 31, 2009, at 16–18.

[50] *See National Stock Exchange*, 2007 U.S. Dist. LEXIS 23876, at *17.

[51] *See MBIA*, Order dated Dec. 31, 2009, at 12 n.6.

[52] *See, e.g.*, Hazen Paper Co. v. United States Fidelity & Guaranty Co., 407 Mass. 689, 555 N.E.2d 576, 581 (Mass. 1990).

[53] *See* Pendergest-Holt v. Certain Underwriters at Lloyd's of London, No. 10-20069 (5th Cir.)(Order dated March 15, 2010).

[54] *Pendergest-Holt*, Order dated March 15, 2010, at 5–6 (emphasis added).

[55] *Pendergest-Holt*, Order dated March 15, 2010, at 12.

[56] *Pendergest-Holt*, Order dated March 15, 2010, at 12–13.

[57] *Pendergest-Holt*, Order dated March 15, 2010, at 13–14 (citations omitted).

[58] *Pendergest-Holt*, Order dated March 15, 2010, at 16.

[59] *Pendergest-Holt*, Order dated March 15, 2010, at 16–17.