New York Law Journal

Key Considerations for Obtaining Insurance Coverage for Internal Investigations

Joseph I. Lieberman, Robin L. Cohen and Daniel J. Fetterman, New York Law Journal

November 9, 2015

In today's regulatory environment, companies more than ever face the prospect of having to conduct internal investigations. Internal investigations can be triggered when a company receives information suggesting that it may have engaged in serious misconduct. Such information can originate with past or present employees, customers, transactional partners, audits, or government officials investigating company conduct. They also can be triggered by whistleblowers, qui tam complaints, or civil actions. Given regulators' and enforcement agencies' high expectations when it comes to corporate cooperation—not to mention the potential business and reputational implications that can arise if a company does not get a handle on potential corporate wrongdoing—it often is necessary for a company to conduct a thorough internal investigation to find out what occurred and to take appropriate remedial measures. Such internal investigations can be time consuming and expensive. While an extreme example, it has been reported that Walmart spent more than $400 million related to a Foreign Corrupt Practices Act (FCPA) investigation that Walmart has been conducting and self-reported to the Department of Justice in November 2011.

Companies facing the prospect of an internal investigation should not overlook the availability of insurance coverage to pay for some or all of the expenses incurred. More importantly, companies should plan ahead so that in the event they need to conduct an internal investigation, they have put themselves in the best position possible to have the investigative fees and costs covered. Unsurprisingly, insurers often take narrow positions regarding coverage for internal investigations and attempt to deny coverage for expenses relating to them, arguing, for example, that such expenses do not constitute a covered "claim," as defined in their policies. In situations in which the company has set up an independent board committee, insurers have contended that fees for outside counsel retained by the board committee to conduct an internal investigation are not covered because such counsel are not representing the "insured" or their work is not "defensive" since they are supposed to be neutral and objective. Therefore, according to this line of argument, fees to pay for counsel representing an independent board committee should not be covered as a "defense cost."

Such insurer arguments denying coverage are divorced from the business realities of insureds and generally elevate form over substance. Insurers' arguments disregard the connection between investigating potential wrongdoing and the coordinated effort taken (and paid for) by the company to respond to regulatory requests—all of which can inure greatly to the company's economic benefit. For example, if instead of conducting an internal investigation and cooperating extensively with an enforcement agency to avoid prosecution, a company is indicted and faces criminal prosecution, the defense, reputational and business costs could be many multiples of the cost for the internal investigation. Similarly, if through its internal investigation a company learns that its employees engaged in misconduct for which the company ultimately will likely be held accountable, the company can alter its defense strategy to minimize the costs of litigation and verdicts by, for example, settling quickly and efficiently with potential victims and litigants. In that case, both the company and its insurers would have benefitted greatly from the work of outside investigative counsel.

Given these high stakes, companies should consider such issues when they first purchase insurance. Compared to many other forms of insurance, directors and officers (D&O) policies are less likely to be cookie-cutter standard-form policies. Companies should seek policy terms that give them the greatest possible chance of coverage when the need to perform an internal investigation arises. Ideally, the definition of "claim" should be as broad as possible and definitely should not be limited to claims for monetary damages. It should expressly extend to both formal and informal government investigations as well as requests for information. Also, companies should ensure that the definition of "loss" or "defense costs" specifically includes costs of investigation, and that there is no separate sublimit for those costs. If possible, the company's obligation to notify the insurer should be tied to knowledge of the claim by specific people—for example, notice is not required until the claim becomes known to the company's risk manager or general counsel or both.

To avoid compromising coverage, counsel with a sophisticated understanding of insurance issues and experience litigating in this area should be involved from the investigation's inception to ensure the company's ability to maximize insurance recoveries. Once a claim comes in, a company's right to coverage for an internal investigation will depend not only on the policy terms and exclusions, but also on the precise facts triggering the investigation and the manner in which it is set up and conducted. Accordingly, when commencing such an investigation, it is crucial to consider insurance issues early on to fully maximize available insurance coverage.

Demonstrating That an Internal Investigation Is a Covered "Claim."

The issue we have dealt with most is whether the investigation constitutes a "claim." Both D&O and comprehensive general liability (CGL) policies generally cover only those investigative costs associated with responding to a claim, and that is where the coverage battle usually begins.

Typically, a company does not need to be sued or charged for its investigation costs to be covered by insurance. While definitions of "claim" vary widely, they almost always include lawsuits, written demands for money and administrative proceedings. They may also cover the costs of responding to a subpoena, a Wells Notice, or a target letter. Some policies include coverage for both "formal and informal investigative orders." In recent years, at least one company released a D&O policy form that specifically included coverage for certain "pre-claim" inquiries where a governmental body requests—as opposed to commanding through formal process—an individual or organization to appear or produce documents related to the organization's business.

Beyond those kinds of express coverage, many policies have definitions of claim that are broad enough to encompass the investigation costs incurred in connection with various forms of activity not specifically mentioned in the policy. For example, in a recent case,[1] Syracuse University incurred substantial costs responding to federal subpoenas relating to sexual abuse charges against the University's associate basketball coach. The definition of "claim" in the policy included a written demand for non-monetary relief. The insurance company argued that because Syracuse was not a "target" of the investigation, the subpoena was not a claim against the university, and its costs therefore were not covered. First, the trial court and then the New York Appellate Division rejected that argument, holding that nothing in the policy definition of "claim" required that Syracuse be a target of the investigation, and that because the subpoena was a written demand for non-monetary relief in the form of documents that the University would be required to produce, it constituted a covered claim.

Notifying the Insurer.

As with every other form of liability insurance, the question of when and whether to give notice of a claim to the insurance company is critical. A policyholder may not be able to recover any investigative costs that are incurred before giving notice, even if those costs otherwise would be covered under the policy. Most importantly, a delay in providing prompt notice will lead to coverage battles and can, if the delay is significant enough to prejudice the insurance company, result in a forfeiture of coverage.

Once notice has been provided and the insurance company is paying for the investigation, the insurer may be deemed a co-client of the attorneys conducting the investigation and within the zone of privilege. Accordingly, the insurer may be able to access privileged communications. Given the highly sensitive nature of internal investigations, it is important that the policy permit the company to retain sophisticated counsel who will not attempt to use the confidential information inappropriately to undermine the company's right to insurance coverage.

In New York, when the insurance company has a conflict of interest between its defense of the policyholder in the underlying matter and its coverage position, the policyholder has the right to independent counsel.[2] D&O policies typically contain fraud exclusions that may trigger such a conflict of interest. Under such an exclusion, an adjudication of fraud against the policyholder may permit the insurer to escape coverage entirely. On the other hand, it is in the policyholder's interest to avoid any final adjudication of fraud and to attempt to settle in such a way that does not preclude coverage. In such a situation, the policyholder has a right to independent counsel. Insurers, however, may attempt to limit that right by including policy provisions requiring the policyholder to choose its counsel from a narrow list of "panel counsel" pre-approved by the insurer. Policyholders should carefully review such provisions before purchasing insurance to ensure that acceptable counsel are included on the insurer's approved panel counsel list.

Obtaining Coverage for Internal Investigation Costs.

Another significant issue is whether a policy covers the costs of an investigation, as opposed to just defense costs. Most D&O policies separately list "costs of investigation" as a covered item, along with judgments, settlement and defense costs, as one of the "losses" covered by the policy, though they sometimes provide a lesser sublimit for certain investigation costs. This can become a particularly important distinction when seeking coverage for costs other than attorney fees related to an internal investigation, such as forensic accountants, electronic data or e-discovery consultants, private investigators and other types of non-attorney experts.

This distinction was important in the MBIA case in the Second Circuit.[3] After a shareholder derivative action was filed against the company, MBIA formed an independent special litigation committee to determine if the derivative action was in the best interests of the corporation, as it was required to do under Connecticut law. The insurer argued that costs incurred in hiring outside counsel were not covered because the special litigation committee exercised "independent decision making." The special litigation committee consisted of board members employed by the corporation to determine the validity of allegations that placed the corporation in a defensive posture against derivative plaintiffs. The Southern District of New York held that the costs billed by the special litigation committee's outside legal counsel were covered, and the insurer appealed.

On appeal, the Second Circuit rejected the insurer's argument that the special litigation committee costs were not covered because the committee was not an "insured person" as defined by the policy, finding that the special litigation committee was a part of the insured, MBIA. The court also rejected the insurer's argument that the work of the special litigation committee was subject to the policy's $200,000 separate sublimit for investigation costs. Rather, the court held that the work of the committee was part of MBIA's defense and thus fully covered under the policy. Finally, the Second Circuit considered the definition of "securities claim" in MBIA's policy, which was: "a formal or informal administrative or regulatory proceeding or inquiry commenced by the filing of a notice of charges, formal or informal investigative order or similar document." The court concluded that the subpoena issued by the New York Attorney General was akin to a "formal or informal investigative" order and therefore a "Claim" under the policy.

Coverage Limited to Individual Insureds.

Even where D&O policies provide investigations coverage, that coverage may be limited to insured directors and officers or require that they at least be identified as investigation targets before the company itself may be covered. This requirement does not match up with the reality of how many investigations are pursued. Often, in the early stages, a government agency will name the company, but not any particular officer of director, as subjects or targets of the investigation. Even when it is clear to company counsel and forensic accountants that one or more individuals are the subjects or targets of an investigation, the D&O policy is not triggered unless the individuals also are named. As a result, if the policy contains such a limitation, little to no coverage may be afforded even if "investigations coverage" was purchased.

For example, in one unpublished decision, *Office Depot v. National Union Fire. Ins. Co. of Pittsburgh, PA*,[4] the court ruled that costs "voluntarily" incurred by the company assisting an SEC informal investigation were not covered. The policies covered "securities claims," which were defined as "an administrative or regulatory proceeding against an Organization, but only if and only during the time such proceeding is also commenced and continuously maintained against an Insured Person." Although the insurer conceded that the SEC subpoenas to officers and directors were covered, based upon that specific language, the court found no coverage for the company's pre-subpoena costs.

Contending With Intentional Conduct Exclusions.

Policy exclusions also differ from policy to policy and should be examined carefully. D&O policies commonly exclude intentional conduct such as fraud, willful misdealing or self-dealing. Companies will not be able to entirely avoid purchasing coverage with such an exclusion, but should make sure that it includes one critical limitation. The exclusion should not be operative until and unless there is an actual, final judicial adjudication of wrongdoing (including all appeals having been exhausted), and it should bar the insurance company from seeking such a determination in a separate action. Thus, the exclusion will become operative only if there is a judicial finding of wrongdoing. This protection can be critical because it prevents an insurance company from either withholding defense costs or starting a separate lawsuit alleging wrongdoing by the company, which can seriously disrupt the investigation and defense of the original claim.

Conclusion.

When facing the challenges presented by an internal investigation, companies should not overlook their insurance coverage, which may prove extremely valuable in recovering considerable expenses as well as in funding its ultimate resolution. Insurance should be purchased with this possibility in mind, and a company should pay careful attention to policy terms, sublimits and exclusions that may limit the company's ability to obtain coverage. Once an investigation is commenced, complex coverage issues are likely to arise, as coverage for internal investigations remains a developing area of the law and is highly dependent on the wording of each policy. To avoid compromising coverage, counsel with a sophisticated understanding of insurance issues and experience litigating in this area should be involved from the investigation's inception to ensure the company's ability to maximize insurance recoveries.

Endnotes:

1. *Syracuse Univ. v. Nat'l Union Fire Ins. Co.*, 975 N.Y.S.2d 370 (Sup. Ct. March 7, 2013), aff'd, 112 A.D.3d 1379 (N.Y. App. Div. 2013).

2. *Public Service Mut. Ins. Co. v. Goldfarb*, 53 N.Y.2d 392 (1981).

3. *MBIA v. Federal Ins. Co.*, 652 F.3d 152 (2d Cir. 2011).

4. 453 Fed. Appx. 871 (11th Cir. 2011).

Joseph I. Lieberman is senior counsel, and Robin L. Cohen and Daniel J. Fetterman are partners, at Kasowitz, Benson, Torres & Friedman. The authors' firm represented MBIA in 'MBIA v. Federal Ins. Co.', and Syracuse University in ' Syracuse Univ. v. Nat'l Union Fire Ins. Co.', discussed herein.
