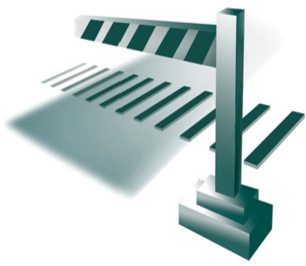


OakBridgeAlert:

The Chartis Investigation Edge Policy

Introduction

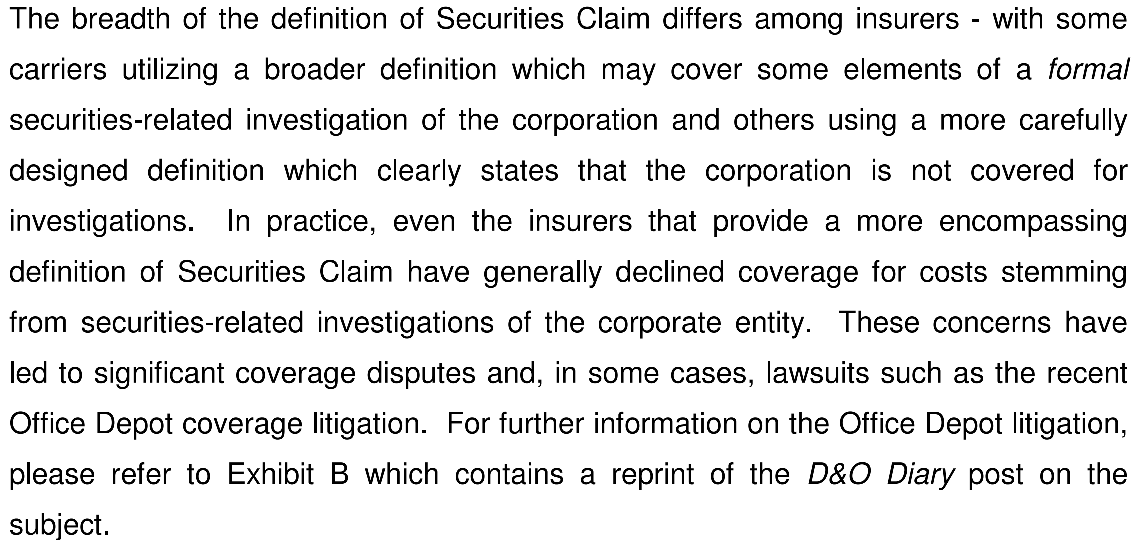
In early March, Chartis developed a solution to fill a coverage void in the marketplace by introducing a new insurance product called the **Investigation Edge**. This policy is designed to insure the corporation for costs it incurs in responding to an investigation by an enforcement body stemming from a defined Securities Violation.

While this new product is akin to a traditional Directors and Officers Liability (D&O) policy, it is important to note that the Investigation Edge provides no coverage to the individual directors and officers. It is purely balance sheet protection for the corporation. It is written on a stand-alone basis and is meant to operate separate and apart from a traditional D&O policy. Although the individual directors and officers are well covered for their investigation exposure by the latest generation of D&O policies, investigation expense coverage under the D&O policy for the corporation itself is still quite limited.

Below, we will first discuss the differences between a Securities Claim (which is covered by the entity coverage included in the traditional D&O policy) and investigations of securities violations (which are generally not covered by a D&O policy). Second, we will detail the key provisions of the new Investigation Edge policy. Third, we will provide an illustration of the SEC's investigation process in Exhibit A.

Securities Claims under the D&O policy versus securities violation investigations

Nearly all modern D&O policies provide coverage for the direct exposure of the corporation to Securities Claims. This so called entity coverage was introduced in the mid-nineties largely to avoid the need to allocate liability between the directors and officers and the corporation in shareholder class action suits. Securities Claims are generally defined to include claims arising from the purchase or sale of (or offer to purchase or sell) securities of the company and claims brought by securityholders in their capacity as such.

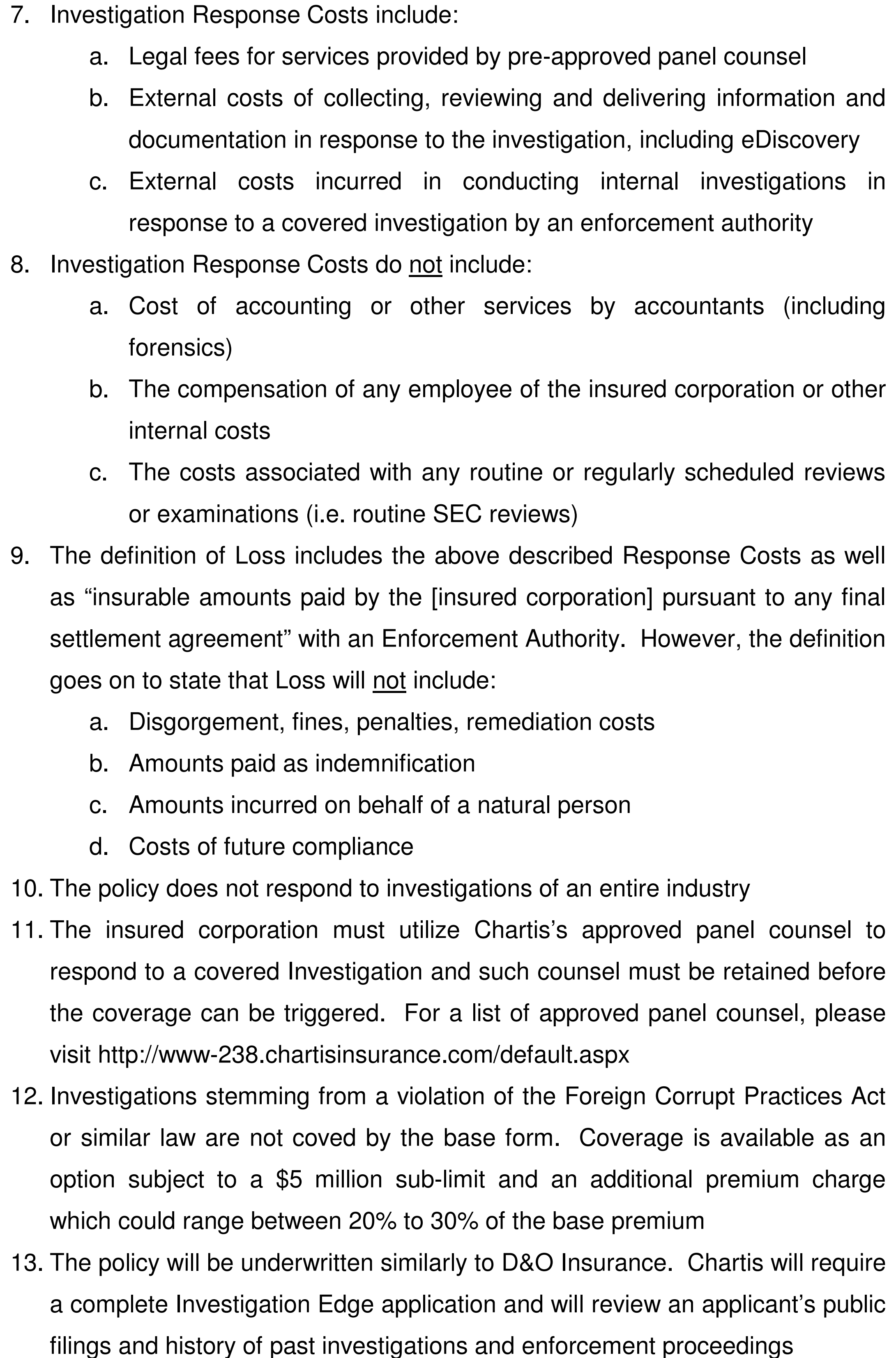


The breadth of the definition of Securities Claim differs among insurers - with some carriers utilizing a broader definition which may cover some elements of a *formal* securities-related investigation of the corporation and others using a more carefully designed definition which clearly states that the corporation is not covered for investigations. In practice, even the insurers that provide a more encompassing definition of Securities Claim have generally declined coverage for costs stemming from securities-related investigations of the corporate entity. These concerns have led to significant coverage disputes and, in some cases, lawsuits such as the recent Office Depot coverage litigation. For further information on the Office Depot litigation, please refer to Exhibit B which contains a reprint of the *D&O Diary* post on the subject.

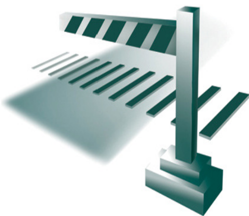
The New Chartis Investigation Edge Policy

Chartis developed the Investigation Edge policy to provide coverage for some of the uncovered costs incurred by the corporation associated with an investigation for a securities violation. We have carefully reviewed this form and conducted a number of discussions with Chartis in an effort to understand the intent of the policy, the underwriting process and the available options. The following outlines key issues to take into consideration:

1. The policy affords no coverage to the individuals, only the corporate entity is covered for its own direct exposure
2. Chartis has indicated that the premium for this policy will range between $30,000 and $60,000 per million of limit
3. Chartis will impose a 15% co-payment feature - which means that the insured corporation will be responsible for 15 cents out of every dollar of covered Loss
4. The policy covers both formal and informal investigations
5. Coverage is provided only for defined Response Costs emanating from an Investigation of a Securities Violation by an Enforcement Authority
6. The policy ceases to provide coverage once an Enforcement Authority brings a civil, criminal, administrative, regulatory or arbitration proceeding against the insured corporation



7. Investigation Response Costs include:
    a. Legal fees for services provided by pre-approved panel counsel
    b. External costs of collecting, reviewing and delivering information and documentation in response to the investigation, including eDiscovery
    c. External costs incurred in conducting internal investigations in response to a covered investigation by an enforcement authority
8. Investigation Response Costs do not include:
    a. Cost of accounting or other services by accountants (including forensics)
    b. The compensation of any employee of the insured corporation or other internal costs
    c. The costs associated with any routine or regularly scheduled reviews or examinations (i.e. routine SEC reviews)
9. The definition of Loss includes the above described Response Costs as well as "insurable amounts paid by the [insured corporation] pursuant to any final settlement agreement" with an Enforcement Authority. However, the definition goes on to state that Loss will not include:
    a. Disgorgement, fines, penalties, remediation costs
    b. Amounts paid as indemnification
    c. Amounts incurred on behalf of a natural person
    d. Costs of future compliance
10. The policy does not respond to investigations of an entire industry
11. The insured corporation must utilize Chartis's approved panel counsel to respond to a covered Investigation and such counsel must be retained before the coverage can be triggered. For a list of approved panel counsel, please visit http://www-238.chartisinsurance.com/default.aspx
12. Investigations stemming from a violation of the Foreign Corrupt Practices Act or similar law are not coved by the base form. Coverage is available as an option subject to a $5 million sub-limit and an additional premium charge which could range between 20% to 30% of the base premium
13. The policy will be underwritten similarly to D&O Insurance. Chartis will require a complete Investigation Edge application and will review an applicant's public filings and history of past investigations and enforcement proceedings



14. Chartis is not targeting the financial institution (FI) sector with this product, although they will consider FI risks on a case by case basis

As this is a new product, we will be working carefully over the upcoming months to ensure that we structure a product that will respond as favorably as possible in the event of a securities-related investigation. For instance, we are currently reviewing the following items:

1. The known acts exclusion - the provision currently contains a sweeping definition of existing knowledge and does not embody a severability provision
2. The policy form is fully rescindable by Chartis
3. The lack of coverage for forensic and other accounting services - this is often a large component of the costs associated with an investigation
4. Pursuant to policy Section 9. b., the insurer has the right to rescind coverage not only for known misrepresentations in the application, but also in the event of "known acts" triggering the "known acts" exclusion

Notwithstanding these items, this new product clearly has value. Of particular note, the policy is the only solution of which we are aware that provides meaningful coverage for the corporation's costs of responding to *informal* securities related investigations. In addition, purchasing this product will allow insureds to secure affirmative coverage for formal investigations and avoid the coverage disputes which often arise when D&O insurers deny coverage for the entity for securities-related investigations.

We have been informed by Chartis that an updated version of this form will be released this month which will further refine the coverage and improve the optional coverage for Foreign Corrupt Practices Act related violations. We will continue to work with Chartis to ensure that this coverage package is as robust as possible, but in the mean time, we look forward to discussing the new Investigation Edge Policy with you in further detail.

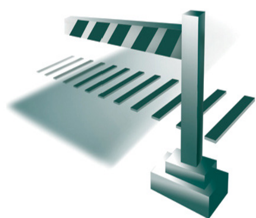
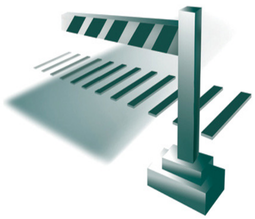


Exhibit A: The Stages of an SEC investigation

Stage	Significance	SEC Actions	Comments
Matter Under Inquiry (MUI)	The threshold determination for opening an MUI is low.	Requests for Voluntary Document Production and Testimony (See Note Below)	Converts to Investigation after 60 days.
Investigation	"Do the facts suggest possible violations of the federal securities laws involving fraud or other misconduct?"	Requests for Voluntary Document Production and Testimony	Not necessary that the matter first go through the MUI stage.
Formal Investigation	Commenced by formal order of investigation by the Commission or certain SEC officials	Allows SEC to "issue investigative subpoenas to compel testimony or the production of documents."	A formal investigation is not necessarily required. The SEC can proceed to the Wells Process and the Enforcement Process without first obtaining a formal order of investigation.
Wells Process	The purpose is to advise the subject of the investigation (in a Wells Notice) and to allow the subject to submit a statement (a Wells Submission) prior to the presentation of the staff recommendation to the Commission		Mandatory process for the SEC prior to commencing the enforcement process.
Enforcement Process	Filing or institution of any enforcement action must be authorized by the Commission	Can result in a civil trial or administrative proceeding; often the subject of negotiated resolutions	

Source: SEC Enforcement Manual (February 2011)



The fact that the process may be "informal" and the production of information is "voluntary", should not be interpreted to suggest that the process is not serious. Indeed, the SEC's Enforcement Manual specifically states that "*voluntary document requests are a principal means of gathering documents, data and other information.*" This information will determine whether or not the investigation will advance to a formal investigation or an enforcement action.

Further, merely because the process is voluntary does not mean that the process is simple or inexpensive. To the contrary, the process is often complex and expensive. The list of documents requested is usually quite extensive. All physical and electronic files must be reviewed in order to identify possibly responsive document. The documents must be accumulated, sorted and reviewed for privilege. The documents must be Bates Stamped and reviewed by counsel so that the significance of the material can be assessed. The production of electronic documents can be particularly burdensome and expensive. It is not uncommon for companies to incur millions of dollars of cost as part of this process – all before an investigation has become "formal."

About OakBridge Insurance Services, a division of R-T Specialty, LLC

OakBridge Insurance Services is one of the nation's leading Executive Liability insurance intermediaries. The firm provides its services through CoBrokerage alliances with strong, regional insurance brokers across the country. Please inquire whether your broker works with OakBridge or visit *www.oakbridgeins.com*.

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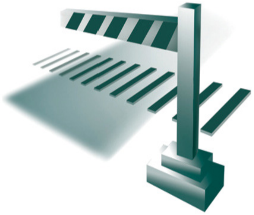


Exhibit B: D&O Insurance: Defense Costs Incurred in Informal SEC and Internal Investigations

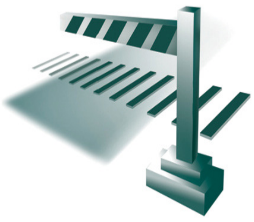
Posted at 3:56 AM on October 21, 2010 by Kevin LaCroix

Among the most frequently recurring and arguably most vexatious D&O insurance coverage issues are the questions of the carrier's obligation under the policy for defense expenses incurred either in connection with an informal SEC investigation or an internal investigation.

In an October 15, 2010 summary judgment ruling in insurance coverage litigation involving Office Depot, Southern District of Florida Judge Kenneth Marra, applying Florida law, denied coverage for both of these categories of defense expense. Though the decision is a direct reflection of the specific facts involved and the particular policy language at issue, the ruling provides an interesting insight into these recurring issues.

Background

In June 2007, Office Depot was the subject of news report suggesting the company had improperly disclosed material information to securities analysts in violation of Sec. Regulation FD. In a July 17, 2007 letter, the SEC advised Office Depot it was "conducting an inquiry" to determine whether the securities laws had been violated, and requested certain information from Office Depot "on a voluntary basis." Office Depot opted to voluntarily cooperate by providing documents and making its employees and officers available for sworn testimony. On July 31, 2007, the SEC requested that Office Depot preserve the records of numerous employees and offices, which it identified by job title.



Office Depot forwarded the letter to its insurers. Office Depot's primary insurer accepted the letter as a "Notice of Circumstances" that may give rise to a claim.

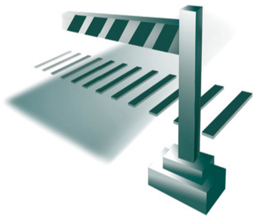
In addition, in July 2007, before it received the SEC's informal inquiry, Office Depot received an internal whistleblower letter raising concerns relating to the timing of recognition of Office Depot's vendor rebate funds. Office Depot self-reported the whistleblower allegations to the SEC, which expanded its inquiry to include the whistleblower allegations. The company's audit committee conducted its own investigation of the allegations, retaining lawyers, accountants and consultants for those purposes. The internal investigation resulted in Office Depot's restatement of its 2006 financial statements.

In November 2007, two shareholder derivative lawsuits and two securities class action lawsuits were filed against the company. The shareholder suits alleged misrepresentations in connection with the company's financial reporting of vendor rebates. In January 2010, the defendants' motions to dismiss the securities class action lawsuit were granted. The dismissal is now on appeal. The plaintiffs in the derivative lawsuits voluntarily dismissed those cases.

In January 2008, the SEC issued a formal "order directing private investigation" and during the course of 2008 subpoenaed the company and at least eight current and former Office Depot officers and directors, including several who previously voluntarily testified. The notice did not name any individuals as wrongdoers. In November and December 2009, the SEC issued Wells notices to three Office Depot officers. In December 2009, the company reached an undisclosed settlement with the SEC staff.

Office Depot requested reimbursement from its D&O insurers of the over $23 million the company had incurred in responding to the SEC, indemnifying individuals against defense expenses, and conducting an internal investigation of the whistleblower allegations.

The primary carrier acknowledged its obligation to reimburse Office Depot for defense costs incurred by officers and directors after having been served with SEC



subpoenas and Wells notices, and for the costs incurred in the four securities lawsuits. However, the approximately $1.1 million of acknowledged expenses did not exceed the policy's $2.5 million retention. The primary insurer denied coverage for the other expenses, and Office Depot filed an action alleging breach of contract and seeking a judicial declaration of coverage. Office Depot's excess D&O insurer intervened the action.

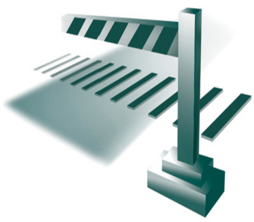
The parties filed cross motions for summary judgment.

The October 15 Ruling

The insurers argued that there is no coverage for Office Depot's costs incurred in voluntarily responding to the SEC's investigation and for the costs of Office Depot's internal investigation of the whistleblower allegations because the costs did not arise either because of a "Securities Claim" against Office Depot or a "Claim" against an insured director or officer. All policy references below refer to the language of the primary policy.

The policy's definition of Securities Claim contains threshold language that excludes from the term "an administrative or regulatory proceeding against, or investigation of, an Organization." However, the definition contains a "carve back" which specifies that the term Securities Claim "shall include an administrative or regulatory proceeding against an Organization, but only if and only during the time that such proceeding is also commenced and continuously maintained against an Insured Person."

Judge Marra found it significant that the threshold language excluded coverage for "an administrative or regulatory proceeding against, *or investigation of*" an Organization, but the carve back preserving coverage refers only to "an administrative or regulatory proceeding" – and thus the carve back does not refer to "an investigation" as does the threshold language. Judge Marra concluded that "the carve-back clause does not restore coverage for 'an investigation of' the Organization"



Judge Marra also found the policy's definition of "Claim" distinguishes between "a proceeding for relief" and an "investigation of an insured person," specifying that an investigation constitutes a "Claim" only once the insured person has been notified in writing that he or she may be a target or after service of a subpoena.

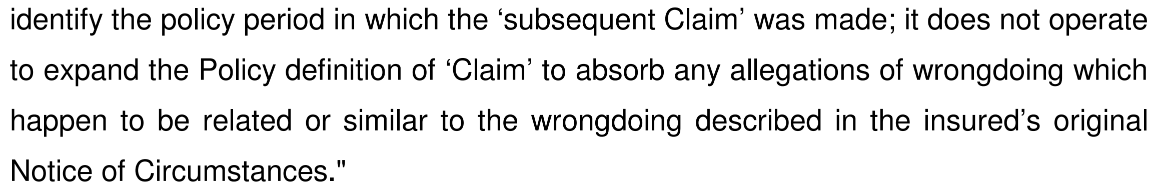
In addition, Judge Marra rejected Office Depot's argument that the term "proceeding" was broad enough to encompass the SEC's informal and formal investigation of Office Depot. In reaching this conclusion, Judge Marra referenced the policy's distinction between "proceedings against" and "investigations of" insured persons and organizations. Judge Marra said this distinction can only be given "any meaning" by giving the term "proceeding" its "plan meaning," which he defined as "a formal legal action or hearing conducted in a court of law or some official tribunal."

Judge Marra concluded therefore that the company's costs of voluntarily responding to the SEC do not represent "loss of the Organization arising from a Securities Claim."

Judge Marra also concluded that the voluntary, pre-subpoena costs incurred on behalf of the individual directors and officers were not incurred in connection with a "Claim." In reaching this conclusion he specifically referenced the trigger required to bring an "investigation" within the definition of "Claim."

Office Depot had argued further that the policy's "relation back" language brought all of the pre-claim costs within coverage when the claims finally did emerge. Office Depot made this argument in reference to the language in the policy's notice provisions which provide that when a policyholder provides a notice of circumstances that could give rise to a claim, and a claim subsequently arises, the claim relates back to the time of the original notice.

Judge Marra ruled that the "relation back" language pertained solely to the question of when a "Claim" is first made for purposes of determining the appropriate claims made policy period. The relation back language, Judge Marra said, "simply serves to

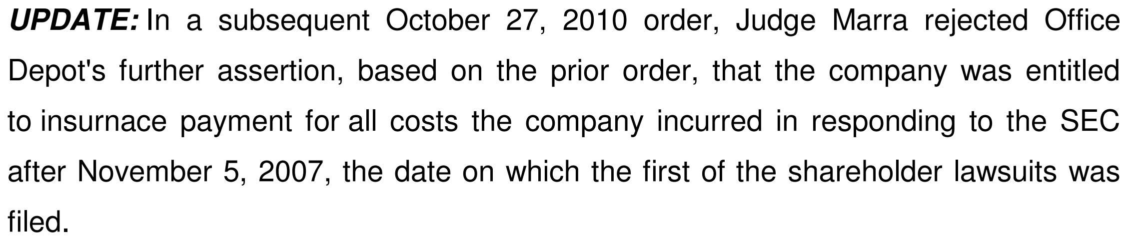


identify the policy period in which the ‘subsequent Claim’ was made; it does not operate to expand the Policy definition of ‘Claim’ to absorb any allegations of wrongdoing which happen to be related or similar to the wrongdoing described in the insured’s original Notice of Circumstances."

Judge Marra also rejected Office Depot’s related argument that the November 2007 securities lawsuit "relate back" to provide coverage for the company’s internal investigation. The company had argued that because the subsequent lawsuits were "subsequent claim," the Policy’s "relation back" language brought under the Policy’s coverage all defenses expenses incurred from the date of the Notice of Circumstances.

Judge Marra said that even if the securities suits were "subsequent claims" that relate back for notice purposes to the date of the original notice of circumstances, "it does not follow that any pre-suit investigation costs which may have related to and benefitted the defense of those suits…are transformed into a covered ‘loss’ which ‘arises from’ that securities litigation."

Finally, Judge Marra held that the Policy’s definition of covered Loss does not include the costs of investigating potential or anticipated claims, rejecting Office Depot’s argument that those costs are "arising from" the defense of a claim. He found that the "arising from" phrase "connotes a sequential relationship" between the Claim and the Loss that "arises from it" – that is, Loss that "follow sequentially in time." He said that covered loss "does not include related pre-suit or pre-claim investigation costs, regardless of how ‘related’ or ‘beneficial’ those costs may have ultimately proved to be in defending against the claim which ultimately materialized." He added that "while these costs may well have reasonably been incurred in contemplation of anticipated or potential litigation, that is not enough to meet the Policy’s requirement that the ‘resulted solely from’ the investigation or defense of a Claim."



UPDATE: In a subsequent October 27, 2010 order, Judge Marra rejected Office Depot's further assertion, based on the prior order, that the company was entitled to insurnace payment for all costs the company incurred in responding to the SEC after November 5, 2007, the date on which the first of the shareholder lawsuits was filed.

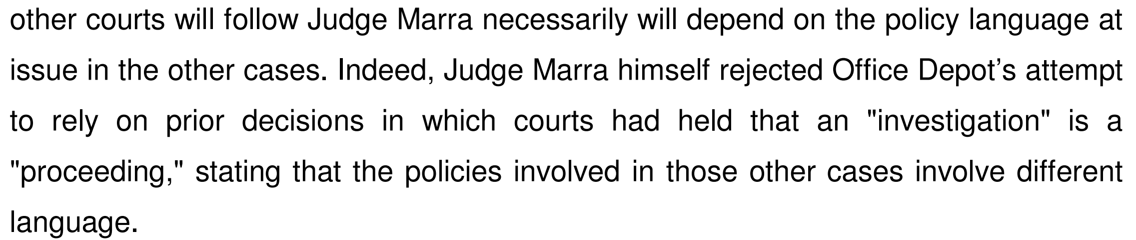
In his October 27 order, Judge Marra said that voluntarily SEC response costs the company incrred after the shareholder suit was filed "may have followed the securities lawsuit sequentially in time, they did not 'grow out of' or 'flow from' the subject lawsuits, and therefore did not 'arise from'" those suits. Judge Marra added that even though the comany incurred SEC response costs after the shareholder suit was filed, that "does not transform the post-suit SEC response costs into covered 'Loss" ... even though some of those response costs may have been related to or had utility in Office Depot's defense of the securities lawsuit."

Discussion

Judge Marra's analysis and conclusions are a direct reflection of the specific language at issue in the Office Depot case, and his analysis might or might not produce the same or similar outcome under different policy language. He seemed particularly persuaded that Office Depot's primary D&O policy draws a clear distinction in how the policy responds to "investigations" on the one hand and "proceedings" in the other.

That said, Judge Marra's analysis is quite detailed and represents a very thorough examination of what policyholders are entitled to under the policy before an investigation ripens into a formal administrative or regulatory proceeding. The opinion also represents a detailed examination of what insurers are responsible for before a claim has been made under the Policy.

Insurers will undoubtedly welcome this decision and will attempt to rely on it in other cases. As a district court opinion, the decision has limited precedential value, but the insurers will seek to rely on the decision for its persuasive value. The extent to which

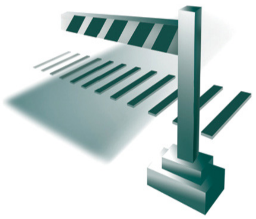


other courts will follow Judge Marra necessarily will depend on the policy language at issue in the other cases. Indeed, Judge Marra himself rejected Office Depot's attempt to rely on prior decisions in which courts had held that an "investigation" is a "proceeding," stating that the policies involved in those other cases involve different language.

Notwithstanding Judge Marra's decision, policyholders will continue seek coverage for defense costs incurred in informal investigations and for internal investigation, particularly where distinctions in policy language would seem to justify a different outcome. The sheer dollar costs involved alone (see, e.g., Office Depot's $23 million in expenditures) ensure that policyholders will continue to agitate on these issues.

Given the perennial nature of these issues, the question arises of what are the practical lessons of Judge Marra's opinion. The most important lesson seems to be that the policy's wordings of "Securities Claim" and "Claim" are very important and the specific wording used with relation both to "investigations" and "proceedings" can be critically important. A particularly important issue for insurance buyers and their advisors to keep in mind is that a court may differentiate "regulatory and administrative proceedings" on the one hand and "investigations" on the other hand, and it is critically important to analyze coverage with respect to these two sets of considerations separately.

One final note relates to Judge Marra's analysis of whether pre-claim defense expenses may be said to be "arising from" a subsequent claim. Judge Marra reduced this analysis to a question of temporal relation, in effect concluding that any particular item of defense expense can only "arise from" a claim if it comes later in time. I am not sure this analysis takes into account all of the possibilities, In particular, there are occasions when defense expenses are incurred earlier that would inevitably have been incurred later, the argument being the expenses "would have been incurred in any event" and the fact that they were incurred prior is an accident of timing. Arguably, Judge Marra's analysis is not (or perhaps fairly ought not to be) preclusive of this argument. (Please refer to the Update above for further on this point).



It is probably worth noting that there have been recent innovations introduced into the D&O insurance marketplace designed to try to provide coverage for certain pre-claim expenses incurred by or on behalf of individual directors and officers. The most recent formulations would not address the pre-claim expenses or internal investigative expenses of the insured entity itself, but it would at least provide direct or reimbursement coverage for costs incurred by or on behalf of individuals before a "Claim" has emerged.

These issues surrounding informal inquiries and internal investigations raise many points of contention, and policyholders and their insurers will continue to struggle with these issues. It seems probable that insurers facing these disputes will attempt to rely on Judge Marra's opinion.

Special thanks to Steve Brodie of the Carlton Fields law firm for providing me with a copy of Judge Marr's opinion. The Carlton Fields firm represented the primary insurer in the coverage litigation.