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WHEN IS AN SEC INVESTIGATION A "CLAIM" VERSUS A "CLAIM FOR A WRONGFUL ACT"

Inconsistent primary policy language has led to a divergent body of case law regarding regulatory investigations. Over the past several years, this has produced regular court battles over when a claim materialized and what coverage or exclusions apply. Insureds will likely become more vigilant in deciding when to tender these matters to D&O carriers, in the hopes of preserving coverage. An insured may provide a carrier with an early "notice of circumstance" as soon as the SEC issues a formal order of investigation. However, insureds will have to balance such notices of circumstance with "prior notice" exclusions. This will likely lead to even more insureds seeking clarity on exactly when they can and should notice government investigations to obtain coverage under their D&O policies.

I. The *Patriarch* Case

A recent decision out of the Southern District of New York found that an SEC Investigation was a claim for purposes of a pending and prior claim endorsement.[1] The facts as to the AXIS policy were unique when compared to the rest of the tower, and are likely unique when compared to other legacy towers. Patriarch Partners was renewing its Private Equity Liability tower in July 2011, and purchased the AXIS policy in August 2011, which added a $5 million layer to its $20 million tower.

In December 2009, the SEC sent requests for information to Patriarch, which the SEC characterized as an "informal inquiry." In May 2011, the SEC made additional requests, which targeted specific funds, and characterized its requests as an "informal investigation." On July 1, 2011, the SEC sent a subpoena to a former Patriarch executive, Meric Topbas, which stated that "federal law requires you to comply with this subpoena." The subpoena followed the formal order of investigation into Patriarch, dated June 3, 2011. On February 27, 2012, the SEC sent Patriarch a subpoena, which it tendered to the carriers on March 5, 2012. All the carriers, including AXIS, accepted the Patriarch subpoena as a covered claim. AXIS later sent a reservation of rights, and Patriarch eventually brought a declaratory judgment action after exhausting the underlying limits.

The AXIS Policy included a "Pending and Prior Claims Exclusion Added," which stated the policy did not apply to "any amounts incurred by the Insureds on account of any claim or other matter based upon, arising out of or attributable to any demand, suit or other proceeding pending or order, decree, judgment or adjudication entered against any Insured on or before July 31, 2011, or any fact, circumstance or situation underling or alleged therein." AXIS disputed this effective date, because the AXIS policy was bound after the rest of the tower, but the court gave Patriarch the benefit of the doubt in this regard. Even with this timing dispute, the court still determined the endorsement applied to exclude coverage under the AXIS policy.

Patriarch argued the Topbas subpoena was not a demand for non-monetary relief, and attempted to downplay the significance of the formal order of investigation and the Topbas subpoena. However, the court

determined that both the Topbas subpoena and formal order of investigation, whether taken separately or together, were a "demand" for "non-monetary relief" under the primary CNA policy and Second Circuit precedent. Both preceded the July 31, 2011 date found in the pending and prior claim endorsement. The court went on to say that "an SEC subpoena is not a mere request for information, but a substantial demand for compliance by a federal agency with the ability to enforce its demand."[2] It seems likely that this ruling will apply in limited circumstances where the insured is subject to a new government investigation, and where the endorsements to the policy are not backdated, which may affect application of similar exclusions.

II. The *MusclePharm* Case

Just weeks after the *Patriarch* case was decided, the Tenth Circuit ruled on a similar matter involving the tender of an SEC investigation as a notice of circumstance under a D&O policy.[3] In an unpublished decision, the Tenth Circuit affirmed a district court decision that found costs related to an SEC investigation order were not covered if they were incurred before a Wells Notice was issued.[4]

Similar to Patriarch, MusclePharm received a voluntary request to produce documents from the SEC in May 2013. MusclePharm tendered the request to its D&O carrier, Liberty, in June 2013, and stated that if the request did not constitute a "claim," then it wanted Liberty to consider the tender a "notice of circumstance." On July 8, 2013, the SEC issued an "Order Directing Private Investigation and Designating Officers to Take Testimony." Liberty denied coverage, but accepted the SEC's May and July communications as a notice of circumstance. On February 13, 2015, the SEC issued Wells Notices to two MusclePharm executives. Liberty agreed to cover defense costs that post-dated the Wells Notices, but refused to reimburse MusclePharm for costs incurred between the issuance of the July 8 order and the Wells Notices. The District Court of Colorado granted summary judgment to Liberty, finding that the Wells Notices were the first "claim for a wrongful act," and any costs incurred before there was a "claim for a wrongful act" were not covered under the policy.

The Tenth Circuit affirmed this logic, finding that the July 8 order was not a claim for non-monetary "relief." Further, the Tenth Circuit found there was no claim for "wrongdoing" in the July 8 order, in light of the language that the SEC "has not determined whether [the insureds]... violated the law."[5] The court also determined that the July 8 order was not a "proceeding" under the definition of claim. The Liberty policy specifically stated that a proceeding must have been commenced by a Wells Notice or target letter.[6] The case is again limited, because MusclePharm was seeking coverage of its defense costs from the date of the July 8 order to the issuance of the Wells Notices. The court did permit MusclePharm to relate the claim back to the policy period under which is gave its notice of circumstance, as Liberty accepted the notice of circumstance as part of its original denial letter.

III. Background and Related Cases

In its motion for summary judgment, Patriarch relied on several cases to justify the position that the Claim was not made until the February 2012 subpoena was issued to the company.[7] The *MusclePharm* court also went to lengths to discuss and distinguish many of the same cases in its decision. However, the issue of

investigatory costs for individuals, and related entity investigation costs, has been a hot button issue for years. The *Office Depot* case was particularly instructive concerning notices of circumstances, and the nuances between entity and individual coverage for government investigations.[8]

The Southern District of Florida noted that a July 2007 informal "notice of inquiry" from the SEC and a January 2008 formal "order directing private investigation" were both captioned "In the Matter of Office Depot, Inc." These documents both named the business of Office Depot as the topic of inquiry. Neither identified any particular officers or directors as respondents or potential targets of a civil, criminal, administrative or regulatory proceeding. The policy did not provide entity coverage for such an investigation, but Office Depot provided a notice of circumstance to AIG, which was accepted during the policy period.[9]

Like the formal order of investigation in Patriarch, the formal order sent to Office Depot contained general statements referencing conduct of the officers and directors who committed "possible violations" of the securities laws.[10] In finding that the formal order was not an investigation of an insured person, the court observed that "Office Depot is essentially seeking to recover the costs of investigating a 'potential claim' ...."[11]

This is the gray area that the insureds will seek to avoid. Specifically, if they provide a valid notice of circumstance, will they be footing the bill for the defense of insured individuals before they are subpoenaed or specifically identified by a regulatory agency, even though those individuals are identified later? There are several public company forms that provide limited coverage in these circumstances, but where they do not, expect insureds to seek answers from courts.

An RSUI case concerned the issuance of grand jury subpoenas and search warrants as part of an ongoing government investigation, similar to the *Diamond Glass* case Patriarch relied on.[12] In the *Desai* case (Universal Healthcare), the individual insured argued that a search warrant and accompanying grand jury proceedings constituted a Claim for a Wrongful Act under the policy. Unlike the *Patriarch* court, which only needed to find that the SEC subpoena constituted a "Claim," the *Desai* court specifically found that the search warrant and grand jury subpoena were not a "Claim for a Wrongful Act."[13] On this point, the language of the policy is critical, as to whether coverage depends on whether a "claim" is made against the insured, or a "claim for a wrongful act" is made against the insured.

IV. Concerns Going Forward

As noted, the *Patriarch* court did not hold that the Topbas subpoena stated a claim for a wrongful act. The court confined its logic to the fact that the subpoena stated a demand for non-monetary relief, and constituted a claim. To that end, it is unclear that the Topbas subpoena would have been covered under the policy. Instead, the subpoena may have served solely to exclude coverage under the AXIS policy. The distinction between a "claim" and "claim for a wrongful act" may make a difference as to when an insured provides notice of a regulatory investigation, and may impact the applicability of exclusions, like the exclusion in the *Patriarch* case.

As a general rule, SEC subpoenas request documents or testimony related to a certain time period for specific entities, which gives the insureds clues about what the SEC is investigating. However, the subpoenas often make very clear that the SEC (or other government entity) has evidence that "tends to show" a wrongful act, but the subpoena itself does not state a "claim for a wrongful act." Several carriers have successfully argued that subpoenas do not meet the conditions of an Insuring Agreement, under this notion that they do not state a "Claim for a Wrongful Act."[14] In the case of government subpoenas, the *Patriarch* court made it clear that if federal law compels a response, the subpoena itself is a demand for non-monetary relief. It is unlikely that these subpoenas will overtly state a wrongful act, and we should expect that insureds will litigate for a clear answer on when coverage is triggered for such investigations.

It begs the question: should an insured provide a notice of circumstance where the claim does not state a wrongful act, potentially triggering a prior notice exclusion when a claim for a wrongful act is actually made? In light of this case, it seems likely that carriers can expect more notices of circumstance as soon as the SEC issues a formal order or an individual subpoena. An insured would then hope that the NOC would pin the claim to an earlier policy in the event the SEC issues company subpoenas or Wells Notices.

This tactic could present problems for an insured, if they lack sufficient detail to provide a NOC that complies with the policy's requirements. Even in the case of *Office Depot*, the insured provided an adequate notice of circumstance, which was accepted by AIG, but the court did not permit broad coverage, despite the insured's compliance with the policy's NOC requirements. Specifically, the court did not permit Office Depot to sweep in investigation costs before a formal order of investigation was issued. This will likely remain the norm, but will prompt insureds to seek more clarity on these issues.

The Patriarch case may be a one-off, given that the exclusion AXIS raised only applied to its policy. It is doubtful that the same exclusion would have applied to the underlying limits, given that it was the first policy AXIS issued to Patriarch and the underlying limits pre-dated any SEC inquiries. Still, it seems that individual subpoenas and formal orders of investigation may be the new impetus for insureds to provide notice, even if coverage is not yet available under the policy. Courts have shown that they will stick to literal interpretations of the policy, as it did in *Patriarch.* In *Patriarch*, the exclusion likely would not have applied if it required a "claim for a wrongful act." On the other hand, the exclusion in *Desai* may not have applied if the language only excluded a "claim." With that, whether the policy language excludes "claims" or excludes "claims for wrongful acts" is beneficial to carriers will depend on the facts of each individual case.

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[1] *Patriarch Partners, LLC v. AXIS Ins. Co.*, No. 16-cv-2277, 2017 WL 4233078 (S.D.N.Y. Sept. 22, 2017).
[2] *Minuteman Int'l, Inc. v. Great Am. Ins. Co.*, No. 03 C 6067, 2004 WL 603482, at *7 (N.D. Ill. Mar. 22, 2004); *see also Weaver v. Axis Surplus Ins. Co.*, 639 F. App'x 764, 766-67 (2d Cir. 2016) (concluding that a letter was a "demand" because it "set forth the division's request under a claim of right, including its entitlement to the documents identified therein, and put [the recipient] on notice of the legal consequences").
[3] *MusclePharm Corp. v. Liberty Ins. Underwriters, Inc.*, No. 16-1462 (10th Cir. Oct 17, 2017).
[4] *Id.* at 17.
[5] *Id.* at 13.
[6] The *MusclePharm* case specifically distinguishes *Patriarch*, stating the following in a footnote: Patriarch Partners is further distinguishable on this point. In Patriarch Partners, the relevant policy's "claim" definition

expressly included the "Investigation of an Insured alleging a Wrongful Act," where "Investigation" was defined to encompass "an order of investigation or other investigation by the" SEC. In contrast, here an investigation was not covered under the policy until such time as the SEC issued a Wells Notice or a target letter—"at the point when the insured has been charged with wrongdoing." See *Patriarch*, 2017 WL 4233078, at *6 (interpreting the policy in ProMedica)(internal citations omitted).

[7] *Diamond Glass Cos. v. Twin City Fire Insurance. Co.*, 2008 WL 4613170 (S.D.N.Y. Aug. 18, 2008).

[8] *Office Depot, Inc. v. National Union Fire Ins. Co of Pittsburgh, PA.*, 734 F.Supp.2d 1304 (S.D. Fla. 2010).

[9] 734 F. Supp. 2d at 1310.

[10] *Id.* at 1320.

[11] *Id.* at 1323.

[12] *RSUI Indem. Co. v. Desai, et al.*, No. 13-cv-2629 (M.D. Fla. 2014).

[13] *Id.* at 8.

[14] *Minuteman Int'l, Inc. v. Great Am. Ins. Co.*, No. 03 C 6067, 2004 WL 603482, at *7 (N.D. Ill. Mar. 22, 2004); *see also Weaver v. Axis Surplus Ins. Co.*, 639 F. App'x 764, 766-67 (2d Cir. 2016); *Syracuse University v. National Union Fire Insurance Co.*, 975 N.Y.S.2d 370, 40 Misc. 3d 1205(A) (N.Y. Sup. Ct. 2013)(finding a duty to defend a grand jury subpoena, where the court found that non-compliance with subpoena was punishable by contempt).