Coverage for Corruption: U.S. Style

D&O insurance policy issues arising from the Foreign Corrupt Practices Act

By Karen Mariscal and Dan Simnowitz

Revelations about Wal-Mart's internal probe into bribes paid to Mexican officials made headlines this year, shining a brighter spotlight on a decades-old anti-bribery law known as the Foreign Corrupt Practices Act.

Amid news of the giant retailer's cover-up of the bribes, the basics of the law and the vigilance of the Securities and Exchange Commission and the U.S. Department of Justice in recent years are becoming clearer. Less understood are the mechanics of directors and officers liability insurance policies in response to costs that companies incur in responding to actions taken by two enforcement bodies.

The primary D&O insurance issue concerns the payment of defense costs. In the United States, it is understood generally that D&O policies do not provide coverage for the fines and penalties resulting from FCPA violations. But defense costs and expenses can be huge—even exceeding $100 million—depending on the breadth of the allegations and the number of individuals targeted, each of whom would likely retain separate counsel.

As a result, we find that insureds fervently pursue coverage for defense costs—and that they are often surprised by the limitations placed on investigation cover in the typical D&O policy.

Claim Definition: More Than A Formality

In recent years, corporate insureds have proactively initiated internal investigations upon learning of potential FCPA violations perpetrated by their officers or employees. The practice of voluntary compliance stands in stark contrast to the more reactionary positions that were assumed by corporate insureds during the latter part of the 20th Century.

The rationale behind voluntary compliance is that it may persuade the SEC or the DOJ not to prosecute, or may result in a reduced fine or penalty levied on the corporation in exchange for its cooperation in the government's prosecution of the allegedly culpable officers and employees.

Avon Corporation reportedly incurred in excess of $200 million in legal costs in connection with its internal investigation into potential FCPA violations by its employees in recent years. (In its 2011 annual report, Avon disclosed that it spent approximately $93.3 million in 2011 on an internal investigation of possible violations of the FCPA. Avon incurred $95 million in connection with internal investigation in 2010 and $59 million in 2009.) Siemens AG reportedly incurred nearly $1 billion in legal costs in connection with its internal investigation into FCPA violations.

Given the amount of costs incurred in connection with internal investigations, corporate insureds have increasingly pressured D&O insurers to provide coverage for such costs on the ground that they are "reasonably related to" or "redound to the benefit of" a covered claim—a related shareholder derivative action or securities class action. The "reasonable relatedness" argument has not generally been a fruitful avenue for finding coverage for pre-claim costs, however. (See accompanying textbox, "Down To Cases").

Down To Cases

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- In 2011, in *Office Depot, Inc. v. National Union Fire Ins. Co. of Pittsburgh, P.A.*, the U.S. Court of Appeals for the 11th Circuit held that pre-suit investigation costs, which may have "related to and benefited" Office Depot's defense of the claim (i.e., the securities lawsuits) were not covered "Loss"
- *In National Stock Exchange v. Federal Ins. Co.*, in 2007, the District Court for the Northern District of Illinois held that "legal fees incurred before a matter ripens into a claim are not covered, regardless of whether the legal fees are reasonably related to the defense of a claim.

The central question is whether an insurer is required to begin paying for the defense when the insured first begins to incur costs—for example, by producing documents or participating in an interview by the DOJ or the SEC—or when the insured actually has a formal "claim" made against it. The answer often depends on the breadth of the definition of "claim" in the policy. Although definitions vary, the general trend among courts in the United States is that only a "formal" regulatory investigation is a "claim." Another common triggering point for a "claim" is the point at which the SEC or DOJ identifies individuals as targets of the investigation.

Determining whether an investigation by the SEC is a "claim" fits relatively neatly within the existing legal framework because the SEC may issue a "formal" order of investigation to the corporate insured or a Wells Notice to the individual directors, officers or employees who are under investigation. These actions ordinarily constitute a claim, and trigger the policy.

A Wells Notice is a notification from the SEC that it intends to recommend that enforcement proceedings be commenced against the prospective defendant or respondent. The Wells Notice may identify the violation that allegedly occurred and provides the respondent an opportunity to submit a written statement to the SEC.

On the other hand, the SEC may instead issue a "Notice of Inquiry," which requests information from a company, but states that the notice should not be interpreted as an indication that the SEC believes that a crime was committed. This is not a claim, unless the definition of "claim" is written to include inquiries or investigations.

Under standard D&O policies, there is typically no cover for the company's own costs incurred in undertaking an internal investigation regarding a pos-

Subpoena Power

Courts have split on the issue of whether a subpoena issued by a grand jury is a "claim" under a D&O policy.

In *MBIA Inc. v. Federal Ins. Co. et al.*, in July 2011, the Second Circuit held that a subpoena constituted a claim "because it is similar to other forms of investigative demands made by regulators" and is not merely a discovery device.

In contrast, in *Diamond Glass Cos., Inc. v. Twin City Fire Ins. Co.*, in 2008, the U.S. District Court for the Southern District of New York held that a grand jury subpoena cannot be considered a claim because it does not constitute "demand for non-monetary relief."

sible FCPA violation. Nor is there cover for responding to informal investigations by regulators unless an individual is targeted in writing, and then only for the costs incurred by that particular individual.

In the context of a criminal investigation by the DOJ, courts have split on the issue of whether a subpoena issued by a grand jury is a "claim" under a D&O policy. As always, the actual policy language is key. (See related textbox, "Subpeona Power").

Even if the SEC issues a subpoena to a director and officer, that subpoena may simply seek to obtain information and documents from the director and officer as a witness and does not necessarily mean that the SEC is targeting that individual or is alleging that the individual committed any wrongdoing.

Claim Redefined

As the need for investigation cover has grown, some D&O insurers have expanded the definition of "claim" to include coverage for early stages of regulatory investigations—even where the particular director or officer may not be a target of the investigation. There are D&O policies now covering "pre-claim inquiry" costs incurred by "insured persons" in connection with interviews or requests to produce documents as part of a regulatory or internal investigation. Moreover, one major insurer has released a separate policy that covers the costs incurred by the company in responding to an SEC investigation of any securities violation. (For more information on the entity coverage for investigation, see article titled, "Chartis On The Cutting Edge," in the December 2011 edition of MLj.)

Some carriers are even providing limited coverage for individuals for certain FCPA fines and penalties. This may seem surprising given that it is generally against public policy in the United States (and the U.K.) to insure intentional actions. However, the policies only cover civil penalties assessed under 2(g)2(B) of the statute—a section which does not require that the actions be willful, and which limits fines to a maximum of $10,000.

In addition, a major insurance broker also has created a standalone policy that covers legal, accounting, auditing and consulting costs associated with FCPA and U.K. Bribery Act investigations—for both individual directors and officers and the organization. We note that a standalone policy makes sense for insureds who are concerned that the policy limits may be exhausted by governmental investigations.

Guilty As Charged

The intentional acts and personal profit exclusions in D&O policies, collectively known as conduct exclusions, may provide a basis for an insurer to deny coverage, and potentially recoup the costs advanced to the directors and officers that pleaded guilty or were convicted of a criminal offense under the FCPA. The application of the conduct exclusions, however, is typically limited by a clause that requires that the conduct underlying the particular exclusion be established by a "final adjudication."

Because of the "final adjudication" limitation, D&O insurers typically advance defense costs under a reservation of rights to insureds named as defendants in an FCPA-related criminal prosecution by the DOJ, a civil proceeding brought by the SEC, a securities class action, or a shareholder derivative action arising from the insured's false and misleading public statements regarding FCPA compliance.

In 2010, as part of its Enforcement Cooperation Initiative, the SEC amended its Enforcement Manual to make it easier to provide immunity to defendants in exchange for cooperation. This may cause more defendants to plead guilty in order to avoid jail time. Some U.S. courts have held that either a guilty plea by an insured is a "final adjudication" that triggers the exclusion, while others have found that a "final adjudication" occurs after the insured is sentenced.

Conduct Unbecoming

U.S. courts have held that a guilty plea by an insured is a "final adjudication" that triggers the conduct exclusions of at D&O policy in several cases, including: *Herley Industries, Inc. v. Federal Ins. Cos., Inc.* (E.D. Pa. Aug. 21, 2009) and *First Nat. Bank Holding Co. v. Fidelity and Deposit Co. of Maryland* (N.D. Fla. 1995).

In other cases, courts have held that a final adjudication occurs after the insured is sentenced. Among these cases are: *Great American Ins. Co. v. Alfred Gross, et al.* (E.D. Va. May 3, 2005), holding that the "mere entry of [the defendants'] guilty pleas is not enough to bar entitlement to Policy benefits under the Fraud Exclusion"; *In re Enron Corp. Securities, Derivative & ERISA Litigation* (S.D. Tex. 2005), noting that "case law is clear that a criminal adjudication is not final until a sentence is imposed on the defendant," but holding that judicial estoppel relating to a guilty plea can trigger a conduct exclusion.

In civil cases, courts have held that a settlement is not sufficient to trigger the conduct exclusion. Instead, a judgment establishing the underlying intentional or profiteering conduct must be obtained against the insured. Sample cases are: *AT&T v. Clarendon America Ins. Co.* (Del. Super. Ct. June 25, 2008); *Alexander Mfg., Inc. v. Illinois Union Ins. Co.* (D. Or. 2009) *Pendergest-Holt v. Certain Underwriters at Lloyd's of London* (5th Cir. 2010) *Wojtunik v. Kealy* (D. Ariz. March 31, 2011).

(See related textbox, "Conduct Unbecoming"). In civil cases, courts have held that a settlement is not sufficient, and a judgment establishing the underlying intentional or profiteering conduct must be obtained against the insured to trigger the exclusion.

In the event of a "final adjudication" establishing intentional or profiteering conduct, the insurer may be entitled to recoup the defense costs advanced to the insured. Many D&O policies also confer upon the insurer the right to recoup defense costs if it is later determined that coverage is not available. Even if the D&O policy does not expressly provide the insurer the right to recoup, some U.S. jurisdictions allow an insurer to recoup defense and indemnity payments advanced to an insured based on the common law principle of unjust enrichment. (See California and New York cases, *Buss v. Superior Court* decided in 1997; *Federal Ins. Co. v. Kozlowski*, decided in 2005).

In practice, a D&O insurer's ability to recoup defense costs advanced to an individual insured depends on the individual's financial ability to repay. Further, the specific severability language will dictate the extent to which a guilty plea by an individual insured may provide a basis for a D&O insurer to deny coverage for defense costs incurred by other individual insureds.

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