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Whistleblower Claims: Are You Covered?

Law360, New York (September 27, 2011, 6:14 PM ET) -- Press reports and court and agency decisions relating to whistleblowing activity, eligibility for substantial monetary awards from the U.S. Securities and Exchange Commission and claims of retribution and retaliation against employees for whistleblowing activity continue to attract attention. Several federal statutes provide for whistleblower benefits and/or protections, including in the health care, food and nuclear power industries and with respect to government contracts. Pursuant to these statutes, multimillion-dollar penalties have been imposed on companies for improper conduct brought to light by whistleblowers.

There are also many pro-whistleblower organizations that continue to promote the efforts of whistleblowers. For example, the International Association of Whistleblowers met for several days in September 2011 in Washington, D.C. The Government Accountability Project also announced on Sept. 13, 2011, that it was sponsoring the American Whistleblower Tour "aimed at educating the public — particularly America's university students — about the phenomenon and practice of whistleblowing." The tour will be visiting college campuses this fall. See www.WhistleblowerTour.org.

Congress sharpened the public's focus on whistleblowing activity with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in July 2010 in response to the 2008 financial crisis. The Dodd-Frank Act may be best known for its bounty provision through which the SEC, recognizing limitations on its resources, seeks to encourage whistleblowers to provide high-quality tips about financial fraud and other misconduct.

There was considerable debate about the Dodd-Frank proposed rules by those who asserted that the bounty provisions would severely undermine the extensive corporate compliance programs implemented by many companies in response to Sarbanes-Oxley and, on the other hand, by those who asserted that internal employee complaints of wrongdoing are frequently ignored, thus necessitating direct reporting to the SEC for fraud prevention to truly be effective.

The SEC's Final Dodd-Frank Rules went into effect on Aug.12, 2011, and confirmed the mechanisms for whistleblowers to claim rewards for as much as 30 percent of sanctions in excess of $1 million recovered by the SEC if based on certain credible information supplied by a whistleblower. On the day that the SEC Final Rules went into effect, its newly created Office of the Whistleblower listed 170 cases on its website in which the SEC had recovered sanctions of over $1 million, inviting eligible whistleblowers to submit claims for a reward. See www.sec.gov/whistleblower.

Companies must carefully navigate many strategic considerations when faced with a whistleblower complaint, such as to determine the scope of the investigation, whether to self report potential violations to the applicable agency and whether additional claims may arise out of the conduct being investigated such as shareholder litigation. The strategies to be reviewed and coordinated also include to analyze the company's insurance program to assess if and how the policies will apply to the different aspects of a whistleblower claim and any private or government action resulting from it. Questions about insurance coverage will include:

- Will the costs incurred in responding to government action prompted by the whistleblower's complaint be indemnified by an organization or directors and officers policy?
- Will the costs of an internal investigation prompted only by a whistleblower complaint be indemnified?
- Is the whistleblower an "insured" under the company's D&O policy?
- Is there an insured-vs.-insured exclusion in the D&O policy, and, if so, is there a carve-back provision covering whistleblower claims?
- Will the company's employment practices liability coverage respond to a whistleblower retaliation claim?

As is the case with almost all insurance questions, the policy language is the key variable to determining the scope of potential coverage, most assuredly including the definitions of "claim" and "loss." Those definitions can apply quite differently with dramatically different results.

Will the costs incurred in responding to government action prompted by the whistleblower's complaint be indemnified by an organization or D&O policy?

A whistleblower's complaint may lead to a variety of actions against a company. The government may commence an inquiry, whether "formal" or "informal," issue a subpoena, issue a Wells Notice, file an administrative complaint, or file a lawsuit. While a lawsuit will almost certainly be a claim under any organization or D&O policy, whether the other actions constitute a claim will depend greatly on the particular language of the policy.

Recent cases illustrate how courts can interpret different claim language in a policy. In Office Depot Inc. v. National Union Fire Insurance Company of Pittsburgh, et al., 734 F. Supp. 2d 1304 (S.D. Fla. 2010), a Dow Jones newswire article reported that Office Depot may have violated SEC regulations that prohibit selectively disclosing material, nonpublic information. Shortly thereafter, the SEC notified Office Depot that it was commencing what the court called an "informal" inquiry.

Before receiving the SEC letter, Office Depot was contacted by an internal whistleblower who accused Office Depot of accounting irregularities concerning a vendor rebate program. The company commenced an internal investigation about the substance of the whistleblower's complaint and restated its financial statements several months later as a result of the investigation. Two shareholder derivative suits and two securities lawsuits were filed against Office Depot and several of its officers.

The SEC also began what the court referred to as a "formal" investigation, whereby it issued a "formal order directing private investigation" at the beginning of the year and issued subpoenas to Office Depot and its employees and officers over the summer and fall. Later, the SEC issued Wells Notices, indicating that it intended to recommend to the commission that enforcement proceedings be instituted against three officers.

Office Depot sought reimbursement from its carrier for over $23 million in legal fees and expenses incurred in responding to and settling with the SEC, indemnifying "insured persons" against defense costs, and conducting the internal investigation triggered by the whistleblower complaint. The insurer acknowledged that it had to indemnify the company for the defense costs incurred by its officers and directors served with SEC subpoenas and Wells Notices and for the costs incurred in defending the lawsuits. However, it rejected Office Depot's claim for reimbursement for costs to respond to the "informal" SEC inquiry and the cost of the company's internal investigation of the whistleblower complaint.

The Office Depot policies insured for "loss" arising from a "securities claim" against it and for "loss" arising from a "claim" against an "insured person."

The court first held that the SEC investigation was not a "securities claim." A securities claim included an administrative or regulatory proceeding against Office Depot, but only if the SEC simultaneously commenced and maintained such a proceeding against an Insured Person. The court noted that neither the informal notice of inquiry nor the formal SEC order identified anyone as a respondent or potential target in a proceeding. Thus the court held that the phrase "administrative or regulatory proceeding against" did not include the SEC's informal or formal investigation of Office Depot.

Further, in the court's view, "proceeding against" means "formal legal action, such as the filing of a lawsuit or administrative complaint … and does not encompass preliminary agency investigatory action."

Next, the court held that the SEC investigation was not a "claim" under the policy. While "claim" did include "administrative or regulatory investigations," it was more specifically defined to require the insured person to be identified in writing as a person against whom a proceeding may be commenced or, in the case of an investigation by the SEC, as occurring "after the service of a subpoena."

Thus, the court held that the costs incurred by Office Depot on behalf of its officers, directors and employees in connection with the informal inquiry and formal investigation before these individuals received a subpoena or Wells notice did not constitute a loss arising from a claim.

In contrast to Office Depot, in MBIA v. Federal Insurance Co., 2011 (2d Cir. July 1, 2011), the Second Circuit recently ruled in favor of the insured, which sought coverage for costs, including those incurred in responding to federal and state subpoenas.

The policies at issue also covered "securities claims" but, unlike the policies in Office Depot, included "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 policies also covered "securities defense costs," which included costs incurred in defending or investigating "securities claims."

In 2001, the SEC issued a formal order of investigation, looking into certain companies' compliance with the securities laws. Pursuant to that investigation, it issued the first of several subpoenas to MBIA in 2004 and the New York Attorney General (NYAG) did the same thing. The SEC and the NYAG considered issuing additional subpoenas, but MBIA asked the regulators whether they would accept voluntary compliance with their demands in lieu of subpoenas to avoid adverse publicity for the company. The regulators agreed.

The court ruled that the NYAG's subpoena was a securities claim, as it was at least a "similar document" to a formal or informal investigative order. The court agreed with the district court's "sensible intuition" that a businessperson would "view a subpoena as a 'formal or informal investigative order' based on the common understanding of these words."

The court also held that the particular underlying transactions fell within the scope of the SEC's order and subpoena and the NYAG's subpoena. The court rejected the insurers' argument that the investigation was conducted through MBIA's voluntary compliance, rather than in response to a subpoena, as "meritless." The court said that "the insurers cannot require that as an investigation proceeds, a company must suffer extra public relations damage to avail itself of coverage a reasonable person would think was triggered by the initial investigation."

The two decisions highlight substantially different outcomes depending upon how "claim" is defined. Companies may be able to avoid the Office Depot result by negotiating broad claim language, such as to specify that an investigation, not only a proceeding, is a covered claim. Moreover, to ensure that all types of investigations are included, an insured should request that "claim" include language such as "an informal regulatory or administrative investigation of an Insured Person or Company."

A public company may expand the definition further to include: "a 'Wells' or other notice from the Securities and Exchange Commission or a similar state or foreign governmental authority that describes actual or alleged violation of securities or other laws." A company's directors and officers may be subject to criminal investigation, so it may be advisable that the insured request that "claim" include "a target letter identifying an Insured Person as the subject of a criminal investigation".

Finally, the MBIA court looked beyond the particular claim definition language. As noted, it applied a "businessperson" test to analyze whether a subpoena was a "similar document" to a formal or informal investigative order. This raises an interesting question — will other courts go beyond strict interpretation of policy definitions and examine whether a businessperson would view the particular government action as an example of the type covered by the policy?

Will the costs of an investigation prompted only by the whistleblower's complaint be indemnified?

Another issue to consider is whether costs incurred in responding directly to a whistleblower complaint will be covered. In Office Depot, the answer was no and the company argued, in effect, that there should be an exception allowing the company to recoup its costs incurred in connection with the internal investigation where the fruits of the investigation related to and benefited the defense of the litigation that was filed against the company thereafter.

The court examined the definitions of "claim" and "loss" and held that the pre-suit, internal investigation costs were not reimbursable, noting that "Office Depot is essentially seeking to recover the cost of investigating a 'potential claim' against it, when the Policy definition of covered 'Defense Costs,' encompasses only the cost of investigating an actual 'claim.'"

The court also highlighted that the internal investigation was prompted by the whistleblower complaint received before the company was notified of the SEC inquiry and that the internal whistleblower investigation continued to evaluate the vendor rebate issues for several months before the SEC expanded the scope of its inquiry. The applicable policy language provided coverage for a "loss … arising from … a Claim" and that loss includes "defense costs," which covered "reasonable and necessary fees, costs and expenses … resulting solely from the investigation, adjustment, defense and/or appeal of a claim against an Insured."

Finding that the applicable language did not cover pre-suit or pre-claim internal investigation expenses, the court denied indemnification for that portion of the $23 million in attorneys' fees and costs attributable to the lengthy internal investigation.

This reasoning could be particularly applicable to company internal investigations initiated in response to internal whistleblower complaints under Dodd-Frank. In an effort to encourage whistleblowers to invoke company internal compliance procedures, the Dodd-Frank Final Rules provide benefits to whistleblowers who report to the company before going to the SEC.

For example, a whistleblower who reports internally to a company about certain misconduct will benefit because sanctions based on additional wrongdoing that may be uncovered by the company during its investigation and that are subsequently reported to the SEC will count for calculating the bounty.

Essentially, the whistleblower's incentive is that she will be eligible for a bounty based on sanctions imposed for conduct that the whistleblower did not raise. The Final Rules incorporate a 120-day window within which the company can self-report to the SEC following an internal complaint, during which time costly investigations will take place. Companies will need to consult their applicable insurance policies to see if language similar to that in Office Depot will preclude indemnity for internal investigation costs.

Is the whistleblower an "insured" under the company's D&O policy?

As a general matter, the more broadly the company's policy defines "insured," the more expansive the coverage will typically be. If A-Side coverage applies to officers, directors, board members and employees, the whistleblower would be considered an insured under the D&O policy.

That, however, would implicate the standard insured-vs.-insured exclusion, which precludes coverage for a claim asserted by one "insured" under the policy against another "insured." Here, an expansive definition of insured to include employees would work initially to the company's disadvantage by precluding coverage.

Is there an insured-vs.-insured exclusion in the D&O policy and, if so, is there a carve-back provision covering whistleblower claims?

The next inquiry is whether there are any exceptions to the insured-vs.-insured exclusion, such as a "carve-back" to expressly provide coverage for whistleblower claims. Even if so, the company must assess the scope of the whistleblower "carve-back" language. For example, does it apply broadly to "employment-related whistleblower claims," or is it a hold-over from prior year policies, limited to Sarbanes-Oxley whistleblower claims? If so, coverage may be determined by whether or not the company is publicly held as well as the nature of the complained of conduct.

Will the company's employment practices policy respond to the whistleblower complaint?

A recent case considered whether an employment practices liability carrier was responsible for the investigation costs incurred by a company that responded to an administrative charge filed by the U.S. Equal Employment Opportunity Commission. The applicable definition of "claim" included "a civil, administrative, or arbitration proceeding commenced by the service of a complaint or charge, which is brought by any past, present or prospective 'employee(s)' of the 'insured entity' against any 'insured.'"

The U.S. District Court for the Middle District of Tennessee held in Cracker Barrel Old Country Store Inc. v. Cincinnati Insurance Company, No. 3:07-cv-00303, slip op. at 11 (M.D. Tenn. Sept. 16, 2011). that the policyholder did not prove that its claim was covered by the policy duty to indemnify because the definition of "claim" unambiguously required that a covered proceeding be initiated by the employee, not an agency, even though the EEOC brought the administrative charge on behalf of the employee.

The court compared the Cracker Barrel policy language to broader EPL definitions of "claim" that included proceedings initiated or claims made against the insured without regard to whether the employee commenced the proceeding or an agency did so on the employee's behalf.

Conclusion

The implementation of Dodd-Frank's whistleblower provisions is another reminder to companies of the myriad of insurance coverage issues that a whistleblower complaint can present because a company and its employees can be subject to a wide variety of "claims." Accordingly, companies should closely examine their policies to ensure that they are drafted in a way that provides the companies and their employees with the maximum coverage possible.

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