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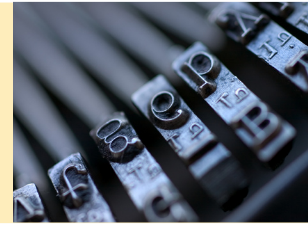

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Dodd-Frank, SEC Enforcement Activity, Whistleblowers and D&O Insurance[1]

By Carolyn Polikoff[2] and Priya Cherian Huskins[3]

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Is the Dodd-Frank Act[4] ("Dodd-Frank"), signed into law on July 21, 2010, potentially a game-changer when it comes to the exposure of officers and directors of public companies to litigation? Yes. And unfortunately for directors and officers and the companies they serve, the scope of insurance coverage afforded by director and officer ("D&O") liability insurance policies can be problematic.

The "Great Recession," the financial crisis that began in late 2007, was met with howls for financial reform. Dodd-Frank, first formally proposed in December 2009, was Congress' response to the financial frauds and abusive Wall Street practices that led to the Great Recession. Dodd-Frank has the potential to increase directors' and officers' exposure to litigation for the long-term because of:

- the SEC's potentially enhanced budget,
- new clawback provisions, and
- new bounties available to whistleblowers.

In addition, increased SEC enforcement activity will likely lead to more private plaintiff litigation against directors and officers.

SEC BUDGET INCREASES CONTEMPLATED BY DODD-FRANK MAY LEAD TO MORE SEC ENFORECEMENT ACTIONS

As of the writing of this article, the SEC's budget has been caught in the vise of the federal budget debate.[5] As a consequence, it is at risk for being cut. However, in the immediate aftermath of the financial crisis, there were numerous calls to increase the SEC's budget. Dodd-Frank sought to address this issue by doubling the SEC's budget by 2015. In addition, the act created a reserve fund of up to $100 million for the SEC.

Increased SEC activity arguably leads to increased litigation against directors, officers, and their companies. Certainly in the past, the plaintiff's bar has been quick to use SEC enforcement activity as a launching point for litigation against directors, officers, and their companies. This is at least in part because private litigation pursued simultaneously with on-going SEC enforcement activity tends to be more lucrative for the plaintiff's bar (i.e. leads to bigger settlements compared to litigation brought in the absence of SEC enforcement activity).[6] There is nothing about Dodd-Frank that would suppress this dynamic. Consequently, if there is increased SEC enforcement activity, it's a good bet that there will be increased private litigation against directors, officers and their companies as well.

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[1] This paper is a update of the paper of the same title published in January 2011. Portions of this paper were originally published in "Directors' and Officers' Insurance Policies Should Be Reviewed in Light of Anticipated Increase in Whistleblowing Activity Instigated by the Dodd-Frank Act and the UK Bribery Act, " Squire Sanders Client Alert (January 2011).

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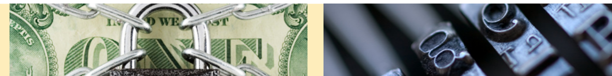
[4] Also known as the "Wall Street Reform and Consumer Protection Act of 2010."

[5] See, for example, "SEC Hurt by Disarray in Its Books, " New York Times (February 2, 2011); "SEC's Schapiro Rings Alarm about Budget Woes," Wall Street Journal (February 5, 2011).

[6] Data provided by Professor Michael Klausner, Stanford Law School's Nancy and Charles Munger Professor of Business and Professor of Law.



D&O INSURANCE COVERAGE FOR SEC ENFORCEMENT ACTIONS IS OFTEN NOT COMPREHENSIVE

Notwithstanding insurance carrier marketing and insurance broker hype, those experienced with SEC investigations know that companies are often surprised by the limited nature of coverage available to them under any given D&O policy.[7] The quality of coverage differs for individuals when compared to that of a company, and policy language varies widely among insurers. In general, individual directors and officers are covered if they are specifically identified as the target of a formal SEC investigation. In the currently prevailing soft insurance market, some insurers have expanded coverage to cover certain legal costs of individuals when responding to an informal SEC investigation. In some cases, this expanded coverage does not require the individuals to be the named target of the investigation.

By contrast, insurance coverage for the investigation of a company (as opposed to an individual insured person) by the SEC is usually much less comprehensive. Many insurers provide no coverage at all for a company being investigated by the SEC, formally or informally. Some insurers will cover a company only if the company is co-named with a covered individual from the beginning and throughout a formal investigation. Under this policy language, a company would have no coverage if it is the subject of a formal investigation with no insured individuals named, even if the formal investigation was later expanded to include a specific individual.

The thinness of coverage afforded to public companies by D&O policies can be especially problematic because of the way the SEC pursues its investigations. As a matter of process, the SEC typically does not begin an investigation against an individual (other than investigations for insider trading) by first pursuing the individual. Instead, the SEC usually first pursues and/or seeks the cooperation of the individual's company. It is only much later in the process that the SEC may directly name the individual—including individual directors or officers—that it is pursuing. There is nothing about Dodd-Frank that would cause this typical process to change. The insurance consequence, unfortunately, is that companies can incur millions of dollars in uncovered legal costs.

[7] *By contrast, a seperate investigations policy can provide a dedicated limit of insurance for an SEC investigation of a company.*

DODD-FRANK CLAWBACKS ARE AN AREA OF GREATLY ENHANCED FINANCIAL EXPOSURE FOR EXECUTIVE OFFICERS

Dodd-Frank creates new clawback provisions that result in new liabilities for executive officers. Sarbanes-Oxley Section 304 famously provided for clawbacks of CEO and CFO incentive compensation after an accounting restatement that was due to material noncompliance "as a result of misconduct with any financial reporting requirements under the securities laws."[8] Dodd-Frank Section 954 not only expands the pool of persons who are subject to clawbacks to all current and former executive officers of a company, it also deletes the misconduct trigger. Moreover while the Sarbanes-Oxley clawback was limited to a one-year incentive compensation look-back, the Dodd-Frank clawback contemplates three years. Finally, the Dodd-Frank clawback will be enforceable both directly by the SEC and derivatively by private plaintiffs as well.[9] Of course derivative suits generally involve members of a company's board of directors, so this is an area of enhanced litigation risk for directors too.[10]

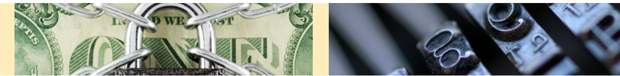
D&O INSURANCE IS NOT LIKELY TO BE EFFECTIVE AT SHIELDING DIRECTORS AND OFFICERS FROM THE LIABILITY EXPOSURE CREATED BY THE NEW DODD-FRANK CLAWBACKS

One of the insurance issues that can arise in the face of something like a clawback is whether insuring the clawback violates public policy. For example, penalties that are levied against an individual or a company after a final adjudication

[8] *Sarbanes-Oxley Section 304, emphasis added.*

[9] *"Securities Litigation Risks for Public Companies Arising from the Dodd-Frank Wall Street Reform and Consumer Protection Act,," Richard Gallagher and Kenneth Herzinger, http://www.orrick.com/publications/item.asp?action=article&articleID=2863, (Orrick, July 29, 2010).*

[10] *There is one feature of the Dodd-Frank clawback that seems to be less onerous than the Sarbanes-Oxley clawback: the Dodd-Frank clawback does not necessarily lead to the loss of the entire amount of an executive's incentive bonus. Rather, the Dodd-Frank clawback is limited to the excess earned over what should have been earned had the financial statements been rendered correctly. By contrast, the Sarbanes-Oxley clawback contemplates the return of all incentive compensation for the period in question.*



of wrong-doing are not insurable as a matter of public policy. The thinking is that insurance must be prohibited lest it be used to circumvent the public policy purpose the government seeks to enforce by setting the penalty in the first instance. It is for this reason that regulatory bodies such as the SEC will not let an individual settle with it if the penalty being paid to the SEC is reimbursed through corporate indemnification or D&O insurance. Whether Dodd-Frank clawbacks are uninsurable as a matter of public policy is an open question.

Another insurance issue that can arise in the face of something like a clawback is whether the clawback is uninsurable because it is a type of disgorgement, i.e. the paying back of something the defendant was never entitled to have in the first instance. The analogy is to stealing: a thief cannot insure against the possibility that he or she will have to give back a purloined bar of gold. Consider, however, that the Dodd-Frank clawback applies regardless of actual misconduct. Whether a strict liability clawback, as opposed to one that is imposed as a result of actual misconduct, is properly characterized as uninsurable disgorgement is an open question.[11]

Other insurance issues will arise depending on the form of Dodd-Frank clawback enforcement being pursued. If enforcement is being pursued by a government entity like the SEC, the same investigation and related insurance coverage issues discussed above may arise. To the extent enforcement is being pursued by plaintiffs pursuant to a derivative action, the company's board of directors may decide to launch an investigation. It is unlikely that the legal costs associated with this type of investigation would be fully reimbursed by D&O insurance since most policies impose a sublimit[12] to the extent they cover derivative suit investigations at all. Finally, if the board directs the company to pursue an individual for reimbursement, the individual and the company could lose D&O insurance coverage because of the insured versus insured or entity versus insured exclusions (both discussed below).

[11] *Notably, the D&O insurance market routinely provides coverage in an arguably analogous situation. Specifically, companies are strictly liable, regardless of intent, for misstatements in a registration statement pursuant to Section 11 of the Securities Act of 1933. Even though disgorgement is one of the remedies available under Section 11, D&O insurance policies routinely cover the settlement of these claims.*

[12] *A sublimit is always less than the full limit of insurance otherwise available. It is often available on a first dollar, no deductible basis.*

THE NEW WHISTLEBLOWER INCENTIVE PROGRAM MAY ENCOURAGE MORE WHISTLEBLOWERS TO REPORT TO THE SEC

Dodd-Frank's whistleblower incentive program has received enormous attention both in the D&O insurance marketplace and in the general press. The new provisions are certainly designed to encourage more individuals to report potential violations of the federal securities laws to the SEC. Under Dodd-Frank, a whistleblower may receive 10 to 30 percent of the penalty that the SEC imposes based on information the whistleblower provides to the SEC provided the action by the SEC or other governmental agency results in $1 million or more being collected.

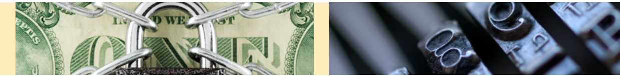
Most commentators expect this new whistleblower incentive program to increase significantly the number of SEC investigations.

However, it could be the case that the whistleblower provisions will not in fact lead to a flood of new SEC enforcement actions. In the short term, the SEC still has to establish the new office that will administer and enforce the whistleblower provisions. Perhaps more significantly, the SEC is arguably already the recipient of more whistleblower leads than it is able to handle. In the popular press, the Bernie Madoff scandal became emblematic of the SEC's inability to handle whistleblower leads because the SEC failed to uncover this massive fraud despite having received numerous tips about it.[13] Thus, even with expanded resources, more whistleblower leads may not necessarily result in more SEC enforcement actions. Nevertheless, it is only prudent for officers, directors and their companies to proceed as if there will be increased numbers of whistleblower-driven enforcement actions.

D&O INSURANCE COVERAGE MAY BE SPOTTY IF A WHISTLEBLOWER IS AN INSURED UNDER THE D&O POLICY

Carriers can often find defenses to their coverage obligations when a whistleblower is a director or officer or even just an employee. This is because of the wide-spread existence of the insured versus insured ("I v I") exclusion in D&O policies.

[13] *"Madoff Whistleblower Went Unheeded for years," MSNBC.com, http://www.msnbc.msn.com/id/28310980/ns/business-us_business/# (December 19, 2008).*



In its purest form, the I v I exclusion excludes from coverage any action that is brought or supported by the cooperation of an insured under the D&O policy. The I v I exclusion is an especially dangerous one in the post-Dodd-Frank world because the folks best able to take advantage of the new whistleblower incentive program are most likely going to be employees and could potentially be officers or directors.

In modern D&O insurance policies, most I v I exclusions have been modified to give some back coverage in certain defined situations. For example, many policies with I v I exclusions contain a grant back of coverage for claims brought by whistleblowers (as defined by the policy). Unfortunately, some insurance carriers have drafted their language so as to only allow coverage for suits involving employee whistleblowers and not whistleblowers who are directors or officers.

D&O INSURANCE RECOMMENDATIONS

In general, companies should work closely with an experienced and trusted insurance broker to consider the following in advance of their next D&O insurance renewal:

1. **Where possible, ensure that the D&O policy's fraud exclusion can only be triggered by a final adjudication of wrong-doing in "the underlying action."** For clarity, it is difficult to obtain this language. Indeed, a number of major D&O insurance carriers are not currently offering this language at all. However, without the underlying action clarification, one might expect insurance carrier to argue that a finding of wrong-doing by the SEC is effectively an admission of wrong-doing applicable to any other litigation that may have accompanied or resulted from the SEC's actions. By inserting "the underlying action" language, an insured can be certain that his or her legal fees will be paid until a final adjudication of the relevant matter at hand.

2. **Ask for, and attempt to expand as much as possible, coverage specifically afforded to the company (as opposed to individuals) for investigations by the SEC.** Where possible, ask for coverage for individuals and for the company for both formal and informal investigations. If this enhanced coverage is not available from your D&O insurance carriers, consider purchasing a stand-alone entity investigation policy of the type that Chartis released in March 2011.

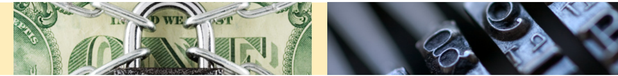
3. **Where possible, seek clarification that insurance carriers intend to provide defense costs to individual officers who find themselves targeted by the new Dodd-Frank clawback.** An even more aggressive tactic might be to attempt to secure clarification for coverage that would respond to settle a Dodd-Frank action, especially if it were a private action. At the time of the printing of this paper, these sorts of clarifications are not readily available in the insurance marketplace.

4. **To the extent that a company is successful in expanding coverage to include previously uncovered items such as a formal investigation by the SEC, be sure to re-examine and possibly increase the total limit of insurance being purchased.** This step may be less important if the expansion of coverage is limited to a small sublimit or resides in a stand-alone investigations coverage policy.

5. **Many D&O insurance policies automatically cover employees for securities claims.** Companies will want to ensure that this expansion of coverage does not lead to problems later should an employee be a Dodd-Frank whistleblower. Confirm that your policy has a clear carve-back (grant back of coverage) for employees from the I v I exclusion. (Unfortunately, in most cases, this carve-back will not include directors or officers of the company.)

6. **Re-examine the carve-back from the I v I exclusion that should already exist for whistleblowers in the D&O policy.** Often the whistleblower definition is narrowly drawn. For example, a whistleblower carve-back that is defined with reference to Sarbanes-Oxley may not be helpful if you have a Dodd-Frank—or other type—of whistleblower on your hands. Ask the carrier to expand the definition of who is a whistleblower appropriately, and be sure to include foreign equivalents. In some cases, it will be possible to include officers and directors in this carve-back from the I v I exclusion.

7. **Obtain renewal coverage from a carrier that is willing to migrate from the I v I to the newer, more policy-holder friendly "entity versus insured"**



exclusion. Unlike with an I v I exclusion, when a policy only has an entity versus insured exclusion, there would be still coverage for a claim that was brought against the company or an individual director or officer with the assistance of an individual insured under the policy. The entity versus insured exclusion would be triggered only if it were the company itself that was bringing or supporting the claim against an insured under the policy. Chartis took a lead position in the insurance market on this issue in 2010 with the release of its newest D&O insurance policy form; other carriers have followed suit.

8. **Ensure that the "Side A" D&O policy has no I v I exclusion at all.** Side A policies only protect directors and officers; the company is not an insured under the policy. Since Side A policies only respond when the company is financially or legally unable to indemnify directors and officers for an insurable matter, it is all the more important that Side A policies be as comprehensive, and have as few exclusions, as possible.

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Of course requests for expansion of coverage under a company's D&O insurance policy will cause an insurance carrier to attempt to charge a greater premium. For most companies, however, the insurance market remains highly competitive. If negotiated properly by a skilled insurance broker, many of the enhancements listed above may be available for little or no additional premium. This is especially true for companies that are "good risks," i.e. not in the midst of, or currently at high risk for, litigation. Where appropriate, a competitive renewal process that involves multiple insurance carriers' bidding on a company's insurance renewal will be helpful—especially if the company simultaneously compares not just price but insurance coverage terms and each carriers' claims paying expertise as well.

Questions? Comments? Suggestions? Please contact Carolyn Polikoff (cpolikoff@wsandco.com or 415-402-6513) or Priya Cherian Huskins (phuskins@wsandco.com or 415-402-6527).