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Guidelines for Maximizing D&O Insurance Coverage For SEC Matters

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Most corporate counsel know that their D&O insurance may advance or reimburse defense costs, and settlements or judgments incurred in civil litigation naming their directors and officers (as well as the company if entity coverage is purchased). Depending upon policy terms, D&O insurance may also pay defense costs incurred in response to various Securities and Exchange Commission (SEC) actions as well, including an informal investigation, a formal order of investigation, a subpoena or an indictment. Coverage varies widely depending upon the D&O policy terms. Any corporate counsel approached by the SEC must tread carefully, as hundreds of millions of dollars in coverage have been lost by major corporations facing SEC matters.

The following are some inquires and suggestions designed to help in-house counsel secure their rights under D&O policies in SEC matters and derive the greatest benefit from their premiums.

Does the SEC Matter Constitute a Claim or Circumstances That May Give Rise to a Claim?

Counsel should first determine whether a claim has been made that triggers coverage under the D&O policy. Claim definitions span a continuum from very narrow, *e.g.*, "written notice of a demand for monetary or non-monetary relief," to express inclusion of investigations and subpoenas (for example, a civil, criminal, or administrative or regulatory investigation of a director of officer: 1) once that director or officer is indentified in writing as being a person against whom a proceeding may be commenced; or 2) in the case of an SEC investigation, after service of a subpoena).

These differing claim definitions rendered a significant difference in available coverage. Likewise, some policies define a Securities Claim to include "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." (Emphasis added.) This definition was sufficient to trigger coverage for a SEC subpoena and oral request for documents in *MBIA, Inc. v. Federal Insurance Co.*, 652 F. 3d 152 (2d Cir. 2011). The court held that a subpoena could be construed as a "formal or informal investigative order," or, at a minimum, "a similar document," and thus constituted a covered "Securities Claim."

In contrast, a definition of "Securities Claim" that excluded coverage for investigations" and proceedings" but restored "coverage for proceedings" (but not investigations) did not encompass an SEC letter inquiry. *Office Depot Inc. v. National Union Fire Insurance Co. of Pittsburgh, Pa.*, 2011 WL 4840951, (11th Cir., Oct. 13, 2011). Thus, counsel must carefully compare the D&O policy's claim definition with the particular SEC letter, demand, subpoena, etc., to determine whether the SEC has asserted a claim under the policy.

Complicating this analysis is the question against whom the claim is directed. For example, if a subpoena seeks documents related to an investigation of another company or individual (as opposed to an insured), the insurer may take the position that the claim is not "made against the insured" and therefore is not covered. The claim must be made against an insured person as a director or officer of the company or against the company if the company has purchased entity coverage. If the SEC has not yet identified a target, but is only collecting information, the insured will have a more difficult time arguing that a claim has been asserted against an insured. Therefore, counsel must examine not just the language of the SEC communication, but at whether the communication suggests a claim against an insured.

Even if the matter at hand does not satisfy the definition of claim, it may well meet the definition of circumstances that may give rise to a claim. D&O policies allow insureds to provide insurers with notice of circumstance that could give rise to a claim. For example, if the insureds "become aware of any circumstances which may reasonably be expected to give rise to a claim" and give written notice to the insurer of the circumstances, then any claim subsequently made against the insureds arising out of the same circumstances will be considered to be given at the time of the notice of circumstances. Thus, if a company gives notice of an informal investigation but its D&O policy limits a claim to a formal investigative order, any subsequent formal investigative order arising out of the same informal investigation would be treated as a claim under the policy. Corporate counsel should therefore carefully review the policy's notice of circumstances provision.

What Are the Requirements For Notice of Claim?

Notice of Claim

D&O policies are claims-made policies and require written notice during the policy period or an extended reporting period if purchased — and typically require notice as soon as practicable. These policies often specify particular requirements for a notice of claim, including, *e.g.*, identifying the policy number and specifically requesting coverage. They also may require that notice be communicated in a certain way, whether by certified mail, express courier, or e-mail, and will specify an address. Be cautious with package policies, which include different types of coverage, because the notice conditions for the D&O coverage may be found in the General Terms and Conditions section rather than in the D&O section of the policy. Package policies may also require the insured to identify the particular section of the policy under which coverage is sought.

Notice of Circumstances

D&O policies typically itemize requirements for notice of circumstances, such as the alleged wrongful acts that form the basis of the potential claim. Counsel should carefully read the notice section of the policy to ensure compliance. Unlike

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other policies where transmittal of a civil complaint constitutes adequate notice, a simple transmittal of an SEC inquiry may not be considered sufficient.

Does the Policy Advance or Reimburse Defense Costs?

Some D&O policies pay defense costs as incurred so that the individual insured (or the indemnifying company) need not advance defense costs and seek reimbursement from the insurer. Corporate counsel should review the defense costs provisions to ensure that they are receiving the coverage that the company purchased and are not seeking reimbursement when the policy provides for payment of costs as incurred. Some policies also explicitly require insureds to repay non-covered defense costs advanced by the insurer: The latter "will pay covered defense costs on an as-incurred basis. If it is finally determined that any defense costs paid by the insurer are not covered under this policy, the insureds agree to repay such non-covered defense costs to the insurer." Counsel should be aware of such provisions in the event that a coverage dispute results in an adverse outcome for the insureds.

How Can We Maximize Coverage?

Insureds and their insurance companies often dispute the scope of defense costs that are covered by a policy once a claim is established. D&O policies include allocation clauses that are generally favorable to the insurer because they allow the insurer to use its "best efforts" to allocate defense costs among covered and uncovered claims or persons based on the "relative legal exposures." These clauses typically force the insured parties to discount defense costs in negotiations with their insurers, or resort to formal proceedings to determine any disputed amounts. For example, if counsel represented both an insured and an uninsured individual, the insurer may attempt to push defense costs toward the uninsured individual. Careful time-keeping can reduce the effectiveness of such insurer strategies.

What Are the Requirements For Keeping the Insurer Apprised of Developments?

D&O policies require insureds to cooperate with their insurers in defense of claims. For example, they may require that the insureds give them "all information, assistance and cooperation that the insurer may reasonably request." The scope of the insured's duty may depend on the insurer's defense obligation, with reimbursement policies posing a less onerous duty to cooperate than policies that pay defense costs as incurred. Provision of attorney-client privileged or work-product information to an insurer could be construed as a waiver if the insurer has not agreed to pay defense costs or defend the insured.

Therefore, insureds should insist that insurers take a formal coverage position before providing written documentation that, if disclosed to a third party (*e.g.*, plaintiffs in a class action arising from the SEC matter), could be damaging to the insureds. The tension between adequate disclosure, including satisfaction of the duty to cooperate, and protection of privileges, can be a difficult one, and may vary by state law. Individual directors and officers may have additional Fifth Amendment or privilege concerns that need to be protected.

What Is the Scope of Potentially Applicable Exclusions?

Conduct Exclusions

D&O policies typically exclude coverage for certain intentional conduct, such as fraud. The question arises when these conduct exclusions are triggered. Broader conduct exclusions refer to a finding "in fact," which allow the insurers to argue that any factual finding of the defined conduct triggers the exclusion. More favorable policies, however, require "final adjudication," preferably in an underlying action. In the context of an SEC proceeding, this language requires a judicial finding of the wrongful conduct in the underlying enforcement action. Settlement without any final adjudication avoids this exclusion.

Civil Fines and Penalties

Some policies expressly grant coverage for civil fines and penalties unless unenforceable by governing law. Other policies exclude this category of damages. Some D&O insurers have successfully characterized damages in securities enforcement actions as restitution or disgorgement of ill-gotten gains and therefore unenforceable as a matter of law or pursuant to specific exclusions for disgorgement or restitution.

Governmental or Regulatory Investigations

Some D&O policies expressly encompass regulatory exclusions that identify specific regulatory agencies; others either do not identify the agencies, or better yet, omit such regulatory exclusions. These exclusions are not as common as some other exclusions.

Obtain Insurer Consent Before Settlement

D&O policies typically require the insured to obtain the insurer's consent to settlement, which may not be unreasonably withheld. Unfortunately, insurers can use the consent requirement as a trap for the unwary insured. Insurers can withhold consent on the ground that they need more information before granting consent, and then when the insured resolves the matter, deny coverage on the ground that the insured did not obtain consent. Nevertheless, insurers that refuse to participate in settlement discussions and expressly deny consent may waive the consent requirement in the policy.

The insured should create an adequate record to establish the futility of obtaining consent from a recalcitrant insurer. If the company must settle the matter without the insurer's consent, counsel should pay special attention to policy exclusions and relevant law and avoid using language in settlement documents that could inadvertently give rise to coverage defenses.

Are There Exhaustion Issues In a Tower of Coverage?

Insureds often purchase a D&O tower of coverage, which includes a primary policy with excess policies sitting above the primary layer. In settlement negotiations involving claims that exceed the primary coverage and reach into the excess layer, insureds should be careful to avoid providing the excess insurers an escape hatch depending upon the language of the excess policy.

If the excess policy requires that the underlying insurer pay the full amount of the underlying limit, and the insured accepts less that the full amount from the primary insurer and fills the gap with its own funds, the excess insurer could prevail on an argument that a precondition to excess coverage has not been satisfied. Other policies contain less restrictive language, requiring, for example, only that the underlying amounts be paid (whether by the primary insurer or the insured) and thus may close this excess insurer loophole.

Conclusion

When possible, corporate counsel should communicate with their in-house risk management counterparts to negotiate terms and conditions that are favorable to coverage for SEC matters as well as other potential threats to the company and its directors and officers. Careful negotiating of terms and conditions at the outset can avoid many of these pitfalls. After all, the best time to ensure adequate insurance coverage is not when the loss occurs, but when the company negotiates coverage.v