One More Thing to Keep Directors and Officers Awake at Night:
Dodd-Frank's Impact on D&O Insurance
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I. INTRODUCTION

In July 2010, Congress passed sweeping legislation, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"),[1] in response to the recession and credit crisis that nearly crippled the global financial system. According to SEC Chairman Mary Schapiro, "this landmark legislation set out to reshape the U.S. regulatory landscape, reduce systemic risk and help restore confidence in the financial system."[2]

Dodd-Frank's full impact is uncertain, in part because some of Dodd-Frank's most important provisions are winding through the rulemaking pipeline. Yet there can be little doubt that Dodd-Frank will impact the potential liability exposure of corporate directors and officers significantly. Most notable in this regard are two provisions of the Act, one of which provides hefty incentives and protections for corporate whistleblowers. The other provision greatly expands the circumstances in which a company must go after its own directors and officers to recoup incentive-based compensation paid prior to an accounting restatement.

Dodd-Frank's provisions also raise serious coverage questions under directors' and officers' (D&O) insurance policies currently on the market. Policyholders and insurers should anticipate that several key provisions of D&O policies will be litigated in the context of the Dodd-Frank reforms. As with past legislative reforms regarding directors' and officers' liability, the ensuing litigation may lead to material changes in policy language.

II. DODD-FRANK BACKGROUND AND POTENTIAL IMPACT ON DIRECTOR AND OFFICER LIABILITY

Dodd-Frank appears likely to significantly expand on the last dramatic piece of reform legislation, the Sarbanes-Oxley Act (SOX),[3] passed on July 30, 2002, which like Dodd-Frank includes whistleblower protection and compensation claw-back provisions.

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A. The Dodd-Frank Whistleblower "Bounty" Provision

One of the more notable, and controversial, provisions of the Dodd-Frank Act is the so-called "bounty" provision, which is expected to increase substantially the volume of corporate whistleblower activity.

Section 922 of the Dodd-Frank Act amends the Securities Exchange Act of 1934 by inserting Section 21F, entitled "Securities Whistleblower Incentives and Protection."[4] This Section sets up an "Investor Protection Fund," and provides for payments from that fund of awards to whistleblowers who (i) voluntarily provide (ii) "original information" to the SEC (iii) that leads to the successful enforcement of judicial or administrative action (iv) resulting in monetary sanctions in excess of $1,000,000.00.[5] "Original information" means information that is "derived from the independent knowledge or analysis" of the whistleblower and is not known to the SEC from any other source.[6]

The potential "bounty" payment to the whistleblower is significant, ranging from ten to thirty percent of the monetary sanction ultimately imposed, with the amount of any particular payment to be determined at the discretion of the SEC.[7] The Act does not require whistleblowers to first pursue recourse through the company's internal compliance procedures, though the SEC's implementing rules, effective on August 12, 2011, do clarify that voluntary participation in corporate internal reporting programs can increase the amount of the award.[8] Dodd-Frank continues to change, however, as seen in recently offered legislation that would require a whistleblower to first report the matter to his or her employer if that whistleblower wanted to partake of Dodd-Frank's generous "bounty."[9]

SOX's whistleblower protection provision differs from Dodd-Frank's in that the SOX provision does not call for bounty payments.[10] The Dodd-Frank provision also significantly expands the scope of protections available to prevent retaliation against whistleblowers.[11] Most interested observers anticipate, therefore, that the Dodd-Frank provision will incentivize new whistleblower complaints.

B. The Dodd-Frank Executive Compensation "Claw-back" Provision

No less significant from the standpoint of increased liability exposure for directors and officers may be the Dodd-Frank provision entitled "Recovery of Erroneously Awarded Compensation Policy."[12]

Section 954 of the Act provides that the SEC will, by rule, direct the national securities exchanges and associations to prohibit the listing of any security of an issuer that does not develop and implement a policy providing:

> that, in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any

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> financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.[13]

Here again, the Dodd-Frank compensation claw-back provision expands significantly on SOX's compensation claw-back provision.[14] Under SOX, a company's CEO and CFO are subject to potential claw-back of compensation following a restatement. Dodd-Frank expands the universe of potential targets to "any current or former executive officer." The SOX provision requires reimbursement by the targeted executives of any bonus or other incentive or equity-based compensation paid in the 12-month period following the issuance or filing of the original (and erroneous) financial document. Dodd-Frank expands the claw-back period to a full three years pre-dating the restatement. SOX only allows recoupment in the event of a restatement that results from misconduct. Dodd-Frank eliminates the misconduct requirement, in effect imposing strict liability for purposes of the claw-back provision. Finally, there is no private right of action under the SOX claw-back provision.[15] By contrast, the Dodd-Frank version expressly requires the company to recover the improperly paid compensation.

The full impact of the Dodd-Frank claw-back is as yet unknown, since the SEC has not yet issued rules implementing and clarifying the statutory provision. However, such rules are expected to be proposed later this year and adopted in early 2012 (albeit likely too late for the 2012 Proxy Season).[16] There is little doubt that the Dodd-Frank claw-back provision will lead to increased SEC enforcement, as well as shareholder derivative actions seeking the recoupment of incentive-based compensation.

III. D&O INSURANCE COVERAGE IMPLICATIONS

Directors and officers hardly need more to worry about in addition to the increased likelihood of government and shareholder claims under Dodd-Frank, but undoubtedly there will be uncertainty surrounding the operation and interpretation of several key D&O insurance-coverage terms. For example, even if their D&O insurance policies were updated after the passage of SOX (shudder to think if they were not), several key provisions may now be out of date with Dodd-Frank's passage. Given the uncertainty created regarding the existing D&O insurance policy language in the context of the new legislation and implementing regulations, we should anticipate several years of litigation over the policy terms' meaning and application. In addition, with the Dodd-Frank rulemaking process still underway, insurers may be hesitant to allow changes during the renewal process that they perceive as increasing the risk that is being underwritten.

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Key provisions in the D&O insurance context include (a) coverage for government agency investigative costs; (b) the definition of "Loss;" (c) the Personal Profit Exclusion; and (d) the Insured versus Insured (I v I) Exclusion.

a. Coverage for Governmental Agency Investigative Costs

Increased SEC enforcement under Dodd-Frank means particular attention should be paid to provisions of the D&O insurance policy that relate to governmental agency investigative costs. Even the cost of responding to an informal agency inquiry can be significant. While many D&O insurance policies provide coverage in the case of a *formal* agency investigation targeting individual insureds, there is often a policy-by-policy debate (or litigation) regarding whether and to what extent *informal* investigations, or investigations naming the company and/or individuals who might not be insured individuals, are covered.

Whether an informal agency investigation is covered may well turn on the policy's definition of "Claim." The typical definition of a covered "Claim" includes, *inter alia*, a "written demand...for monetary, non-monetary, injunctive, or other relief," as well as "a formal administrative or regulatory proceeding" commenced against one or more of the individual insureds. Clearly even an informal request for information from an agency like the SEC cannot be ignored, and can subject the insured to significant cost and burden in responding. However, some D&O policies have been interpreted to provide no coverage for costs incurred in responding to what are deemed informal inquiries from government agencies, under the theory that a simple request for information is not a "demand" for "relief" from the insureds.[17]

Another issue that arises in the context of a government inquiry is whether and to what extent that inquiry targets one or more individual insureds, as opposed to the company itself. D&O policies often provide coverage even for formal investigations only if the inquiry is commenced by a written document that identifies one or more of the individual insureds as a potential target. Accordingly, when the company, or even one of the directors or officers, receives a subpoena from the SEC or some other regulatory body, the carrier may still take the position that no "claim" has yet commenced if the subpoena does not identify an individual insured as a potential target of enforcement action.[18]

Dodd-Frank may also have an impact on analysis of D&O coverage for internal company investigations. For example, Dodd-Frank now allows a private action via derivative lawsuit for enforcement of the claw-back provision. An increase in derivative actions will lead to an increase in Special Litigation Committee investigations to assess them. While some policies provide for separate internal investigation coverage, subject to a sub-limit, there has been much debate recently as to whether costs associated with Special Litigation Committee investigations are covered more broadly under other policies. Most of the recent case law has found in favor of coverage.[19]

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In the current soft market for D&O insurance, some carriers have begun to expand the scope of coverage for investigative costs. For example, some policies now provide coverage for pre-claim inquiry costs and/or costs incurred by the insureds in response to an agency inquiry that does not yet identify one or more individual insureds as a target. Anecdotal information suggests that the market for these specialty products remains small, perhaps reflecting the reality that companies with well-negotiated D&O insurance programs are often able to successfully argue that costs associated with agency investigations are covered "Claims." If, as expected, Dodd-Frank and its implementing regulations result in a material increase in SEC investigation and enforcement activity, however, this issue may be more frequently disputed, and the demand for expanded investigative cost coverage may continue to grow.

b. Definition of "Loss"

If the Dodd-Frank bounty provision actually results in an increase in SEC enforcement actions, whether the monetary sanctions awarded in those actions are covered will be fertile ground for dispute. For example, insurers will continue to assert that fines and penalties are not within the definition of "Loss" for purposes of coverage.

In addition, to the extent that officers are required to reimburse companies under the Dodd-Frank claw-back provision for improperly paid incentive compensation, there will be significant debate as to whether those payments are covered. Some courts have taken the position that payments in the nature of restitution or disgorgement of "ill-gotten gains" are not covered "loss" because it is not permissible to insure against the risk of being ordered to return funds that were wrongfully acquired in the first instance,[20] although parties have been able to contract around some of this case law by endorsement.

Accordingly, while officers may be able to recover costs incurred in defending a recoupment action (subject to the Personal Profit Exclusion, discussed below), the extent to which coverage will be available (at least without a fight) to pay judgments, settlements, or sanctions remains to be seen.

c. Personal Profit Exclusion

Most D&O policies also contain an express exclusion for claims alleging that an individual insured gained a personal profit or advantage to which the individual was not legally entitled. Like most conduct exclusions, the Personal Profit Exclusion usually includes language that the exclusion is not triggered unless and until there has been a judgment or other final adjudication that establishes the receipt of such "ill-gotten gains."

The Dodd-Frank claw-back provision requires actions by the company to recover incentive compensation from individuals following an accounting restatement, so it will be more important than ever for individual insureds to have the protection of this "final adjudication" trigger language. The "final adjudication" trigger ensures that the individual insureds will have

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coverage for defense costs and settlements that occur prior to an adverse adjudication on the issue of ill-gotten gains. To maximize protection, insureds should negotiate—if for some reason they have not done so already—for inclusion of language providing that the "final adjudication" must occur in the underlying proceeding in order to trigger the exclusion.

d. Insured v. Insured Exclusion

Another significant exclusion in the context of these Dodd-Frank provisions is the I v I Exclusion, which typically bars coverage for any claim brought by, on behalf of, or with the active assistance or participation of any insured. This exclusion is commonplace in D&O insurance policies, and was developed to preclude coverage for collusive actions, where one insured would file a sham action against another for the purpose of collecting insurance dollars. Given the overall expansion of the definition of an "insured" in many policies, however—including past, present, and future directors and officers, the company itself, and sometimes even other employees as well—the exclusion can be extremely problematic for the insured even in cases that do not appear to suggest collusion.[21]

Many current D&O insurance policies avoid the problematic and unintended consequences of the I v I Exclusion through carve-outs. These carve-outs expressly provide that certain types of non-collusive claims are covered, even if technically brought "by or on behalf of" one or more persons or entities within the definition of "Insured." For example, some commonly included carve-outs are for non-collusive shareholder derivative claims, actions between insureds for contribution or indemnity arising out of an otherwise covered claim, actions by former directors or officers who have been gone from the company for several years, and actions by a bankruptcy trustee or receiver for the insured entity.

Insureds should pay special attention to the carve-outs in the I v I or Company vs. Insured Exclusions, because not all carve-outs are created equal. As a result, one insured may have a significantly narrower I v I Exclusion simply because their risk manager or counsel insisted the insurer update the carve-out. For example, many I v I Exclusions were updated in the wake of SOX to include a carve-out for whistleblower claims. But, depending on how the carve-out was drafted, it may not cover whistleblower claims under Dodd-Frank. Recent renewals suggest that insurers are reluctant to include specific language in a carve-out for protected whistleblower activity—of any manner—under Dodd-Frank. Insureds should nonetheless be mindful of the potential disputes that may arise from a more limited whistleblower carve-out, and push for language that is clearly broad enough to cover Dodd-Frank whistleblowers. Other common carve-outs (for non-collusive shareholder derivative actions or for employee versus director or officer whistleblowers) should also be examined closely.

It may be better to insist on an Entity/Company vs. Insured Exclusion. These exclusions, introduced in recent years as a replacement for overworked I v I Exclusions, preclude coverage only for claims brought against an insured by the company itself, as opposed to one of the various individuals who fall within the definition. Nevertheless, special care should still be taken

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to ensure that other terms of the policy do not eviscerate coverage for Loss resulting from a whistleblower protected under Dodd-Frank.

IV. CONCLUSION

It would be an understatement to say that the director and officer liability landscape is evolving in the wake of Dodd-Frank. Future SEC rules will refine and clarify potential exposure, and practical experience over time with the agency's ability and willingness to enforce these new provisions will greatly inform the magnitude of the increased threat to directors and officers. In any case, potential gaps in D&O insurance coverage for such claims are sure to be highlighted, litigated, and ultimately addressed through modifications to policy language. In the meantime, all involved should carefully consider the potential coverage implications of Dodd-Frank and consult with their advisors regarding how best to manage their risk.

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[1] Pub. L. 111-203.
[2] *See* http://www.sec.gov/spotlight/dodd-frank.html.
[3] Pub. L. 107-204.
[4] 15 U.S.C. § 78u-6.
[5] 15 U.S.C. § 78u-6(b)(1), (g).
[6] 15 U.S.C. § 78u-6(a)(3).
[7] 15 U.S.C. § 78u-6(b), (c).
[8] *See* 17 C.F.R. § 240.21F-6 (2011); *see also* http://www.sec.gov/rules/final/2011/34-64545.pdf.
[9] H.R. 2483, 112th Congress (2011).
[10] 18 U.S.C. § 1514A.
[11] 15 U.S.C. § 78u-6(h).
[12] 15 U.S.C. § 78j-4.
[13] 15 U.S.C.§ 78j-4.
[14] 14 15 U.S.C. § 7243(a).
[15] *See, e.g.*, *Cohen v. Viray*, 622 F.3d 188. 193-94 (2nd Cir. 2010) (noting that the provision for a private right of action elsewhere in the statute confirmed the intent to create no such right with respect to Section 304); *In re Digimarc Corp. Derivative Litigation*, 549 F.3d 1223. 1230-33 (9th Cir. 2008) ("In the absence of clear evidence of congressional intent, we may not usurp the legislative power by unilaterally creating a cause of action.").
[16] *See* http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.html.
[17] *See, e.g.*, *Diamond. Glass Co., Inc. v. Twin City Fire Ins. Co.*, 2002 U.S. Dist. LEXIS 86752. at *11 (S.D.N.Y. Aug. 18, 2008) (cost of responding to grand jury subpoenas not a "claim" under the policy; "based on the ordinary and accepted meaning of the word 'relief' and the context in which it is used in the Policy, it is clear that investigative subpoenas and search warrants are not 'demands for non-monetary relief'"); *but see Minuteman Intl, Inc. v. Great Am. Ins. Co.*, 2004 U.S. Dist. LEXIS 4660. at *22 (N.D. Ill. Mar. 18, 2004) ("[a] demand for 'relief' is a broad enough term to include a demand for something due, including a demand to produce documents or appear to testify"; noting 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").
[18] *See California Union Ins. Co. v. Am. Diversified Sav. Bank*, 914 F.2d 1271. 1276-77 (9th Cir. 1990) (letters from Federal Home Loan Bank Board regarding alleged problems at bank not a "claim" for coverage purposes "because they neither threatened formal proceedings against [a former director] as a consequence of failure to comply nor propose to hold the officers and directors personally liable for the deficiencies"); *but see Polychron v.*

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Crum & Forster Ins. Cos., 916 F.2d 461. 463 (8th Cir. 1990) (legal fees incurred by bank officer to respond to grand jury investigation were covered; rejecting carrier's argument that no "claim" existed until officer was indicted; "The subpoena, it is true, was directed to the bank, but the documents demanded ... related to the plaintiff's conduct as a bank official. Further, the grand jury's investigation and the questioning by the Assistant United States Attorney amounted, as a practical matter, to an allegation of wrongdoing against [the officer], for which he prudently hired an attorney.").

[19] *See, e.g.*, *MBIA, Inc. v. Federal Ins. Co.*, 2011 U.S. App. LEXIS 13402, at *26 (2d Cir. July 1, 2011) ("[C]ost incurred by the SLC in terminating the derivative litigation were covered 'Defense Costs' (or 'Securities Defense Costs') under the [D&O] policies.").

[20] *See, e.g.*, *Level 3 Comms., Inc. v. Federal Ins. Co.*, 272 F.3d 908, 911 (7th-Cir. 2001) ("An insured incurs no loss within the meaning of the insurance contract by being compelled to return property that it had stolen, even if a more polite word than 'stolen' is used to characterize the claim for the property's return."); *but see Unified Western Grocers, Inc. v. Twin City Fire Ins. Co.*, 457 F.3d 1106 (9th Cir. 2006) (reversing summary judgment for carrier where complaint include allegations of loss beyond just restitution; "[t]he fundamental distinction is not whether the insured received 'some benefit' from a wrongful act, but whether the claim seeks to recover only the money or property that the insured wrongfully acquired").

[21] *See, e.g.*, *Carolina Casualty Ins. Co. v. Sowell*, 603 F. Supp. 2d 914,933-34 n.19 (N.D. Tex. 2009) (disregarding insureds' argument that application of the exclusion would be inconsistent with the underlying rationale of the I v..1 exclusion, which is to prevent collusion and abuse; "the purported rationale behind an exclusion is irrelevant when the plain language is unambiguous"); *Sphinx Intl, Inc. v. National Union Fire Ins. Co.*, 226 F. Supp. 3d 1326, 1334-37 (M.D. Fla. 2002) (Finding that lack of collusion did not bar application of the I v. I exclusion–"the original rationale underlying a legal or contractual norm does not provide a legal straightjacket"), *aff'd*, 412 F.3d 1224 (11th Cir. 2005); *but see Fidelity and Deposit Co. of Maryland v. Zandstra*, 756 F. Supp. 429, 431–32 (N.D. Cal. 1990) (denying carrier's summary judgment motion based on I v. I exclusion–"Fidelity's concern with collusive suits, in which an insured corporation might in essence seek to get Fidelity to pay for its managers' mistakes or poor business decisions, is certainly a valid one, but is not implicated here.").

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