## ASSESSING D&O INSURANCE FOR REGULATORY ENFORCEMENT ACTIONS & INVESTIGATONS



From SEC Enforcement to agressive DOJ investigations for alleged FCPA violations, enforcement actions and regulatory investigations consistently rank as a primary concern for both public and private company directors & officers.

> Given the findings in <u>Cornerstone's 2018 SEC Enforcement Report</u> these concerns are warranted; 2018 saw SEC enforcement actions increase 20% from the prior year and approximately 70% from 2012. These actions also regularly give rise to follow-on securities claims and derivative claims - a risk we highlighted in our <u>Public Company D&O</u> <u>Insurance Guide</u>.

> Assessing the scope of regulatory coverage when placing a D&O or E&O insurance policy however, is a complicated exercise due to the their differing terms and nuanced nature. When performing a coverage assessment, there are a considerable number of terms and conditions policyholders will need to review. In beginning with the insuring agreement, all D&O policies are built around the same basic language. Concisely, they provide coverage for; **loss**, arising from **claims** first made against **insureds** during the **policy period** for **wrongful acts**. These terms as defined within the policy will specify at what stage of an action/investigation coverage can be triggered, and for what costs the insurer will provide indemnification.



## POLICY DEFINTIONS

**Definition Of Claim:** Depending on the carriers' policy form and type of company (public vs private), policyholders will need to review the definitions of "claim", "securities claim", and pre-claim inquiry" (or equivalent), in order to determine the full scope of covered actions and investigations. At their most basic, those definitions should be inclusive of (among other claims); civil, criminal, regulatory and administrative proceedings and investigations. When extending coverage for regulatory/administrative proceedings and investigations however,



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Evan@GBAInsurance.com (914) 723-2220 x232 insurers will always embed additional language that will limit the extent to which the policy will respond.

**Formal Vs Informal**: It's important that directors and officers understand how the policy form(s) are defining investigations. Many "off the shelf" policies often limit coverage to formal investigations only. Considering that informal investigations can often be lengthy and labor intensive, policies that limit coverage solely to formal investigations may result in the company incurring significant costs. In the SEC action against MusclePharm, the organization allegedly incurred more than 3 Million in damages responding to the SEC's subpoenas and informal investigation. This case also demonstrates the importance of a D&O policy containing broad triggers for investigative demands. The tenth circuit ultimately ruled those damages were not covered by the insurer due to a restrictive coverage trigger limiting "investigations" to those commenced by receipt of a wells notice. This is in contrast to broader policies that contain a wider range of triggers. In order for insureds to access policy proceeds as early as possible during any proceeding or investigation, policyholders should request policy language that allows coverage to be triggered by:

- A notice of charges, receipt of a subpoena, formal and informal investigative orders, or similar documents
- Requests for information or document production
- Requests for meetings, interviews and sworn testimony,
- Receipt of a wells notice or target letter
- Service of a complaint or notice of charges
- A return of an indictment
- Arrests or detainment of insured persons
- Search warrants, and/or written statements from enforcement authorities

While having a broad range of covered inquiries is favorable, it could however also have the unintended consequence of jeopardizing coverage. Should a company receive an inquiry such as a request for document production, and fail to recognize and report the qualifying claim to the insurer in a timely manner, coverage could later be denied on the basis of late reporting. Accordingly, policyholders should be aware of the terms and conditions of their D&O policy and report any potential claims, for which they may be uncertain of, to their broker as soon as possible. Lastly, it should be noted, even when policyholders are unable to obtain such expansive definitions of claims, some courts have found that a policy's claim definition containing "written demands for non-monetary relief" is <u>sufficient to trigger coverage</u> for subpoenas.



Negotiate, or inquire about the ability to purchase, a broadened definition of "securities claim" affirming coverage for: civil, criminal, regulatory and administrative proceedings, and formal and informal investigations against the entity, with the removal of: 1) any policy term requiring that insured persons be named in the proceeding(s) or specified in the investigation and 2) the removal of the "wrongful act" requirement.

- Obtain policy terms that contain broad claim triggers for such actions, as highlighted above.
- Explore alternative solutions such as specialized policies, absent the ability to negotiate such amendments.

<u>"Loss" & "Inquiry Costs"</u>: The costs and damages related to regulatory proceedings and investigations can be broken down into the following categories. Policyholders should be acutely aware of what is, and what is not covered, and if any separate sub-limits or retentions apply.

**Investigative and Pre-Claim Inquiry Costs**: Policy forms often differ greatly on the types of investigative damages that are covered. With document production and discovery costs accounting for a substantial portion of any investigativerelated costs, it's critical that any policy providing coverage for investigations (or pre-claim inquiries) also includes coverage for such damages in addition to defense costs. Additionally, some broader policy forms and specialty policies can also include coverage for: accountants' fees, experts' fees, consultants costs, costs related to the release of detained persons, and the costs associated with insured persons having to provide testimony and/ or attend interviews and meetings.

**Fines, Penalties & Punitive Damages:** While many D&O policies explicitly exclude civil and criminal fines & penalties, and punitive damages from the definition of "Loss", some carriers will in fact provide affirmative coverage. It is however important to understand whether those covered fines and penalties are limited solely to those levied against insured persons, or whether the policy also provides coverage for fines and penalties levied against the insured organization. In the interest of broadening the policy's terms and conditions, policyholders should:

- Request affirmative coverage for fines, penalties and punitive damages where insurable by law and/or subject to the most favorable jurisdiction
- Inquire about the ability to add affirmative coverage for civil penalties assessed pursuant to the Foreign Corrupt Practices Act, UK Bribery Act and Section 308 of SOX
- Ensure the policy contains an A-Side carve back for fines and penalties imposed in connection with a directors' or officers' services with an insolvent company.
- Lastly, policyholders should understand and address any industry-specific fines that are being specifically included or excluded, such as HIPAA or EMTALA fines levied against healthcare companies and/or their executives.

According to Cornerstone's 2018 SEC Enforcement Report, SEC actions increased 20% in 2018, and were up 70% from 2012 **Disgorgement/Restitution**: When it comes to restitution and disgorgement, carriers will either explicitly exclude "restitution, disgorgement or return of ill-gotten gains" or may rely on softer language which excludes "any matters deemed uninsurable under applicable law". Despite the fact that most courts will deem coverage for disgorgement as uninsurable, policyholders seeking to secure the broadest language should favor softer language when available, request the carrier include coverage for disgorgement/restitution payments "subject to the most favorable venue", and seek policy language that affirms that losses pertaining to violations of Section 11, 12 & 15 of the SEC Act of '33 are not considered disgorgement or restitution.

**Compensation Clawback Costs**: With the SEC's ability to pursue compensation clawbacks following enforcement actions, public company directors and officers should also assess the extent to which costs associated with clawback actions are covered. Sometimes referred to as "facilitation costs", broader policies will include within the definition of "loss", any reasonable fees, costs or expenses incurred in connection with facilitating the return of amounts to be repaid under any clawback provisions (such as SOX 304 & Dodd Frank 954). In addition to ensuring such costs are included within the definition of "loss", directors and officers will also need to address a number of policy exclusions (as discussed below) in order to ensure that such claims are carved back from the respective exclusions.

<u>"Insured Entities" and "Insured Persons"</u>: With a large number of actions brought against subsidiary companies, ensuring those entities are properly insured when structuring a D&O program is critical. This is particularly true given the potential for strict parent liability, and successor liability. In addition to ensuring all subsidiaries are included as insureds, companies should also review the policy's change in control provisions when approaching an acquisition, paying particular attention to 1) any ownership thresholds for newly acquired entities, 2) automatic coverage periods, and 3) carrier notification requirements.

US subsidiaries that are relying on a foreign parent's D&O program should perform a careful policy assessment in order to determine if the policy's terms and conditions are broad enough to respond to enforcement and securities claims brought in the US. Conversely, US companies concerned with foreign enforcement actions, should perform an equally careful assessment to gauge whether the foreign policy is broad enough to respond to foreign investigations and proceedings, and whether those foreign countries will allow payments to be made by a foreign insurer.

In addition to ensuring all corporate entities are properly accounted for, insureds should also review the definition of "insured persons".



More restrictive policies may limit "insured persons" solely to duly appointed directors and officers, however broader policy forms will often extend that definition to include: foreign functional equivalents, shadow directors, and defacto or alleged defacto directors. Lastly, with certain enforcement actions such as FCPA investigations arising from wrongful acts of 3rd parties, it's also important to ensure the "insured person" definition is inclusive of past, present or future employees & independent contractors (for "securities claims" or for which the company requests coverage).

"Wrongful Act": Due to the fact that inquiries and investigations generally do not specify alleged wrongful acts, the wrongful act requirement within the insuring agreement or claim definition acts as a significant barrier to coverage, even when they policy may appear to be providing broad coverage for investigations. Court rulings have been divided and unpredictable as to whether or not inquiries such as subpoenas do in fact constitute a claim alleging a wrongful act. So while there may be coverage for informal investigations under a given D&O policy despite any amendments to the "wrongful act" requirement, directors and officers would be best advised to seek policy language that removes this requirement. This is most commonly achieved by means of a separate insuring agreement, coverage extension for investigative demands, or subsection to the insuring agreement.





## POLICY EXCLUSIONS

**Regulatory Exclusions:** Regulatory exclusions, while typically uncommon, are generally included in D&O policies written for companies that maintain an increased risk for regulatory actions; such as cannabis companies, crypto companies, and healthcare or lifescience companies. It's important to remember that these exclusions can be hidden within the policy definition as well. Policies that contain narrow "claim" definitions omitting regulatory proceedings and investigations, are effectively excluding coverage for such actions. Scheduled exclusions however can range from very targeted (excluding only costs and damages related to False Claim Act claims for example), to very broad (excluding any and all costs related to any regulatory action). To demonstrate, a broad regulatory exclusion may preclude coverage for any claims, interviews or investigative demands:

"By or on behalf of, or in the right of, at the behest of, at the direction of, or with the participation of any regulator in any capacity whatsoever....or any person or entity which any regulator, in any capacity whatsoever, has asserted any claim or demand of whatever nature", OR "Based upon, arising out of, directly or indirectly resulting from, or in any way involving any agreements, consents or other agreements with any regulator, or any actions required by a regulator....or any loss or reduction of earnings resulting from any agreement with, or action by any regulator"

In addition to acting as a hard exclusion for any and all costs associated with any regulatory actions, it should be noted the above exclusion has additional reach through its "based upon, arising out of, directly or indirectly resulting from, or in any way involving" preamble. The above policy language would undoubtedly also extend to preclude coverage for any resulting follow-on securities claim or derivative action, following the announcement of a regulatory investigation or settlements with regulators, as such claims would undoubtedly be considered to have "arisen or resulted from" the actual regulatory action.

It's important that policyholders make every attempt to avoid any/ all regulatory exclusions as aggressively as possible, narrowing their scope to the fullest extent when absolutely unavoidable. Specifically, insureds should ensure the exclusion contains a carve-backs for both securities claims, and non-indemnifiable claims (particularly important in preserving coverage for follow on derivative actions). In situations where carriers are unwilling to accommodate appropriate carve-backs, incorporating a layer of Side A DIC with its <u>broader coverage terms</u>, can serve as an alternative solution in securing appropriate coverage. Court Rulings have been divided and unpredictable as to whether or not inquiries such as subpoenas do in fact constitute claims alleging wrongful acts. **Conduct Exclusions:** With regulatory actions often asserting some degree of intentional wrongdoing, and the DOJ focusing on individual accountability and admissions of wrongdoing, insureds should perform a very careful review of the policy's conduct exclusion. Aggressive efforts should be made to narrow the exclusion as much as possible by attempting to remove any reference of "dishonest acts", and making sure the policy specifies; "**deliberately** fraudulent or **deliberately** criminal acts, or **willful** violations of statutes or laws". The exclusion should also specify that the insurer will advance defense costs until there is a final, non-appealable adjudication in the underlying action. Policies that agree to advance defense costs until there is a "determination of fact" should be avoided entirely due to the fact that such language grants the exclusion significantly broader reach, and is easily avoidable in today's marketplace.

Lastly, the policy's terms should include both application and exclusion severability clauses in order to ensure a director or officer's misconduct and/or misrepresentations are not imputed to other insured persons. Even when the aforementioned language is in-tact however, insureds may still have concerns. One such concern, is that the corporate entity may wrongfully decline to indemnify them, effectively forcing the individual(s) to first meet a large retention (upwards of 1 Mill) before being able to access coverage. Additionally, the c-suite may also be concerned with the prospect of having their assets exposed should the insurer attempt to recoup any defense costs already provided, following a determination of guilt. In such situations, a separately placed Side-A DIC policy can often address both of these concerns by bypassing any "presumptive indemnification" clause and entirely carving back defense costs from the conduct exclusions.

**Insured Vs Insured Exclusion**: The "insured vs insured" exclusion is commonplace within all professional and management liability policies. Its purpose is to preclude coverage for claims involving "infighting". Without appropriate tailoring however, it also has the ability to preclude a wider range of claims; from claims brought by debtors in possession, to claims brought by whistleblowers. In order to ensure coverage is preserved for the broadest range of enforcement actions and any follow on suits, directors and officers should insist that their policy's "insured vs insured" exclusion contains the following carve-backs (among others):

- Whistleblower claims This can either be achieved through a specific whistleblower carve-back (to the insured vs insured exclusion), or by replacing the "insured vs insured exclusion" with the more favorable "entity vs insured" exclusion.
- Derivative demands To ensure coverage for "follow on" derivative suits following regulatory actions.
- Costs incurred in connection with investigations or inquiries by regulatory authorities

- Defense costs that are non-indemnifiable
- Clawback" claims asserted against the directors or officers pursuant to SOX 304 or Dodd Frank 954 provisions.

**Ilegal Profits / Return of Remuneration Exclusion**: In order to secure coverage for costs associated with SEC enforcement actions pursuing the clawback of compensation, policyholders should ensure any exclusions pertaining to illegal profits or return of remuneration are subject to a final-non appealable adjudication in the underlying action, and contain an appropriate carve-back for costs incurred in connection with alleged violations of SOX 304 and Dodd Frank 954 provisions, as well as securities claims alleging violations of section 11 or 12 (of the SEC Act of '33).

**Professional Services, Products & Laser Exclusions**: Policy exclusions such as the professional services exclusions and any product-related exclusions (more commonly found in private D&O policy forms) also have the ability to nullify coverage. The case of Hotchalk Inc v. Scottsdale Ins, Co, is one such example. Employees of Hotchalk filed a qui tam action against the entity, arising from Hotchalk's payments to recruiters which were ultimately deemed in violation of Title IV of the Higher Education Act. The underlying D&O insurer ultimately denied coverage for the qui tam action citing the policy's professional service exclusion which precluded coverage for claims:

*"alleging, based upon, arising out of, attributable to, directly or indirectly arising from, in consequence of, or in any way involving the rendering or failing to render professional services".* 

While this claim was not asserting errors or failures in their actual rendering of services, the court determined that the claim did in fact "arise from" said services. Similarly, product-related exclusions can create similar barriers to coverage. To demonstrate, a typical product exclusion may preclude coverage for claims:

"Based upon, arising from, in consequence of, directly or indirectly involving, or in any way related to any malfunction, defect, or failure of goods or products manufactured, sold, installed, marketed, developed or processed by the insured, or the failure of goods, products, brands or services to conform with any statements or misrepresentations of quality or performance made in the advertising, marketing or labeling...."

The insurers' intent is understandable: to push product liability claims to an appropriate product liability policy. The un-intended consequence however, is that the above exclusion has the ability to preclude a significantly wider range of claims, from enforcement actions to any securities claims and derivative actions that may follow. This is due, in large part, to the exclusion's broad "based upon, arising, involving or related to" preamble. Consider the recent DOJ action against Hydro Extrusion for violations of the False Claims Act, stemming from allegations that the company falsified its products' test results. The above exclusion would very likely serve as a significant barrier to coverage considering that the enforcement action both involved (and arose from) misrepresentations regarding the quality of the company's products. In the interest of narrowing such exclusions as much as possible, policyholders should:

- Narrow the preamble from "for, based upon, arising from, or in any way related to" to simply "for" such claims.
- Narrow the exclusion's language. In the prior example for instance, narrowing the product exclusion to apply only to product failures, is a significant enhancement over the broadly defined exclusion above.
- Carve back coverage for defense costs and/or coverage for non-indemnifiable claims, and securities claims. While more challenging, policyholders can also attempt to carve back coverage for investigations and administrative/regulatory proceedings.

Lastly, in order to assist the c-suite and their counsel with assessing their policies' regulatory coverage, and assist with securing favorable terms, we have included a thorough assessment.

DE	FINITIONS	
"Claim" Definition	Written Demands	
	Gimilar Pleagings & Appeals	
	<ul> <li>Civil / Criminal Complaints &amp; Proceedings</li> <li>Regulatory &amp; Administrative Proceedings</li> <li>Investigations (Assess Below)</li> </ul>	
"Securities Claim" or "Claim" Definition (Side-C / Entity)	<ul> <li>Written Demands</li> <li>Similar Pleagings &amp; Appeals</li> </ul>	
	Civil / Criminal Complaints & Proceedings	
	Regulatory & Administrative Proceedings	
	□ Investigations (Assess Below)	
Is "Loss" Inclusive Of	□ Fines & Penalties (against insured persons)	
	Fines & Penalties (against the entity)	
	□ Affirmative Coverage For FCPA Fines	
	UK Bribery Act Penalties	
	□ SOX 308 Penalties	
	"Clawback" Defense / Facilitation Costs	
Is "Insured" Inclusive of	<ul> <li>Subsidiaries (threshold reviewed)</li> <li>Shadow Directors &amp; Defacto Directors &amp; Foreign Equivalents</li> </ul>	
	<ul> <li>Employees (For which the company requests coverage)</li> </ul>	
INVESTIGA	TIONAL COVERAGE	
Is There A Separate Sub-Limit Or Retention	Limit: Retention:	
Scope Of Covered Investigations (Against Entity)	🗆 Formal 🔹 Informal	
"Insured Person" or "Wrongful Act" Requirement	□ None □ Insured Person □ Wrongful Act	
Scope Of Covered Investigations (Against Individuals)	🗆 Formal 🔹 Informal 💷 Criminal	
Is Coverage Limited to Side A Claims	🗆 Yes 🗆 No	
Covered Investigational Damages / Inquiry Costs	Defense Costs	
	Discovery, Document Production & E-Forensic Costs	
	Expert Fees	
	Costs relateted to the release of detained persons	
	Costs relateted to the release of detailed persons	
	<ul> <li>Costs for Individuals to testify, attend meetings/interviews</li> </ul>	
Covered Inquiries	<ul> <li>Costs for Individuals to testify, attend meetings/interviews</li> </ul>	
Covered Inquiries	<ul> <li>Costs for Individuals to testify, attend meetings/interviews</li> <li>Accountants Fees</li> </ul>	
Covered Inquiries	<ul> <li>Costs for Individuals to testify, attend meetings/interviews</li> <li>Accountants Fees</li> <li>Subpoenas</li> </ul>	
Covered Inquiries	<ul> <li>Costs for Individuals to testify, attend meetings/interviews</li> <li>Accountants Fees</li> <li>Subpoenas</li> <li>Notice Of Charges / Violation</li> </ul>	
Covered Inquiries	<ul> <li>Costs for Individuals to testify, attend meetings/interviews</li> <li>Accountants Fees</li> <li>Subpoenas</li> <li>Notice Of Charges / Violation</li> <li>Formal &amp; Informal Inquiries</li> </ul>	
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Ε>	<b>(CLUSIONS</b>	
Disgorgement / Restitution Exclusion	Covered subject to the most fa	vorable jurisdiction
	□ Section 11, 12, 15 claims omitted from exclusion	
Is There A Regulatory Exclusion	🗆 Yes 🗆 No	
Regulatory Exclusion Preamble	□ Broad / Based Upon	□ Narrowed to "For"
Regulatory: What Exactly is being excluded?	Notes:	
Regulatory Exclusion Carvebacks	□ Side A Claims	Securities Claims
Fraud/Conduct Exclusion Preamble	□ Broad / Based Upon	□ Narrowed to "For"
Does The Fraud Exclusion carveback "facilitation costs"	🗆 Yes 🗆 No	
Does The Fraud Exclusion Specify Deliberate / Willfull	🗆 Yes 🗆 No	
Insured Vs Insured Carvebacks	Whistleblower Actions	
	Derivative Claims	
	□ Employees As Shareholders	
	Defense Costs that are non-indemnifiable	
	Costs incurred in connection with regulatory inquiries	
	<ul> <li>Clawback Claims (SOX 304, Dodd Frank 954)</li> </ul>	
Professional Services / Products Exclusion Preamble	□ Broad / Based Upon	□ Narrowed to "For"
Professional Services / Products Exclusion Carvebacks	□ Side A Claims	Securities Claims
ADDITIONAL	TERMS & CONDITIONS	
Exclusion Severability	🗆 Yes 🗆 No	Imputation By:
Application Severability	🗆 Yes 🗆 No	Imputation By:
Side A DIC Reviewed & Offered	🗆 Yes 🗆 No	
Separate Cyber Insurance Reviewed & Placed	🗆 Yes 🗆 No	



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