D&O Coverage Considerations Amid Increasing SEC Scrutiny

By **Robin Cohen and Orrie Levy** (September 8, 2021)

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We are now six months into the Biden administration and all signs point to increasing regulatory oversight and enforcement by the U.S. Securities and Exchange Commission.[1] This includes President Joe Biden's appointment of SEC Chair Gary Gensler who, as chairman of the U.S. Commodity Futures Trading Commission under President Barack Obama, took an aggressive approach to regulation and enforcement of financial institutions.

Indeed, in a recent speech before the Aspen Security Forum regarding the SEC's role in connection with cryptocurrency, Gensler indicated that this asset class does not yet have "enough investor protection," and "is rife with fraud, scams, and abuse."[2] He noted that "we have taken and will continue to take our authorities as far as they go."

It is therefore critical that companies reexamine their directors and officers, or D&O, insurance programs to ensure that both the companies and their employees are adequately protected in this heightened regulatory climate.

Below are four hot-button issues companies should consider as part of that review.[3]

D&O Insurance Coverage: An Overview

D&O insurance policies generally cover losses, including both defense and indemnity costs, incurred by a company or its directors and officers, in connection with a claim that the company or its directors and officers engaged in a wrongful act in their corporate capacity.

These policies can also cover, to varying degrees, regulatory investigations and internal company investigations, such as an investigation in the wake of a shareholder derivative suit. Although this coverage may seem straightforward in theory, D&O policies can vary widely in their terms and conditions and, as with all contracts, small differences in terminology can make a big difference in the availability of coverage for a particular loss.

Hot-Button Issues in D&O Coverage for SEC Investigations and Enforcement Actions

SEC investigations can take many forms, including letters requesting information, subpoenas and formal orders of investigation. Even if they do not lead to an enforcement action, these investigations can be costly and disruptive for a company to respond to and often require the review and production of voluminous documents, interfacing with the SEC's investigatory staff, and preparing witnesses for interviews and testimony.

If an investigation morphs into an enforcement action, those costs can mount significantly, including amounts paid in potential settlement. Companies should therefore be cognizant of the following hot-button issues and potential pitfalls.

1. Does your D&O policy cover costs incurred in nonformal SEC investigations?

D&O policies generally only cover claims, but the definition of what constitutes a claim can vary widely from policy to policy.

For example, some policies limit coverage to regulatory investigations commenced by formal orders of investigation. Under such a policy, an insurer may deny coverage for less formal regulatory investigations — such as a letter request for information, or a subpoena seeking documents or testimony — on the ground that the letter or subpoena does not constitute a claim, or because it does not expressly allege that wrongdoing actually occurred.

This may come as a surprise to many companies, which recognize that an informal letter request for information from the SEC can be extremely costly to respond to and is far from a mere request that a company can ignore.

Although many courts have construed D&O policies to encompass less formal investigations, the best practice to avoid potential disputes with insurers on this issue is to ensure that your policy's definition of "claim" expressly encompasses the costs of responding to informal information requests from a regulatory body.

2. Is your loss insurable?

D&O policies typically include an exclusionary carveout to the definition of "loss," which bars coverage for loss that is otherwise covered under the policy if the loss is uninsurable as a matter of public policy. Jurisdictions, however, vary widely in terms of their respective public policies on insurability.

Compounding this complication, D&O policies often do not include choice-of-law provisions and there are multiple jurisdictions whose laws could potentially apply to a given policy. Therefore, to avoid disputes relating to the insurability of SEC enforcement actions, companies should confirm that their policies provide that the insurability of any loss is determined under the law of whatever jurisdiction is most favorable to insurability.

3. Are you insured in a covered capacity?

D&O policies typically cover wrongful acts taken by an insured in a corporate capacity. This requirement is often found in the policy's definition of a "wrongful act" but can also be incorporated into specific exclusions in the policy for losses resulting from conduct taken in a noninsured capacity.

SEC investigations, however, are often complex and can target the insured in a corporate capacity or numerous capacities. Although courts have generally required insurers to cover all costs a company incurs in connection with an investigation that may implicate the insured in both covered and uncovered capacities, insurers continue to press this issue and may deny coverage for all or part of a claim that involves allegations that an insured wore multiple hats in connection with a particular wrongful act.

To reduce the risk of such a dispute, policyholders should confirm that their policies contain favorable allocation provisions and do not contain overly restrictive provisions and exclusions relating to capacity.

4. Does your policy's conduct exclusion require a final adjudication in the underlying action?

D&O policies often include an exclusion for fraudulent or intentionally dishonest conduct if such conduct is established by a final, nonappealable adjudication.

Although courts have generally required that such an adjudication be in the underlying action for the exclusion to apply, certain insurers have argued that this adjudication could be had in a subsequent lawsuit with the insurance company regarding the availability of coverage.

To avoid this type of dispute, companies should confirm that any such exclusion in their policies is only applicable if the proscribed conduct is established in a final, nonappealable adjudication in the underlying action.

Confirm Your Policy Actually Provides the Coverage You Think it Does

Given this heightened regulatory environment, policyholders should not assume that all D&O policies are the same and should carefully review their insurance programs with their risk managers, brokers and other advisers to confirm that their policies provide robust coverage for regulatory investigations and enforcement actions. This will reduce the likelihood of disputes over coverage and ensure that a company's coverage aligns with its expectations.

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[1] See https://www.gibsondunn.com/2021-mid-year-securities-enforcement-update/ (last visited August 6, 2021).

[2] https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03.

[3] A comprehensive overview of the ins-and-outs of a robust D&O insurance program is beyond the scope of this article. These topics are intended to be demonstrative of the types of issues companies should be aware of and used as a starting off point for a more fulsome review.