Fines, Penalties and Staying Out of Jail

What is a Covered Loss under a D&O policy?

By Susanne Mast Murray and Fred T. Podolsky

Directors and officers are exposed to financial liability just for doing their jobs. These individuals are generally protected from this risk by the indemnification obligation of the companies that they work for and serve. Directors and officers liability insurance is intended to backstop that indemnification protection by stepping up and making loss payments after the entity has exhausted the retention. When indemnification is not available, D&O insurance is the first line of protection and provides dollar one coverage.

This financial protection is tempered by whether the financial risk at issue is indemnifiable or insurable under the law, as well as whether the company wants to indemnify—and then whether any insurer wants to insure.

This article focuses specifically on the financial exposure of directors and officers to fines and penalties and the extent to which those are insured or can be insured.

Covered Loss Under A D&O Policy

D&O policies generally define Covered Loss as "damages, judgments, settlements and defense costs" with various other costs and expenses thrown in, such as pre- and post-judgment interest, plaintiffs' attorney fees, and the like. Like many other terms and conditions of D&O insurance, the type of loss covered by the policy has broadened over time.

Until recently, the definition of loss on most D&O policies included a much longer statement about what was not covered loss. Expressly excluded from Covered Loss were punitive, exemplary and multiplied damages, amounts for which an Insured was not financially liable, amounts that were without recourse to an Insured (non-recourse

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settlements, for example), cost of complying with non-monetary relief, civil and criminal fines and penalties, taxes, and amounts uninsurable under the law.

Over time, many of these expressly excluded elements of loss have been moved over to the expressly included coverage column—or at least are no longer expressly excluded. The items listed in the accompanying table on the following page ("D&O Loss Definition Evolves") show this evolution, although the number of insurers offering the expanded coverage dwindles as you go down the list. Not surprisingly, this is a substantial area of differentiation in the D&O marketplace.

It is rare to have blanket coverage for all potential financial loss, so most Insureds will not have a definition of loss that includes all of the elements listed. However, many standard D&O policies today do include broad coverage for punitive, exemplary and multiplied damages, some element of Foreign Corrupt Practices Act coverage and for public companies, the addition of SOX 308 costs and Dodd-Frank Section 954 costs. (See related textbox, "What Are SOX 308 and Dodd-Frank 954 Penalties?") Most also provide defense-costs coverage for claims seeking damages that are still excluded

D&O Loss Definition Evolves

Components of loss that were previously expressly excluded from D&O policies are no longer expressly excluded—and in some cases, now expressly included. The following bullets show this evolution, although the number of Insurers offering the expanded coverage dwindles as you go down the list.

Policies have been:

- Expanded to include coverage for punitive and exemplary damages for securities claims, then all claims.
- Expanded to include coverage for multiplied damages (treated differently than punitive and exemplary damages by some courts).
- Expanded to include defense costs coverage for matters otherwise excluded from the definition of loss.
- Changed to remove "without liability/non-recourse" language (although primarily because this was already addressed in the Insuring Agreements, and not because additional coverage was being added).
- Changed to remove the "costs to comply with non-monetary relief" language, although generally only for public companies because such costs are usually asserted against companies rather than individuals, and companies only have securities claims coverage on public D&O forms.
- Expanded to include coverage under a specific provision of the Foreign Corrupt Practices Act.
- Expanded to include civil or criminal fines or penalties imposed outside the United States if such amounts would be covered loss if the claim had been brought in the United States. (In countries where business-related claims fall under the country's penal code, for example, claims are considered criminal and the relief sought in such claims is a criminal fine or penalty.)
- Expanded to include coverage for civil fines or penalties if based on conduct that is neither intentional nor willful.
- Expanded to include fines, penalties and taxes if a personal obligation of an insured Person in connection with their service for a company that becomes financially insolvent.
- Expanded to include taxes and wages if a personal obligation of an insured Person.
- Expanded to include SOX Section 308 civil penalties.
- Expanded to include Dodd-Frank Section 954 penalties.
- Expanded to include all fines and penalties if insurable under the law.

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from the definition of loss. For example, these might include defense costs for claims seeking payment of taxes, although no coverage for the actual taxes themselves.

Defense-Cost Coverage Expanded

The expansion of coverage for defense costs for matters otherwise excluded from the definition of loss is worthy of pause. Whether or not actual fines and penalties are covered by a D&O policy, this defense-costs provision can provide substantial coverage all by itself. The cost of responding to an FCPA investigation, for example, can add up to substantial dollars. Responding to criminal complaints, including costs spent to attempt to avoid going to jail, may also be covered.

One very important caveat is that other provisions of the policy outside of the definition of loss can come into play and affect the amount of coverage available in any particular instance. For example, if an exclusion in the policy is triggered (an adjudication of fraud for example), or another provision of the policy precludes coverage, then this defense costs coverage expansion may not be available.

The most significant limiting factor is whether the costs are incurred in connection with claims against individuals, as opposed to the company. In this regard, under public company D&O policies, if the company is insured, it is only for securities claims. Unless an FCPA or other investigation or proceeding fits within the definition of "Securities Claim" on a particular D&O policy, there is no defense costs coverage for the company for such investigations or proceedings.

FCPA Provisions

Coverage for fines and penalties—including more severe FCPA fines and penalties—is not standard at this point, but it is a topic of conversation that is becoming louder. As to FCPA fines and penalties, the statute sets forth different areas of liability and different standards of culpability. The common reference to coverage for FCPA fines and penalties in D&O policies today is to cite to 15 U.S.C. 78dd-2(g)(2)(B).

This is only one section of the FCPA that is applicable to directors and officers, so the more severe financial fines and penalties that can be imposed against individuals are not included in that specific statutory citation and therefore not covered by any D&O policy that includes that citation. Some policies provide coverage for FCPA fines and penalties without citation, so broader coverage is provided, subject to insurability.

Imposition of Fines and Penalties

Fines and penalties are generally sought in administrative and regulatory proceedings.

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What Is A Non-Recourse Settlement?

Until recently, the definition of loss on most D&O policies expressly excluded amounts that were without recourse to an Insured. Examples include non-recourse settlements, which essentially are agreements between plaintiff and defendant, where the defendant (the insured) agrees to be "liable" for an agreed amount of damages as long as the plaintiff agrees that it will not seek to recover those damages from the defendant, but instead will only seek to recover from the insurance company.

These include proceedings brought by or on behalf of the federal or state government through the Department of Justice or state attorneys general. Proceedings may also be brought by governmental or quasi-governmental agencies, such as the Federal Deposit Insurance Corporation, the Financial Industry Regulatory Authority or the Securities and Exchange Commission.

The FDIC has the authority to seek civil money penalties from financial institutions. The SEC is charged with policing public companies that trade on U.S. exchanges, and is the enforcer of the federal securities laws, including the Sarbanes-Oxley Act of 2002 and more recently, the Dodd-Frank Act. Fines and penalties out of the SEC or the FDIC, or FINRA are not uncommon.

Other federal and state regulators and agencies also seek fines and penalties for violations of laws that they are charged with monitoring and enforcing. These less publicized regulatory fines and penalties can be substantial. The Federal Energy Regulatory Commission, for example, found that an individual violated its anti-manipulation rule and imposed a civil penalty on that individual of $30 million.

Fines and penalties can also be imposed against individual directors and officers for corporate wrongdoing, and even through no fault of their own. This is not a new phenomenon as liability of "potentially responsible parties" is expressly provided under numerous federal laws, including environmental laws such as CERCLA (the Comprehensive Environmental Response, Compensation, and Liability Act, or Superfund).

This Responsible Corporate Officer Doctrine was cited in a California case *(People v. John F. Roscoe)* where the California Court of Appeal found corporate officers liable for their corporation's civil violations under California's underground storage tank laws using the Responsible Corporate Officer Doctrine and imposed personal civil penalties of $2.5 million.

From a liability perspective, this use of the Responsible Corporate Officer Doctrine is of particular concern because it does not require wrongdoing by the individuals in order to hold them liable for the corporation's obligations. From an insurance perspective, because this doctrine does not require personal wrongdoing, conduct exclusions are not likely to be triggered. Other policy provisions may come into play that could adversely affect coverage however, such as a pollution exclusion or a bodily injury/property damage exclusion in environmental claims.

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Insurability

The biggest issue that has been raised in connection with this expansion in the definition of covered Loss is the extent to which these additional elements of loss are insurable. While this is an important issue that is largely unanswered at this point, it is not a unique question.

The D&O marketplace in particular has faced the question of insurability in regard to coverage for punitive, exemplary and multiplied damages and the state-by-state response has not been uniform. Many allow coverage for such damages, some allow coverage only for vicarious liability for such damages, and some preclude coverage entirely.

This split among the states on insurability has resulted in the inclusion of "most favorable jurisdiction" language on this issue in most D&O policies, providing that the policy's coverage will be interpreted by that state's law that most favors the insurability of such damages and that has some connection to the claim. For many insureds, this uncertainty over coverage for punitive, exemplary and multiplied damages, particularly when domiciled or operating in a state that prohibits insurance for such damages, has made the purchase of insurance "off shore"—and therefore potentially outside the reach or jurisdiction of the U.S. court system—more attractive.

Regulators and regulations have also chimed in on insurability of certain types of damages. For example:

- In the Foreign Corrupt Practices Act itself, section 78dd-2(g)(3) states that the fines and penalties contained in 2(g)(2)(B) cannot be paid directly or indirectly by the company.

This provision would suggest that the company is legally precluded from indemnifying for such Loss. It also raises the question of whether the purchase of insurance is akin to

What Are SOX 308 and Dodd-Frank 954 Penalties?

- Section 308 of the Sarbanes-Oxley Act, known as the "Fair Funds For Investors" provision, authorizes the Securities and Exchange Commission to add civil money penalties in addition to amounts required to be disgorged (or repaid) for violations of the Act.
- Section 954 of the Dodd-Frank Act, known as the "Recovery Of Erroneously Awarded Compensation" provision, provides that if an issuer is required to prepare an accounting restatement, then the issuer will be required to seek recovery of (or to "claw back") incentive-based compensation from current or former executive officers that exceeds amounts they would have been paid in absence of the restatement.

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the company's indirect payment of such amounts.

- Part 359 of the FDIC's Rules and Regulations states that civil money penalties involving financial institutions cannot be insured or paid for by the financial institution.
- More recently the FDIC has announced that it will impose a fine on any financial institution that has purchased D&O or other insurance to cover these civil money penalties.
- In May of this year, a bill was presented in the House of Representatives entitled the Executive Compensation Clawback Full Enforcement Act. The intent of the proposed law is 'to prohibit individuals from insuring against possible losses from having to repay illegally-received compensation or from having to pay civil penalties, and for other purposes."

This bill specifically references individuals affiliated with depository institutions, depository institution holding companies, or non-bank financial companies, and provides that the individuals "may not, directly or indirectly, insure or hedge against, or otherwise transfer the risks associated with, personal liability for the [civil money penalty] amounts owed. "

Although the scope of the bill is limited to individuals affiliated with financial institutions, the bill was referred to the Committee on Financial Services, and interestingly enough, to the Committee on Agriculture. A fair amount of discussion over this proposed law has already taken place. One additional comment: since insurance continues to be regulated by state law, isn't insurability still the sole purview of the states?

Market Willingness

Finally, in addition to the question of legal insurability, there is also the question of market willingness to insure. From a covered loss perspective, D&O insurance has continued to expand, even in the face of mounting financial exposures.

The increasing "noise" about more aggressive regulatory enforcement activity, and in particular, enforcement activity aimed at individuals and seeking civil and criminal fines and penalties from those same individuals, has added another layer of financial risk. The D&O marketplace has addressed this risk, by providing insurance coverage for fines and penalties at least to some degree, and at least for individuals.

Whether this coverage availability will change, either by a change in insurer appetite or by a clear legal statement on insurability, remains to be seen. ■

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