MARSH

ACADEMY OF RISK

INVESTIGATIONS AND THE OUTCOMES

MANAGING THE CRISIS WITH A D&O POLICY

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CONTENTS

INTRODUCTION

Regulatory investigations are serious matters that can result in potentially severe outcomes for companies and their directors and officers.

For directors and officers, it is of great concern that the consequences of a regulatory breach can potentially include criminal prosecution, various fines and penalties, litigation, significant legal costs and expenses, and disqualification or imprisonment.

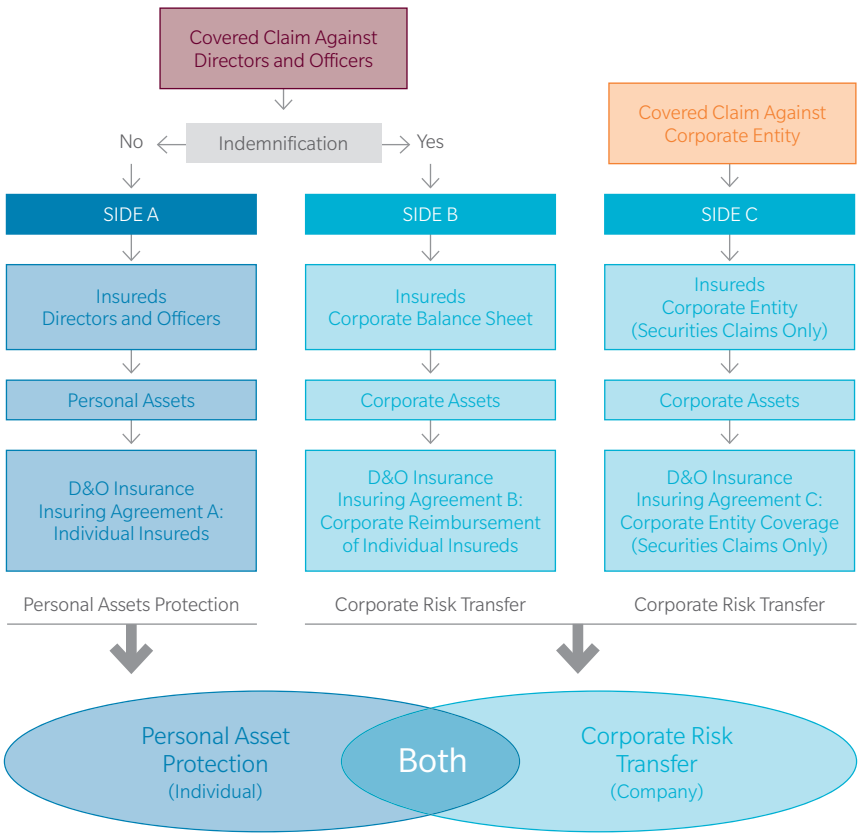
A regular stream of well-publicised cases in this area also serves as a stark reminder that regulators have become increasingly aggressive in their pursuit of investigations and prosecutions not only against companies but also their directors, officers and employees.

In this context, the following paper examines how directors and officers (D&O) liability insurance can help to reduce and contain the cost and impact of a regulatory investigation, and protect a company's bottom line as well as non-financial loss. Regulatory investigations can be complex and protracted processes, with the outcomes often presenting even greater challenges. By thoroughly understanding the coverage available in a D&O policy, and how to best preserve and protect the coverage, directors and officers will be better equipped to navigate the minefield of an investigation, should they be faced with the task.

THE STRUCTURE OF A D&O POLICY

The following diagram illustrates the basic structure and operation of a D&O policy.

D&O POLICY COVERAGE STRUCTURE



Traditionally, directors and officers (D&O) liability insurance contained two separate insuring clauses. The first clause (popularly referred to as Side A cover), pays on behalf of the individual directors and officers for losses that are not indemnified by the company. The second insuring clause (known as Side B cover), reimburses the company for payments it makes to indemnify its directors and officers. Both sides of cover apply only to loss incurred by the directors and officers in claims against them for their own wrongful acts. Neither side of cover insures a company for losses it incurs as a result of claims against the company.

Many D&O policies now include a third insuring clause (also known as Side C cover), which insures loss incurred by the company, resulting from its own wrongful acts. This coverage typically applies only to 'securities claims', and provides cover to companies for their liability in claims made against them in relation to their securities.

The majority of claims fall under the company reimbursement clause (Side B), reflecting the common practice shared by most companies in providing their directors and officers with some form of indemnity. These indemnities can be provided by a company in its constitution and/or by a Deed of Indemnity provided to individual directors. There are, however, certain claims for which it is unlawful for a company to indemnify a director.

The coverage provided directly to directors and officers (Side A cover) is triggered, depending upon the policy wording, when directors and officers are not, or cannot be, indemnified for claims against them in their capacity as such.

There are essentially two situations in which a Side A insuring agreement would typically respond:

- Where the company has a power or an obligation to indemnify one of its directors and officers, but is either unwilling or unable to do so e.g. a cash flow restraint or if the company became insolvent or was in bankruptcy.
- Where the company is prohibited[1] by law from indemnifying its directors and officers e.g. Section 199A of the Corporations Act 2001(Cth)[2] prohibits a company from indemnifying its directors and officers for various liabilities.

  Any policy that purports to indemnify a person against a liability in breach of section 199A is void[3].

It is critical therefore that a D&O policy (to the greatest extent possible) provides cover for liabilities where the company cannot indemnify its directors and officers as a matter of law, otherwise there will be no cover at all and the personal assets of directors and officers may be exposed[4].

1 See also prohibitions under section 229 of the Australian Consumer Law (ACL) and section 77A of the Competition and Consumer Act 2010 (Cth) (CCA). In 2010 the Trade Practices Act 1974 (Cth) was renamed the CCA. The ACL is included as a schedule to the CCA (now schedule 2).

2 Applies to all companies whether public or proprietary and whether commercial or non-profit. See Austin, Ford, Ramsay, *Company Directors - Principles of Law & Corporate Governance* at page 653 LexisNexis Butterworth's Australia 2005

3 Section 199C(2) *Corporations Act 2001 (Cth)*

4 Emilios Kyrou, Partner, Mallesons Stephen Jaques, *' Does the Directors & Officers Policy cover your Risks? – A Gap analysis of Company Indemnity versus the D&O Insurance Policy'*. Paper delivered at the Directors and Officers Liability and Insurance Symposium, Sydney 29 August 2006

COVER FOR INVESTIGATIONS

Coverage offered under D&O policies can vary significantly across different insurer offerings, particularly around cover for investigations and the associated financial loss.

Specific cover for investigations is a recent but rapid evolution and is now considered a critical component in a D&O policy. Whether and to what extent cover will be provided will often depend on the specific nature and type of investigation and the actual language of the policy. The analysis is often very fact intensive and as no two investigations will be the same, neither will the policy response.

Most D&O policies now expressly provide some form of cover for legal representation expenses incurred as a result of an investigation.

Cover is typically triggered when a director or officer[5] is identified in writing[6] by the body instigating the investigation.

An investigation is typically defined in a D&O policy as "a formal administrative or formal regulatory inquiry or examination by a regulatory, self-regulatory, governmental, professional, trade, statutory or official body or institution, including, a royal commission, commission of inquiry, judicial body or stock exchange that is empowered by law to investigate the affairs of an insured person in his insured capacity, or a company or to conduct a raid".

Legal representation expenses are typically defined as "reasonable defence costs which an insured person incurs on account of the attendance and/or the provision of documents or information at or to any investigation or on account of the preparation for such attendance or provision, which attendance and/or provision is required by the body instituting the investigation".

To be provided with the broadest protection in the event of an investigation, this cover should:

- Not be sub-limited. A full policy limit should always apply.
- Apply even when a wrongful act has not been alleged. This can be important in relation to investigations, as at least at preliminary stages, these can be more of an evidence gathering exercise.
- Extend to an employee of a company when the employee is involved in an investigation[7]. Retired D&O should also have the benefit of this cover[8].
- Contain an advance payment promise such that costs will be paid prior to final disposition of the investigation and within a short period of receipt of an invoice[9].

Additionally, it is important to note that cover:

- Does not extend to costs the company may incur in its own name and on its own behalf.
- Does not typically extend to informal or internal investigations or voluntary compliance with a regulator's oral requests (although wordings are rapidly evolving in this regard as discussed below).
- Is often subject to the insured obtaining the insurer's consent to their nominated defence lawyers. This consent in practice extends to the hourly rate proposed to be charged by the insured's nominated lawyers; since a typical D&O policy only requires insurer's to pay 'reasonable[10]' fees, costs and expenses.

PRE-INVESTIGATIVE COSTS

The better D&O polices now include some form of cover for costs incurred by or on behalf of directors and officers in:

- Preparing any formal notification to any regulator or official body of any actual or suspected material breach of a company's legal duty.
- Conducting any internal investigations[11] where requested by the regulator or official body following a company's formal notification.

Cover can be sub-limited and additional premium and conditions may apply.

Although limited cover is available, insurers have generally taken the view that internal investigations should be regarded as a business expense consistent with good corporate governance practices, and not operate to erode coverage under a D&O policy.

5 Or other individuals identified in the definition of Insured Person
6 Costs incurred pre- investigation and for example in self reporting breaches are unlikely therefore to be covered.
7 Refer to the definition of "Insured Person".
8 Refer to the definition of Insured Person in your D&O policy which should include any natural person who was, is or shall be a director or officer of the insured organisation.
9 **Note:** Costs advanced typically must be **repaid** by D&O severally and according to their respective interests, if and to the extent it is determined that such costs are not insured under the D&O Policy.
10 Some policies also include a "necessary" test.
11 For example costs incurred in appearing at or pre-paring for a meeting or interview or in producing documentary or electronic information.

THE AFTERMATH OF AN INVESTIGATION: WILL YOUR POLICY RESPOND?

PROSECUTIONS AND ASSOCIATED COSTS

If a prosecution is commenced by a regulator against a director or officer, this should trigger the definition of a 'claim' (including a criminal proceeding) under a typical D&O policy.

As a result, directors and officers should be covered for amounts[12] they become legally liable for in defending such a prosecution.

The better D&O policies should provide that defence costs will be advanced for or on behalf of the director or officer prior to the final disposition of any prosecution and within a short period (typically 30 days) of receipt of the invoices for such defence costs.

Typically, cover for prosecutions against a company itself is not expressly covered[13] and is unlikely to trigger the definition of claim in a D&O policy, even where Side C cover has been purchased.

CIVIL PENALTY PROCEEDINGS, FINES AND PENALTIES, AND DISQUALIFICATION ORDERS

The definition of 'claim' in most D&O polices includes, among others, any 'civil proceedings' and, consequently, cover should be available for any civil penalty proceedings that may be instigated by a regulator for statutory breaches following an investigation.

D&O policies will typically provide cover for civil fines and pecuniary penalties unless the insurer is legally prohibited from paying such fines or penalties in the jurisdiction where the claim is determined. In some D&O policies, sub-limits and jurisdictional limitations may apply. Given that a company cannot indemnify its directors and officers for civil penalties under the Corporations Act and Competition and Consumer Act 2010 (Cth) to name a few and regulators are increasingly using civil penalty proceedings as a key enforcement mechanism, this is a critically important aspect of cover.

Currently in Australia, there is uncertainty as to whether insurance cover can extend to criminal fines and penalties.

However it is important to keep in mind that most D&O policies exclude matters uninsurable at law.[14] This is for reasons of public policy on the basis that a person may not benefit from his/her own wrongdoing and, by extension, may not be indemnified against the consequences of that wrongdoing. Any insurance contract purporting to insure against such risks would be void and unenforceable. This would include any policy that purports to indemnify a person against criminal liability if the crime is committed with guilty intent.

The position is less clear where the crime is one of strict liability and the conduct of the offender is morally innocent, although the majority of commentators prefer the view that an indemnity ought to, and can be given. It may depend on whether there is an element of fault or intent attributable to the person who has committed the strict liability offence.

It might be argued that the term 'pecuniary penalty' in a D&O policy is broad enough to encompass insurable criminal penalties. In this respect a pecuniary penalty would be viewed merely meaning a monetary penalty.

Importantly, D&O policies do not cover fines and penalties assessed against the company itself.

In addition to cover for legal costs and expenses incurred in defending disqualification orders, most D&O policies will also cover:

- Reasonable legal costs incurred by an insured person to bring legal proceedings (as distinct from defending proceedings) to overturn orders disqualifying a director or officer from managing a corporation. This is an important aspect of cover given the serious consequences that follow disqualification as a company director.
- Reasonable costs and charges in hiring a public relations firm to mitigate the effects of any "published negative statements" arising from an investigation and flow on litigation;
- The cost of associated appeals.

CIVIL LAWSUITS

Follow-on civil lawsuits can take many forms while potential claimants and allegations are numerous.

All D&O policies essentially cover directors and officers for claims alleging wrongful acts and generally encompass 'any civil proceedings'. Further, the definition of wrongful acts is usually broadly defined and typically includes 'any actual or alleged breach of duty, breach of trust, neglect, error, misstatement, misleading statement, omission, breach of warranty of authority or other act done or wrongly attempted by a director or officer in their capacity as such'. On this basis, a D&O policy should respond to follow-on litigation[15].

D&O policies that afford entity coverage for securities claims (i.e Side C cover) will typically include a definition of 'securities claims' or alternate definition of 'wrongful act'. The scope of these definitions can vary significantly between policy forms. Some definitions are rather limited, applying only to claims involving the purchase or sale of securities issued by the insured company. Other definitions are broader, extending beyond claims for alleged violation of any federal or state securities law to include claims for violation of common law or, indeed, any claim brought or maintained by or on behalf of securities holders of the insured company.

Notably, some D&O policies also cover employees named as defendants in a follow-on law suit for the time that the employee is the subject of a claim, along with any director or officer or where such employee is acting in a managerial or supervisory capacity.

As a result, directors and officers (or the company in the event of a securities claim) should be covered for any 'loss'[16] they become legally liable for in defending, investigating, settling or appealing claims that often arise following an investigation.

Loss is typically defined to include damages (including compensation orders), judgments (including pre and post interest), settlements (entered into with the insurer's consent) and defence costs and other associated expenses such as claimant's costs and crisis costs.

14 Refer to the definition of "Loss" as amended by endorsement
15 Subject always to any exclusions, conditions and jurisdictional limitations.
16 Usually detailed in the definition of "Loss". Note exclusionary language often appears.

KEY POLICY EXCLUSIONS: HOW DOES THIS AFFECT THE OUTCOME?

In all D&O policies, coverage for investigations and any follow on litigation will be compromised by any policy exclusions contained.

Most D&O policies exclude the following classes (or components) of claim:

- Bodily injury/property damage – D&O insurance is a protection against financial liabilities and does not extend to cover direct liabilities for personal injury. Claims arising from bodily injury or property damage are typically covered under other policies such as general liability policies. The bodily injury exclusion in the better D&O policies does not apply to occupational health and safety defence /investigation costs, or mental anguish or emotional distress in connection with an 'employment claim'.
- Pollution – Pollution exposures are typically covered under general liability or environmental liability policies. Notwithstanding this exclusion, most D&O policies will offer limited cover for certain environmental claims. Clean-up costs are, however, generally excluded.

- Prior known matters, suits or proceedings – Such matters should have been notified in the period in which the claim, or circumstances giving rise to a claim, arose. Some relief may be available in D&O policies that contain a 'continuity of cover' extension.
- Professional services – D&O insurers do not intend to cover acts, errors or omissions committed by an insured in the performance (or non-performance) of professional services. Such exposures are typically covered under professional indemnity policies.
- Insured v Insured claims – Most D&O policies contain this exclusion, which was developed to avoid the situation of companies bringing lawsuits against their directors in order to trigger a claim (and payment) under the D&O policy. This exclusion may adversely impact a shareholders derivative lawsuit unless one of the exceptions can be seen to apply[17]. The better D&O policies only exclude USA-related insured versus insured claims, subject to certain write backs.
- Fraud and dishonesty – No D&O policy will provide cover to an insured person for his or her own criminal, dishonest or fraudulent acts or omissions. Any profit or advantage gained by an insured person to which he or she has no legal entitlement is also generally excluded. To the extent provided for by the severability and non-imputation provisions, innocent insureds will be entitled to cover.

  In the better D&O policies, this exclusion does not apply to defence costs or other expenses advanced under the D&O policy until a final, non-appealable adjudication in any proceeding establishes the excluded conduct; in which case any costs advanced will need to be repaid.
- Matters uninsurable at law – This exclusion can extend to any cover that the policy may provide for fines and penalties. Notably, some D&O policies specifically exclude cover for any fines and penalties.

17 The exclusion does contain a 'whistleblower and non collusion exception' as well as for Defence Costs and other expenses.

IMPORTANCE OF NOTIFICATION

D&O policies are issued on a 'claims made' basis, which means that the policy covers claims, including investigations, made during the policy period and reported during the policy period (or the extended reporting /discovery period if that option is purchased).

Claims made policies do not require the incident resulting in a claim to have taken place within the policy period.

The better D&O policies also expressly provide for the notification of circumstances likely to give rise to a claim and, consequently, provide cover for claims made outside the policy period if notification took place within the policy period.

Even where a D&O policy does not explicitly provide for the notification of circumstances likely to give rise to a claim, policyholders have a statutory right[18] to notify insurers of any potential claim. Any notification of a potential claim must be made as soon as reasonably practicable and before the end of the policy period.

While investigations and follow on litigation can move quickly and often deal with commercially sensitive and confidential information, it is important that companies pay close attention to the definition of a claim, and follow the notification and claims handling conditions as set out in the policy so as to not prejudice cover when it is most needed.

Problems can arise when a company, director or officer fails to notify insurers at the point it first receives notice of a charge or complaint of potential contraventions, instead only reporting the matter when a lawsuit is filed. This is even more critical if the charge or complaint was made prior to the inception of the policy[19]. Consider that many a class action lawsuit started with a single individual's complaint.

18 by virtue of section 40 of the Insurance Contracts Act 1984 (Cth).
19 All D&O policies contain Prior Notice and Prior Litigation exclusions.

The late notification of claims or circumstances creates unnecessary difficulties between the insured and the insurers. While there is still potential for cover to be provided in certain circumstances, it is not guaranteed, with late notification disputes often requiring a court adjudicated outcome. To avoid these complications, always notify any claims or circumstances promptly and during the policy period.

It is therefore important that companies and their directors and officers:

- are aware of the period of cover;
- review all claims and 'potential claims';
- notify immediately any circumstances (i.e. complaints) likely to give rise to a claim or investigation during the policy period, so as to not prejudice the benefit of cover under the policy for any subsequent claim that may arise. All claims should be notified on receipt;
- do not make any admissions or engage in settlement discussions which may prejudice your insurer's subrogation rights; always seek insurer's consent for strategy and settlement;
- follow the policy's notice requirements. Each insurer's claim reporting requirements often differ by varying degrees;
- retain appropriate experts early and always with the insurer's consent;
- keep a record of all notifications made to insurers and keep insurers informed of developments at all times.

CONCLUSION

Being the subject of an investigation is a serious matter and not just for the company. Directors and officers can personally face significant fines and disqualification periods. Further, both the company and its directors and officers can be the subject of protracted and costly follow on litigation and unavoidable damage to reputation.

As investigations by regulators often result in adverse findings and give rise to civil or criminal proceedings against directors and officers[20], assurances that directors and officers are covered for legal representation, defence costs and the payment of fines and penalties is critical.

Against the current climate, where both regulatory investigations and civil action have become more aggressively pursued, it is important for directors and officers to be confident that the D&O policy is structured to provide them with the broadest cover possible.

20 Refer to Emilios Kyrou article in footnote 4.

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