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Father Knows Best

The SEC continues to improperly insert itself between officers and directors and their insurance defense policies.

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The U.S. Securities and Exchange Commission (SEC) continues to make headlines, not always in a positive fashion, regarding its often-changing statements on major enforcement priorities in areas like digital assets and environmental and social governance disclosure. On September 14, 2021, Gary Gensler, the current SEC chair, appeared before the U.S. Senate Banking Committee. During the committee's questioning, Senator John Kennedy pointedly asked Gensler the following question: "The people and the companies you regulate as chairman of the SEC, do you consider yourself their daddy?" Of course, Gensler denied such a characterization. But the SEC's actions speak louder than its denial.

With press releases about SEC enforcement actions (subscription required) against officers and directors issued on an almost daily basis, serving in such a role for a company can be a very risky undertaking and can even lead to an SEC enforcement action. Directors' and officers' (D&O) liability insurance is supposed to help mitigate that risk by protecting the personal assets of directors and officers from personal liability. *See* Jon Eisenburg, "Surviving an Age of Individual Accountability: How Much Protection Do Indemnification and D&O Insurance Provide?," *K&L Gates*, May 21, 2014; Yaron Nili, "How Much Protection Do Indemnification and D&O Insurance Provide?," *Harv. L. Sch. F. on Corp. Governance & Fin. Reg.*, May 28, 2014. With an apparent perspective that indemnification from any source, including insurance proceeds, is against public policy and unenforceable under any circumstance, the SEC is effectively inserting itself into insurance coverage questions by forcing anti-indemnification provisions on defendants and respondents in its settlement documents—a practice riddled with problems, such as the unauthorized impairment of preexisting contractual rights and obligations.

In this article, we focus on the SEC's practice of inserting itself in D&O insurance coverage questions by unilaterally using anti-indemnification provisions in its settlement documents to ensure that no insurance funds are used to pay an SEC settlement. Specifically, we posit that the SEC should not be able to interfere with the legally valid and binding relationship between insurer and insured without explicit statutory authority and on the basis of questionable public policy justifications. Although the SEC has a long history of attempting to expand its authority to regulate certain products or practices by simply acting as though it has already been authorized to regulate those new sectors, products, or practices (Eisenburg, *supra*; Nili, *supra.*; *see also* *SEC v. Conaway*, 697 F. Supp. 2d 733, 772 (E.D. Mich. 2010)), the SEC should not be allowed to expand its authority to interfere in contractual insurance arrangements by taking regulatory actions.

As discussed below, payment of fees and costs pursuant to an existing insurance agreement should not be subject to the SEC's jurisdiction except in isolated situations, such as an asset freeze and appointment of a receiver. Subject to explicit coverage limitations and exclusions, D&O liability insurance policies are intended to ensure that adequate resources will be available to fund the defense of an insured and to pay a covered settlement or judgment. Corporate executives often look to D&O policies as a last line of defense when they are facing regulatory actions. *See* Dan Bailey & Tom Geyer, "SEC's Dim View of Indemnification Darkens," *Bailey & Cavaliere LLC Client Alert*, Jan. 19, 2005 (describing the SEC's actions as motivated by public policy). In the end, directors and officers just want to know that their company's D&O policy will cover defense costs and any amounts due to the SEC for wrongful acts when a case is settled or a final, non-appealable judgment is entered. Understanding how the SEC treats proceeds of applicable D&O policies in the context of a settlement or judgment is therefore important as corporate executives navigate the ever-increasing complexity of SEC regulatory actions, actions in which neither their D&O insurance nor their company may be able to reimburse them.

Can Directors and Officers Use Insurance Proceeds to Pay SEC Civil Monetary Penalties?

Being a director or officer of a public (or private) company creates significant risk for any individual willing to take on such a role. Eisenburg, *supra*. Exposure to risk increases exponentially when the company or its actions fall under the scrutiny of the SEC. *Id*. And wherever there is an attempt to mitigate risk, insurers are eager to answer the call to assist in reducing that risk for the right price. Although regulating an insurance transaction is facially outside the scope of the SEC's authority, as mentioned above, historically, the SEC has pushed into other analogous areas without a clear delegation of authority. And, while many companies rely on protective measures like D&O insurance to guard their balance sheet assets (Jeff Hirsch, "What We Can Learn From Twitter's $809.5M SEC Settlement," *Shield*, Oct. 5, 2021), to attract investment capital, and to attract and retain strong leaders, the SEC's insistence on anti-indemnification provisions for settlements poses a challenge to these goals.

Currently, every time a defendant settles a civil injunctive action with the SEC during the investigation phase or after the action is filed, the following provision is included in the consent or offer of settlement:

> Defendant agrees that s/he shall not seek or accept, directly or indirectly, reimbursement or indemnification from any source, including but not limited to payment made pursuant to any insurance policy, with regard to any civil penalty amounts that Defendant pays pursuant to the Final Judgment, regardless of whether such penalty amounts or any part thereof are added to a distribution fund or otherwise used for the benefit of investors.

Recent examples of enforcement actions using this language are *Securities & Exchange Commission v. Honig*, No. 18 Civ. 8175 (ER), 2020 WL 1150449, at *5 (S.D.N.Y. Mar. 6, 2020), and *Securities & Exchange Commission v. Govil*, No. 21 Civ. 6150 (JPO), 2021 WL 3188325, at *5 (S.D.N.Y. July 28, 2021) [subscription required].

The area of director and officer indemnification is complex and raises problematic factual and legal issues even without the complication added by the SEC's routine use of such anti-indemnification provisions. And, as written, no amount of transactional structuring, including indemnification planning or pre-settlement insurance policy buyouts, are able to facilitate insurance contribution to a settlement without the risk of running afoul of the SEC's non-indemnification provisions. Ultimately and unfortunately, directors and officers may be forced to forgo the financial protection that insurance is intended to provide, even when their acts were not intentionally wrongful or fraudulent, subjecting their personal assets to risk unnecessarily. Bailey & Geyer, *supra*.

Is an Entitlement to Pay Defense Costs under a D&O Policy an Asset of the Insured, or Can the SEC Interfere with a Prior Insurance Contract Between an Insurer and an Insured?

If insurance coverage intended to defend and indemnify an insured is considered an asset of the insured, then it is logical to conclude that an insured can offer to "buy out" a policy for substantially less than the policy limits, selling the asset, and then use that money (now the insured's money) to pay civil penalties in an SEC settlement action. However, the SEC's routine use of anti-indemnification provisions and its demand to always know the source of funds used to pay any penalty suggest the SEC will not allow a pre-settlement insurance policy buyout to fund a settlement involving civil penalties.

When individuals or entities enter into indemnification agreements or insurance contracts, most have no idea the SEC may, sometimes years down the road, choose to bring an enforcement action against them in which insurance proceeds will not be allowed to contribute to a resolution. Arguably, the SEC's indemnification position violates the Contracts Clause and the prohibition of ex post facto laws in the U.S. Constitution. Ex post facto laws are expressly forbidden by the Constitution in Article 1, section 9, clause 3 (with respect to federal laws) and Article 1, section 10 (with respect to state laws). *See also* Steve Selinger, "The Case Against Civil Ex Post Facto Laws," 15 *Cato J.* 191, 211 (1995). And, although the SEC's position was not created by the passing of a "law," the SEC does make law in this context by bringing (and primarily settling) enforcement actions. Indeed, the SEC often refers to its settled matters as precedent for its current enforcement activity, so the analysis is instructive and a relevant criticism of the SEC's anti-indemnification settlement provisions. *See* Alexander I. Platt, "SEC Administrative Proceedings: Backlash and Reform," 71 *Bus. Law.* 1, 23 (Winter 2015–2016) (noting that over time, settlements add up into a body of agency "precedent" and that a former SEC commissioner has suggested that it is easier to set new legal standards through adjudication than by rulemaking).

Purposes of D&O Insurance and Standard Insurance Policy Language

D&O policies are generally designed to cover loss (including defense costs, settlements, and judgments) incurred by insureds arising from certain claims brought against them for "wrongful acts" (acts, errors, omissions). "Insureds" can encompass the company itself and its directors and officers (and their functional equivalents acting in their capacities as such). D&O policies generally provide three core coverage parts or "sides":

- **Side A** protects solely the individual directors and officers by paying the defense costs and liability levied on them due to a claim, lawsuit, or regulatory proceeding. Side A will only pay the individual directors and officers when their company is unable (i.e., insolvent) or is unable to legally do so.

- **Side B** indemnifies the company after it has paid the individual insureds named in the claim, lawsuit, or regulatory proceeding.

- **Side C** indemnifies the company insured, should it be named, often along with the individual directors and officers in a claim, lawsuit, or regulatory proceeding. This coverage protects the balance sheet of the company insured and will reimburse defense costs, settlements, or judgments incurred. It is not always required that an individual insured director or officer be named as a defendant for the coverage to apply.

Many companies believe D&O insurance covers executives for all misconduct, but just like most other insurance policies, the coverage definitions and the exclusions often seriously carve back the coverage provided. *See* Stephen D. Allred, "Key Issues in Evaluating and Negotiating D&O Insurance Coverage," *Notes Bearing Interest*, June 2014, at 22. For example, most D&O insurance will not provide coverage for what many would consider the worst acts of the directors or officers: dishonesty, fraud, and criminal or malicious acts committed deliberately. *Id.* However, because D&O insurance is intended to provide for a defense against allegations of such intentional, wrongful conduct, most D&O policies also provide that the insured will be entitled to have defense costs paid by the insurer unless or until a final, non-appealable judgment or admission of such intentional, wrongful conduct. *Id.* D&O insurance is also the financial backing for a company's standard indemnification provision, which holds directors and officers harmless for losses (including defense costs) due to their role in the company. Many directors and officers require that their company agree to both indemnification promises and to provide company-procured D&O insurance as a condition of their accepting the position.

The SEC Should Not Be Allowed to Interfere with the Indemnification Rights under Prior Contractual Insurance Agreements

Relying on a public policy rationale, the SEC apparently believes that denying insurance indemnification increases the likelihood that an individual will feel a deterrent effect and not commit violations in the future. *See* Speech by SEC Chairman William H. Donaldson: Remarks Before the New York Financial Writers Association (June 5, 2003). However, the SEC's anti-indemnification provisions themselves arguably violate public policy by interfering with a company's ability to attract and retain qualified executives and board members. For most organized business entities and their executives, it is crucial to have a comprehensive and predictable insurance program in place. The SEC should not place this sort of restraint on a company, preventing it from attracting and retaining valued directors and officers.

Public Policy Concerns

The SEC believes that public policy can be a basis for limiting indemnification under other regulatory or law enforcement laws where Congress *specifically* intended personal liability as a deterrent. For example, Congress expressly prohibited indemnification of individuals adjudged liable under the Foreign Corrupt Practices Act of 1977. 15 U.S.C. § 77dd-2(g)(3). In addition, Congress and courts have found indemnification unavailable for liability under the Racketeer Influence and Corrupt Organizations Act (RICO). 15 U.S.C. § 78ff(c)(3). *See Plato v. State Bank of Alcester*, 555 N.W.2d 365, 368 (S.D. 1996); *Sequa Corp. v. Gelmin*, 851 F. Supp. 106, 108 (S.D.N.Y. 1994) ("Indemnification is unavailable for RICO liability because it would be contrary to public policy. . . ."). Although each of these situations involves a specific congressional delegation of authority, the SEC has *not* been given specific statutory authority to prevent indemnification against claims under the registration and antifraud provisions of the federal securities laws.

The SEC's Lack of Any Statutory Authority for Its Anti-Indemnification Stance

When enacting statutes addressing the availability of indemnification, Congress has sought to balance two conflicting interests. *See* Paul S. Atkins & Bradley J. Bondi, "Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program," 13 *Fordham J. Corp. & Fin. L.* 367, 411 (2008) ("There should not be institutional encouragement for using discretion to formulate theories of liability that overstep the boundaries of existing law. Law making is reserved for legislative process in Congress and the SEC rulemaking process under the strict requirements of the Administrative Procedure Act; it is not a function of the Enforcement Division."). On the one hand, legislators have recognized the need to punish violators, thereby creating a deterrence against improper conduct. On the other hand, they have referenced a desire to reduce the risk of being a director or officer. Most importantly, Congress has yet to provide the SEC specific statutory authorization to bar the indemnification of directors and officers. To the contrary, Congress has articulated a clear desire to avoid restraints on finding the most qualified executives. *See generally* William W. Bratton & Michael L. Wachter, "The Political Economy of Fraud on the Market," 160 *U. Pa. L. Rev.* 69, 139 (2011).

In addition, some state statutes, to prevent regulatory overreach, require a balancing of these interests by crafting indemnification statutes that permit financial protection as long as the insured's actions satisfied "good faith" standards of conduct. *See* 8 Del. Code § 145(a) and (b); Ohio Rev. Code § 1701.13(E)(1). This commonsense alternative provides an incentive to those serving as officers or directors to act in good faith in order to limit risk, obviating the need for the SEC's position on indemnification. The "good faith" standard may be satisfied even if the insured agrees to penalties as part of a "no admit" settlement and, therefore, no finding of bad faith. *Commodity Futures Trading Comm'n v. Richards*, 1996 WL 199729, at *4 (N.D. Ill. Apr. 23, 1996) [subscription required]. Under these statutes, a determination of whether indemnification is proper in a given circumstance should be made by disinterested and independent members of the board, by special counsel appointed by the board, by shareholders, or by a court. The SEC, however, does not have unfettered authority to interfere in prior contractual rights or the policy determinations made by state legislatures, nor does it consider whether the underlying conduct was in "good faith." Nonetheless, the SEC seems to be using its stated deterrent mission as the impetus to insert itself into indemnification decisions in a way that limits financial protections for directors and officers.

The SEC's Requirement of Waiving Indemnification Even in Settlements of Non-Scienter Violations

D&O coverage typically involves an analysis of whether or not the executive engaged in intentionally wrongful, fraudulent, or criminal conduct. Beyond those types of ultimately excluded actions that can be charged by the SEC, notably, the SEC can also charge directors and officers with registration violations under section 5 of the Securities Act and even violations of section 17 of the Exchange Act, which require only a finding of negligence. In any given case, the SEC can allege both intentional and unintentional violations. Thus, by insisting on its anti-indemnity provisions in all settlements, the SEC is requiring the waiving of insurance coverage indemnification to directors and officers even where the required mens rea would otherwise entitle them to insurance coverage.

Conclusion

In sum, companies and their directors and officers should be able to know that a company's D&O policy will cover defense costs and covered amounts due to the SEC by settlement or final judgment, without fear that the SEC will impose anti-indemnity provisions that preclude their bargained-for insurance coverage. Because the SEC has not been given specific statutory authority to bar indemnification, it should not be allowed to insert itself into this risk allocation between insurer and insured under a D&O policy. For this reason, a renewed focus on the D&O policy asset and developing effective strategies to challenge or avoid this SEC practice is recommended as directors and officers navigate the ever-increasing complexity of indemnity for SEC regulatory exposures.

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