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CORPORATE INSURANCE LAW

Expert Analysis

Insurance for the Costs of Defending Regulatory Investigations

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When our clients in the financial services industry ask us to identify the important risks covered by their directors and officers (D&O) insurance policies or, perhaps more bluntly, when they ask "why do we need management liability insurance?" increasingly, we emphasize the coverage available for the costs of defending against a regulatory investigation. Those who have been the target of a Securities and Exchange Commission (SEC) investigation can attest to the fact that defense costs can accrue quickly and may ultimately run in the millions of dollars, particularly given the costs of searching and producing emails and other electronic data that may be necessary to respond to a subpoena. In addition, where the insured entity is unable or refuses to indemnify individual executives for their defense costs, an insurance policy may be the only feasible way of funding their defense. Fortunately, over the last several years, the scope of coverage available for defense costs related to regulatory investigations has expanded in D&O policies issued to private investment managers and investment funds.

Advancement of Defense Costs

Typically, D&O policies are claims-made policies which insure loss arising from a claim against the insured for a wrongful act. To trigger the policy and the insurer's duty to advance defense costs, there must be a claim within the scope of the policy terms. Consequently, whether coverage is available for defense costs incurred in connection with a regulatory investigation most often depends upon the policy definition of "claim."

A decade or so ago, D&O policies provided limited, if any, coverage for defense costs associated with regulatory investigations. Over the last several years, however, the definition of claim has gradually expanded. Early progress was made when insurers began recognizing a Wells Notice as a claim. Next, insurers began including formal investigations of insured persons and subpoenas issued to insured persons in connection with such formal investigations within the definition of a claim. Today, many policies include a regulatory subpoena issued to any insured in connection with the formal investigation of an insured person or insured entity within the definition of claim.

Fortunately, over the last several years, the scope of coverage available for defense costs related to regulatory investigations has expanded in D&O policies issued to private investment managers and investment funds.

In addition, many current policy forms have broadened the definition of claim further, thereby expanding coverage for defense costs to include the costs incurred in

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connection with any written request from a regulatory agency for documents or testimony associated with a regulatory investigation or inquiry of an insured, even if the investigation or inquiry is informal. Alternatively, some insurers now offer retroactive coverage for certain pre-claim costs related to investigations. For example, where an insured provides notice of circumstances to the insurer of a regulatory investigation or inquiry that does not satisfy the requirements of the definition of claim, if the same circumstances subsequently result in an investigation that does constitute a claim, the insurer will cover the defense costs incurred from the date of the initial notice.

Even with these broader coverage options, it is important to remember that the insurer's obligation is limited to a duty to advance defense costs. That means that if the investigation or subsequent proceeding against the insured following the investigation establishes that a policy exclusion bars coverage—for example, an insured is found liable for intentional wrongful conduct or fraudulent conduct—the insurer may have the right to recoup the advanced defense costs from the wrongdoer.

Although D&O policies do not typically cover fines and penalties assessed or negotiated to resolve regulatory investigations, nor do they typically cover related disgorgement of profits, many financial services insureds have come to recognize the value of defense cost coverage for regulatory investigations, and the insurance market has responded by expanding that coverage.

'Freedom Specialty'

Recent court decisions demonstrate that the courts also understand the importance of advancement of defense costs related to regulatory proceedings, particularly where the insureds have no other option for funding their defense. For example, in *Freedom Specialty Insurance Co. v. Platinum Management (NY)*, No. 652505/2017, 2017 WL 6610417 (New York County, Dec. 27, 2017), the Supreme Court issued an injunction directing certain excess insurers to pay the legal expenses incurred by their insureds in criminal and civil proceedings as the expenses accrue, subject to recoupment if a final adjudication establishes that the insureds' alleged wrongdoings fall within the policy exclusions.

In *Freedom Specialty*, the insureds were the subject of a criminal prosecution by the U.S. District Attorney for the Eastern District of New York, a civil enforcement action by the SEC and a parallel civil action in state court in Texas, each of which arose out of an alleged scheme to defraud investors. Initially, the primary insurance carrier acknowledged coverage and agreed to advance the insureds' defense costs. When the $5 million primary policy was exhausted by payment of those legal expenses, the first layer excess insurer assumed the obligation to advance. However, when the $5 million first layer excess policy was also exhausted, the insurers in the next three excess layers refused to advance the defense costs, leaving the insureds with no way to fund their legal defense.

The three remaining excess insurers (collectively representing an additional $15 million in policy limits) disclaimed coverage and filed a declaratory judgment action seeking an order declaring (i) that the excess insurance policies are deemed void because the insureds breached a warranty statement in the policy application by falsely representing that they were unaware of any wrongful act that might result in a claim; and (ii) that the Prior or Pending Demand or Litigation (PPL) Exclusion barred coverage under the policies.

Insureds Seek Preliminary Injunction

The insureds filed a motion for a preliminary injunction seeking an order directing the excess insurers to advance their defense costs immediately. The insureds argued that, in the absence of an order requiring advancement, they would suffer irreparable harm because they would be without coverage for defense costs at a critical point in the criminal proceedings. In fact, they argued that their defense was already suffering because they had been unable to retain expert witnesses critical to rebutting allegations regarding the financial transactions at issue.

Upon review of the motion, the trial court first found that the insureds had demonstrated a likelihood of success on the merits. The court determined that the insureds' failure to disclose an unrelated subpoena

issued in connection with a Southern District of New York (SDNY) proceeding concerning the alleged bribery of a public official did not constitute a breach of the warranty statement. The court also determined that the excess insurers had not established that the PPL Exclusion was applicable because they had not shown that the prior pending SDNY proceeding arose out of the same facts and circumstances as the EDNY and SEC proceedings. Finally, since the insureds had not been found guilty of any of the allegations in the EDNY or SEC proceedings, the policy exclusions regarding intentional wrongdoing did not relieve the insurers of the obligation to advance.

Next, the court found that the insureds would suffer irreparable harm if the insurers were not required to advance defense costs. As the court explained, "without preliminary injunctive relief, the [i]nsureds will be irreparably harmed because they will be unable to mount adequate defenses, particularly in the EDNY criminal proceedings, where, according to the [i]nsureds, critical pre-trial motions were due in November, the government has already produced approximately 15 million pages of documents with discovery still ongoing and the [i]nsureds are in need of funds to pay for the expert witnesses and consultants that are essential to their defense." The court's holding in this regard is consistent with other rulings in which New York courts have held that, under certain circumstances, the failure to receive timely advancement of defense costs may constitute "an immediate and direct injury" to an insured that is sufficient to satisfy the irreparable harm standard. See, e.g., *XL Specialty Insurance v. Level Global Investors,* 874 F. Supp. 2d 263 (S.D.N.Y. 2012).

Finally, the court determined that the balancing of the equities also favored requiring the insurers to advance defense costs. The insureds faced the prospect of defending against serious criminal and civil charges without the funds necessary to adequately defend themselves. In contrast, the insurers merely faced the economic risk of advancing defense costs with the possibility of recouping the costs if a final adjudication established that the insureds were not entitled to coverage. As the court emphasized, "the harm that the [i]nsureds may suffer stemming from being unable to adequately defend themselves, including potentially losing their liberty, outweighs any possible economic loss that" the insurers may incur.

Based on these findings, the court granted the insureds' motion and ordered the excess insurers to pay legal expenses in both the criminal and civil proceedings as the expenses accrue, subject to recoupment up to the policy limits if a final adjudication establishes that the insureds' conduct triggers the policy exclusions for intentional illegal or fraudulent conduct. The court also granted the insureds' motion to stay discovery pending final resolution of the civil and criminal proceedings.

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Looking Forward

After a record year in 2016, the SEC's filing of new enforcement actions reportedly slowed a bit in 2017. Nevertheless, SEC investigations and enforcement proceedings remain a significant concern for insureds in the financial services industry and provide a strong incentive for insureds to maintain D&O insurance. In that respect, the gradually expanding coverage available for defense costs associated with regulatory investigations is good news for insureds.

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