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How the New SEC Settlement Policy Affects Your D&O Coverage

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On January 6, 2012, the Securities and Exchange Commission announced a change in a policy that had previously permitted companies and their directors and officers to "neither admit or deny" allegations as part of any SEC settlement, notwithstanding any prior admissions in a criminal investigation or prosecution. The change raises important considerations for D&O liability policyholders.

New Policy Extends to Additional Admissions

According to SEC enforcement director Robert Khuzami, the SEC, reversing long-standing policy, will no longer permit companies or individuals to "neither admit or deny" allegations that have formed the basis of a conviction or have been admitted to in parallel criminal investigations or proceedings. The SEC's new policy is not limited to cases in which there has been a conviction in a parallel criminal proceeding, but also appears to extend to any admissions made as part of a "non-prosecution agreement" or "deferred prosecution agreement" in a criminal prosecution or investigation.

Non-prosecution and deferred prosecution agreements have become an increasingly frequent tool used by the government to resolve corporate criminal proceedings or investigations. Typically, these agreements involve the government's agreement to forgo prosecution in return for some combination of an admission of responsibility or facts, monetary penalties, cooperation and remediation steps. In contrast to deferred prosecution agreements, non-prosecution agreements are not filed with the court, but both are public documents.

Admissions of facts or allegations made by a policyholder in a non-prosecution agreement, deferred prosecution agreement or civil SEC settlement may result in a policyholder's D&O insurance company asserting that such admissions trigger exclusions that may bar coverage for all related civil and criminal matters. Typically, D&O policies contain so-called "conduct" exclusions that may exclude coverage for claims involving: 1) any dishonest, fraudulent or criminal act or omission by an insured; 2) any willful or intentional violation of any statute, rule or law by an insured; or 3) the gaining of any profit, remuneration or advantage to which an insured is not entitled. In many D&O policies sold in recent years, however, these conduct exclusions will only be triggered if the prohibited conduct has been established by a "final adjudication."

When is the Final Adjudication Triggered?

Many courts traditionally have interpreted the final adjudication trigger to require a final judgment by a court or other tribunal establishing the prohibited conduct and generally have held that a settlement does not meet the final adjudication standard. Few courts, however, have considered whether an admission of facts contained in a non-prosecution agreement, deferred prosecution agreement or civil settlement meets the final adjudication trigger.

In *International Association of Chiefs of Police, Inc. v. St. Paul Fire and Marine Insurance Co.*, however, the court considered whether admissions in a settlement with the government in connection with a criminal investigation were sufficient to trigger a conduct exclusion that required that the prohibited conduct be "proven." In this case, the government and policyholder entered into settlement in which the policyholder admitted to overcharging the government and paid the government restitution. The policyholder made a claim for defense costs, which the insurance company denied on the basis of the exclusion barring coverage for dishonest acts and unlawful profits. In rejecting the policyholder's position, the court held that the admissions of dishonesty and unlawful profit in the settlement agreement were proven for insurance coverage purposes.

Although *Association of Chiefs of Police* did not consider whether an admission in a settlement agreement constituted a final adjudication sufficient to trigger an exclusion, the court's reasoning illustrates the argument that D&O insurance companies may advance in connection with admissions made by companies or D&Os in non-prosecution agreements, deferred prosecution agreements or civil settlements. Good arguments exist, however, that such agreements or settlements do not constitute a final adjudication for the purposes of triggering a conduct exclusion insofar as they are not the judgment or decision of a tribunal. In addition, even assuming that admissions in a non-prosecution, deferred prosecution or settlement agreement are sufficient to trigger a conduct exclusion, "severability" provisions in a D&O policy—which govern whether one insured's

conduct is imputed to another for the purposes of coverage—may significantly narrow the application of the exclusions to the individuals whose conduct formed the basis of the admissions.

Policyholders should be aware that admissions of wrongdoing or responsibility in settlements with government agencies might lead to attempted D&O coverage denials for all related litigation. Whenever possible, therefore, policyholders should consider carefully in advance how best to position themselves to maximize the likelihood of overcoming any coverage denial. ■

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