

Study Tour USA:

The Impact of the Dodd-Frank Act on the U.S. D&O Liability Insurance Market

Introduction

The Global Financial Crisis, started in late 2007 and in many ways still ongoing, is by many economists considered the worst financial crisis since the Great Depression of the 1930s.

During our visits to various insurance companies, brokers and regulatory organizations in the U.S., it was obvious that this economic upheaval has had a major impact on the American insurance industry. Already at our first visits to the AIA (American Insurance Association) and the NAIC (National Association of Insurance Commissioners), there was much talk about the Dodd-Frank Act and its impact and implications for the insurance industry.

As a Directors and Officers (D&O) underwriter, I wanted to know more about this Dodd-Frank Act and if and how these controversial new regulations, derived from the Global Financial Crisis, has changed the conditions for the D&O liability insurance (D&O insurance) market in the U.S. However, if the intention of the Dodd-Frank Act is to regulate the U.S. market, it will most certainly have an impact on the rest of the world.

D&O Liability Insurance

D&O insurance are indemnity policies that provide coverage for claims made against corporate directors and officers, or the corporation itself. D&O insurance protects the corporate executives and board members from liability, derived from wrongful acts relating to the company's business. Wrongful acts include omissions, errors, misstatements, misleading statements, neglect or breach of duty.¹

The market for D&O insurance has grown rapidly in the U.S. and throughout the industrialized world over the last thirty years. New interpretations of company law in the United States in the late 1970s made the directors and officers more easily accountable for the results of their actions, which led to an increase in demand of D&O protection.²

D&O insurance represents an increasing proportion of corporate risk management and is under constant development in order to meet the companies' emerging needs of coverage. It is no

¹ http://www.riskglossary.com/link/d_and_o_insurance.htm

² <http://www.agcs.allianz.com/assets/PDFs/risk%20insights/AGCS-DO-infopaper.pdf>

longer an insurance solution only for large listed companies. Today, also small and medium sized companies and organizations buy D&O insurance. Along with this, there is a clear increase of insurance companies offering D&O coverage.³

In a global perspective, the D&O insurance market has a gross written premium volume of an estimated ten billion USD. About two thirds of this amount is attributable to the U.S. market, explained by the size of its economy and corporations but also because of its litigious society.⁴

The Dodd-Frank Act

Since late 2007, the world has experienced the worst financial crisis since the severe economic depression of the 1930s. Tremendous value of assets has been lost all over the world and unemployment in many countries has been severe. Many large financial institutions have gone bankrupt and major stock markets worldwide have lost much of its value. In many countries, governments have spent immense amounts of money to keep banks and other businesses afloat.⁵

As a response to the financial crisis, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act⁶) into law on July 21 2010. The Dodd-Frank Act brings the most determined changes in the regulatory system of the U.S. financial services industry since the Great Depression.⁷ The aim was to increase the federal government's control over the economy and “promote the financial stability of the United States by improving accountability and transparency in the financial system,” “end ‘too big to fail,’” “protect the American taxpayer by ending bailouts,” and “protect consumers from abusive financial services practices.” Furthermore, the act intended to “increase investment and entrepreneurship,” and “foster competitiveness, confidence in our financial sector, and robust growth in our economy.” Finally, the new law of Dodd-Frank aimed to “bring greater economic security to families and businesses across our country.”⁸

In order to achieve this, more types of financial businesses and products will be reviewed under U.S. federal control. A council of regulators will monitor the financial system and be given the power to direct large financial institutions that get into trouble, or to close down those who pose a threat to the nation’s financial health. A new Consumer Protection Agency will be assembled in order to protect buyers of financial products.⁹ The Dodd-Frank Act will grant the

³ <http://www.bizjournals.com/portland/print-edition/2011/09/09/market-grows-for-do-insurance.html?page=all>

⁴ <http://www.agcs.allianz.com/assets/PDFs/risk%20insights/AGCS-DO-infopaper.pdf>

⁵ <http://news-basics.com/2010/financial-crisis/>

⁶ Named after Barney Frank and Chris Dodd, members of the Congress, due to their involvement with the bill

⁷ <http://financialservices.house.gov/UploadedFiles/FinancialServices-DoddFrank-REPORT.pdf>

⁸ <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>

⁹ <http://news-basics.com/2010/financial-crisis/>

Nordisk försäkringstidskrift 3/2012

U.S. governmental authorities more funding, more information and a discretionary authority to write and interpret new rules.¹⁰

Not everyone has welcomed the new financial reforms. Criticism has been fierce from both sides of the political scale, claiming that the reforms are insufficient to avert another financial crisis or to bail out ailing financial institutions. On the other hand, some will argue that the reforms are too broad and will cripple the U.S. banking and financial market's daily operations.¹¹

Adapting to New Conditions

An increasingly active regulatory environment will affect the landscape for the U.S. D&O insurance industry. With the Dodd-Frank Act in place, companies are more than ever under supervision and need to adapt to these new conditions and to be compliant to current regulations.

The Dodd-Frank Act calls for increased SEC (Securities and Exchange Commission) enforcement activity, leading to more claims targeted at directors and officers. Shareholder related lawsuits increase in number as disappointed investors argue that declining stock prices is a result of mismanagement and want to hold the corporations and their senior executives accountable. Claims in securities fraud have greatly increased in number with large settlements and defense costs consequently. Time-consuming and expensive litigations have become more common.

Because of a more regulated and litigious environment, companies need to evaluate what kind of D&O coverage to buy in order to attract coveted directors and officers. Today, more than ever, directors and officers are interested in indemnification rights under the company's D&O insurance policy. To offer an extensive D&O insurance has become a prerequisite in order to recruit and retain experienced and qualified decision makers to the company.¹²

Prior to the Dodd-Frank Act, internal investigations were rarely covered under the D&O policies as these were considered uninsurable costs of doing business. As the D&O insurance market is transforming, several insurance companies have expanded their coverage and broadened their policy terms and conditions in order to get hold of new exposure opportunities. As the purchased D&O limit increasingly is being used for expensive regulatory investigations, it has become more important for the policyholder to separate most of the coverage for litigation-related costs and settlements of claims against the directors and officers. One option is to buy stand-alone cover to insure the costs of investigations that do not reduce the limits of pre-

¹⁰ <http://blogs.law.harvard.edu/corpgov/2010/07/21/dodd-frank-act-becomes-law>

¹¹ http://en.wikipedia.org/wiki/Dodd%E2%80%93Frank_Wall_Street_Reform_and_Consumer_Protection_Act

¹² <http://www.metrocorpocounsel.com/articles/19583/do-insurance-dodd-frank-era-what-you-need-know-protect-your-directors-and-officers>

existing D&O coverage. The alternative is to request a sublimit, dedicated for internal investigations.¹³

Whistleblower Provision Rules

In 2011, the SEC implemented the whistleblower provisions rules of Dodd-Frank, designed to encourage more people to report potential violations of the federal securities laws to the authorities. The whistleblower incentive program provide that an eligible individual, such as an employee of the company, who voluntarily provides the SEC with original information about a potential violation of the federal-securities laws that ultimately lead to a successful enforcement action, may be entitled to receive a cash award. Under Dodd-Frank, a whistleblower may receive up to 30 percent of the total monetary sanctions in excess of 1 million USD recovered by the SEC in a civil or judicial action.¹⁴

As the whistleblower provisions rules have increased the propensity to engage authorities, many public companies have requested adjustments of the Dodd-Frank Act. There is a widespread concern that potential whistleblowers will go directly to the SEC instead of reporting unlawful activity through the company's own internal reporting and compliance program and thereby making corporate governance less effective. The Commission seeks to create a balance between the route of internal reporting and the alternative to involve the authorities at an early stage. The SEC now allows up to 120 days informing the Commission after reporting internally which would increase the opportunity for whistleblowers to first report potential misconduct through the company's internal compliance program.

Furthermore, by giving credit to a whistleblower who first reports a potential violation internally and whose company passes the information on to the Commission, even if the whistleblower does not, the SEC has created another incentive for companies to maintain a strong internal compliance culture. This would also give the whistleblower an opportunity to get awarded through internal reporting in cases where the whistleblower not otherwise would have qualified for an award because the information was not sufficiently specific.¹⁵

Because of the clear financial incentives to report to the SEC, the cost of internal corporate investigations for most companies is likely to increase considerably. The implementation of the whistleblower provision rules has raised the question of D&O coverage for expenses incurred in connection with regulatory investigations and whether the policy will cover internal corporate investigations resulting out of this. Many D&O insurance carriers provide limited or no coverage for a company being investigated by the SEC. Directors and officers as individuals are usually

¹³ <http://www.forbes.com/sites/richardlevick/2011/07/07/dodd-frank-a-golden-new-opportunity-for-the-do-insurance-industry/>

¹⁴ <http://www.propertycasualty360.com/2011/10/20/dodd-frank-corporate-investigations-should-do-ins>

¹⁵ <http://www.sec.gov/news/speech/2011/spch052511mls-item2.htm>

covered if they are explicitly named as the target of a formal SEC investigation. In recent years, due to soft market conditions, some carriers have more generous policy terms and cover certain legal costs of individuals when responding also to an informal SEC investigation. Even so, this can be a considerable risk for a company as the SEC in most cases pursues the cooperation of the individual's company before addressing the individual director or officer later in the process. Consequently, companies could be left without coverage.¹⁶

Another D&O insurance coverage issue that is likely to become more common with the implementation of the whistleblower provision rules is the insured vs. insured exclusion, found in many D&O insurance policies. The intention of the exclusion is to prevent cases where the policyholder funds business losses through insurance proceeds, where one insured sues another insured.¹⁷ The insured vs. insured exclusion excludes from coverage any action that is brought or supported by the cooperation of an insured under the D&O policy. This is particularly problematic because the respondent is likely to be a director or officer of the company reported.¹⁸

D&O Claw-back Insurance

Another provision under the Dodd-Frank Act which will impact the D&O insurance industry is the "Recovery of Erroneously Awarded Compensation" or the "Claw-back provision", implemented in July last year. A claw-back is "the right of a company to recover from an executive previously earned and paid compensation as the result of some triggering event, such as a financial restatement, the executive's breach of an employment policy or covenant, etc." 19

The Dodd-Frank Act mandates the SEC to require that U.S. public companies adopt a claw-back policy in their executive compensation contracts. In the event of a restatement, the company will recuperate from current and former executives any incentive-based compensation, for the three years preceding the restatement that would not have been awarded under the restated financial statements. Under the Act, a failure to do so will result in delisting.²⁰

The Claw-back policy intends to limit the risk of manipulation and to penalize bad behaviors. There is always an underlying risk that individuals seek to manipulate information used in determining the amount of remuneration. A claw-back policy can reduce this risk by claiming a right to the claw-back if there is evidence of executive malpractice in manipulation of financial

¹⁶ http://www.woodruff-sawyer.com/webmail/Briefings_Newsletters2011/OP_Polikoff_Huskins_2_11.pdf

¹⁷ <http://www.metrocorpounsel.com/articles/19583/do-insurance-dodd-frank-era-what-you-need-know-protect-your-directors-and-officers>

¹⁸ http://www.woodruff-sawyer.com/webmail/Briefings_Newsletters2011/OP_Polikoff_Huskins_2_11.pdf

¹⁹ http://www.klgates.com/files/Publication/bb10169e-d26f-476f-ad8c-13aadba4841f/Presentation/PublicationAttachment/a8c14bfa-f86f-459f-aa18-9bea13d9cd25/DoddFrank_Clawback.pdf

²⁰ http://www.pepperlaw.com/publications_update.aspx?ArticleKey=1868

Nordisk försäkringstidskrift 3/2012

data. A company may also establish a contractual right with their directors and officers to recuperate prepaid compensation in case of deceptive conduct unrelated to a financial restatement.²¹

As a response to the FDIC's²² new claw-back regulations under Dodd-Frank, insurers started to provide coverage in order to protect directors and officers from claw-back compensation. Besides the regular D&O coverage of legal expenses and settlements, they offer an endorsement that covers the compensation of insured executives under the claw-back policy brought by the agency. This includes costs of a FDIC investigation, any lost salary and bonuses or other benefits arising from non-intentional wrongful acts by executives. The insurance also protects the personal assets of executives and directors of financial companies.

The new product has been heavily debated in the industry. Many would argue that the purpose of adopting the rule is to hold executives accountable for their actions. Eliminating that risk through insurance coverage would defeat the intention of the regulation.²³ Contrary, insurers who provide this kind of claw-back insurance argue that the policies do not undermine financial reforms because they don't cover fraud or intentional wrongdoing. Furthermore, claw-backs were designed to recoup money for shareholders and the public rather than to punish officers and directors.²⁴

Conclusion

July marked the two-year anniversary of the Dodd-Frank Act being signed into law. The intention of the Act was to give regulators better tools to regulate the financial markets in order to avert another financial crisis. To date, only about a third of the new rules have been effectuated. Due to the complexity of the reform and heavy lobbying from the financial industry, the rest of the Dodd-Frank rules are either delayed or considerably weaker than originally envisioned.²⁵

What also contributes to the uncertainty is the fact that a majority of all eligible Republican presidential candidates (at the time of writing it is determined that Mitt Romney is the Republican Party's presidential candidate, author's remarks) are opposed to the Dodd-Frank

²¹ http://www.klgates.com/files/Publication/bb10169e-d26f-476f-ad8c-13aadba4841f/Presentation/PublicationAttachment/a8c14bfa-f86f-459f-aa18-9bea13d9cd25/DoddFrank_Clawback.pdf

²² Federal Deposit Insurance Corporation, responsible for implementing a number of initiatives under the Dodd-Frank Wall Street Reform and Consumer Protection Act

²³ <http://insurancenewsnet.com/article.aspx?id=293070&isrc=fen#.UBWGkPUUU5I>

²⁴ <http://www.breakingviews.com/directors-and-officers-insurance-declaws-clawbacks/1620912.article>

²⁵ <http://money.cnn.com/2012/07/21/news/economy/dodd-frank/index.htm>

financial regulation law.²⁶ A Republican presidency may well lead to a repeal of the Dodd-Frank Act or, at the very least, a different course to the rulemaking activity.²⁷

In early summer this year, Barney Frank, Democratic Representative of Massachusetts, introduced a bill titled the “Executive Compensation Claw-back Full Enforcement Act”. The new legislation aims at protecting the intent of the 2010 Dodd-Frank financial reform law that let FDIC recoup compensation or impose fines on individuals who break the law or engage in unsafe conduct. Anyone subject to a claw-back should be personally liable for any payments without being able to insure or hedge against that liability.²⁸ This applies to compensation from a failed financial institution as well as civil penalties imposed by governmental authorities on corporate executives of financial institutions.²⁹

Frank’s bill is a response to the claw-back policies, attached to traditional D&O insurance, and introduced by the insurance industry in early 2011, which were meant to protect directors and officers from claw-backs by the FDIC.³⁰ Although considerable uncertainty exists, it is clear that the ongoing legislation will redefine D&O coverage in the financial industry for years to come.

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²⁶ <http://www.bloomberg.com/news/2012-05-14/romney-vowing-dodd-frank-repeal-hits-jpmorgan-inconvenient-truth.html>

²⁷ <http://www.dandoeandmonitor.com/other-insurance-clause/do---the-uncertain-insurance-implications-of-dodd-frank/>

²⁸ <http://www.reuters.com/article/2012/05/30/usa-congress-clawbacks-idUSL1E8GU55I20120530>

²⁹ <http://www.lexology.com/library/detail.aspx?g=63e1532e-5d7c-4f0b-bc19-1734bdb58eba>

³⁰ <http://www.reuters.com/article/2012/05/30/usa-congress-clawbacks-idUSL1E8GU55I20120530>

Nordisk försäkringstidskrift 3/2012

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