WALKER WILCOX
WALKER WILCOX MATOUSEK LLP

NEW SEC RULES: WHISTLING THROUGH THE D&O GRAVEYARD

Click here for PDF

On May 25, 2011, the Securities and Exchange Commission announced the adoption of new rules (the "Rules") which will significantly increase claim activity on both the regulatory and civil litigation fronts. The Rules, enacted as part of the Dodd-Frank Act, create financial incentives for whistleblowers under Section 21F of the Securities Exchange Act of 1934. A key aspect of this new incentive-based scheme is that whistleblowers can report alleged wrongdoings directly to the SEC rather than internally within their organization. The Rules are set to go live on August 12, 2011.

By guaranteeing payments to whistleblowers and encouraging would-be plaintiffs to bypass an organization's internal reporting procedures, the Rules not only will increase the number of reports of alleged wrongdoing, but will also significantly raise the cost of responding to them. As compliance and investigative costs increase, so will the pressure on D&O insurers to reimburse those expenses.

Now that the Rules are taking effect, D&O insurers must be proactive and take steps to fully understand and respond to the ramifications.

"BLUE SKY" VIEW OF THE RULES

Under the new Rules, the SEC will pay a percentage-based reward to any "whistleblower" who voluntarily provides the SEC with (1) original information; (2) that leads to the successful enforcement by the SEC of a federal court or administrative action; (3) in which the SEC obtains monetary sanctions totaling more than $1 million. If the above criteria are met, the SEC is required to pay the whistleblower between 10% and 30% of the monetary sanctions that are collected. This is in stark contrast to the old system, where the SEC would only make a discretionary payment of up to 10%. Under that system, very few whistleblowers were ever awarded compensation; clearly, the SEC is seeking to spur much greater activity.

Admittedly, the Rules do allow for a "safe harbor" of sorts for whistleblowers who choose to vertically report suspected wrongdoings to their organization's internal compliance department. Under the Rules, potential whistleblowers may save their place in line for any future reward if specific steps are followed. Moreover, there is also the potential for a higher reward if the employee reports the suspect conduct internally first.

However, we anticipate that whistleblowers (and the lawyers representing them) will be inclined to direct their suspicions to the SEC, and return to the days of the "race to the courthouse." Not surprisingly, the plaintiffs' bar has already set up numerous "whistleblower protection" groups to encourage and counsel employees in reporting potential violations and preparing their reward applications.

Whistleblowers are incentivized further by enhancements to a potential private right of action in the event of retaliation, such as the ability to obtain double backpay, fees and reinstatement.

INCREASED CLAIMS, SEC SUITS & THE PRIVATE SECURITIES BAR

Given the SEC's focus on stemming the tide of corporate malfeasance, and the sea of inside information readily available as a result of the Rules, claim frequency will undoubtedly increase. In fact, the SEC budget is set to more than double by 2015, in part to fund the increased investigations and enforcement actions based on whistleblower claims. Moreover, the potential for class and derivative actions by the plaintiffs' bar is also greatly increased. Undoubtedly, there are going to be more private actions brought using the information whistleblowers are now likely to disclose. The obvious goal of the "whistleblower protection groups" is to capture the whistleblower's information before it is presented to the SEC or the company's internal process. Potential insurer liability primarily stems from liberal definitions of "claim" and the reimbursement of defense costs requirement in most D&O policies. Financially-motivated employees who bypass their organization's internal compliance department will generate increased SEC inquiries, which may trigger coverage and defense expense obligations. Policyholder professionals, such as brokers, are already counseling clients on the possible ramifications of increased SEC involvement. In that connection, it is likely that such groups will be seeking larger coverage grants, such as an expanded definition of "claim."

Obviously, not every instance of alleged corporate malfeasance will generate significant exposure for corporations or their insurers. However, given the considerable costs associated with the defense and investigation of these claims, even small increases in frequency and severity could result in an exponential increase in costs for D&O insurers.

CONCLUSION:

The Rules marry the unlimited enforcement powers of the government to a capitalist incentive program to generate more reporting from inside of corporations, more raw material, and more public and private resources to mine that material. The inevitable result is more losses, more expensive losses, and more claims for those losses. Opportunities and pitfalls abound.