

RISKSIGHTS

THE INSIGHTS TRILOGY EDITION

The D&O insurance market began to turn in the second half of 2018. Years of underpricing, heightened claim frequency, deteriorating results from prior years, and accumulating underwriting losses caused several major insurers to begin pushing for rate increases. Further, unfavorable legal developments, such as the *Cyan* decision, and social inflation contributed to the tightening. By the beginning of 2019, there was a general consensus among insurers that pricing was inadequate and needed to increase, and insurers were not, as would have been the case in the recent past, undercutting other insurers' attempts to obtain increases. The level of price increases accelerated as 2019 progressed. By the end of 2019, the D&O insurance market had entered what we would consider a hard market, with many carriers actively seeking to reduce their limits, shrink their exposure to (or exit) certain risk classes, and re-underwrite their books of business.

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The arrival of COVID-19 and the ensuing shutdown of the economy exacerbated all of these market conditions. Premiums increased to even higher levels, and many insurers further restricted their capacity. In addition, in many instances, insurers began to restrict terms and conditions. As a result of the disruption from the pandemic, underwriters began to shy away from hospitality and retail. Further, concerns about both the public health crisis and the pandemic's economic fallout have caused underwriters to significantly increase account level underwriting, as the underwriters attempt to determine the pandemic's impact on companies' business operations and financial condition. For D&O policyholders accustomed to years of declining prices and expeditious renewals, the current disrupted market conditions represent a significant departure.

D&O insurance is a cyclical business, and the periodic hard markets that arise eventually give way to more competitive conditions. Rising prices eventually stabilize, as incumbent and new insurers once again begin to compete based on price. However, as things stand at the moment, there is nothing to suggest

that this market will start to soften anytime soon. Although new capacity is beginning to trickle into the marketplace, it will take some time before the increased capacity makes a meaningful change in these market conditions. There is a strong likelihood that the current hard market will continue for the remainder of this year and into 2021.

In the meantime, the disrupted market conditions mean that now, more than ever, policyholders need the assistance of an experienced and knowledgeable adviser for their D&O insurance placement. This is a time when specialized D&O insurance expertise and deep knowledge of the insurance market are absolutely indispensable.

The following pages address several of the most impactful evolutions of the risks facing directors and officers and the resultant impacts on the D&O marketplace. A discussion of the importance of a federal forum provision in the recent California state court dismissal in the Restoration Robotics IPO case is discussed in a separate *Alert* which we published prior to this *InSights*.

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LULL IN SECURITIES SUIT FILINGS IN THE YEAR'S FIRST HALF

After three consecutive years in which securities class action filings were at or near record high levels, the number of filings declined slightly in the first six months of 2020, at least compared to the pace of filings during the 2017-2019 time period. This relative decline appears to be pandemic-related, at least in part, which raises the question whether the relatively lower filing pace in the year's first half will continue as the year progresses. However, even if the apparent filing lull does continue, the 182 first-half state and federal securities suit filings implies a year-end total number of securities class action lawsuit filings of 364, which would be well below 2019's year-end total of 428 – although still far greater than the 1997-2018 annual average number of 215 securities suit filings per year.

There were a number of factors contributing to the relative decline of securities suit filings in the year's first half, including, in particular, the fact that filings in the months of May and June were well below the filings in the immediately preceding months. This is perhaps as a result of government stay-at-home orders and court closures. According to Cornerstone Research's report on first half filings, the reduced number of filings is largely a reflection of a reduced number of merger objection lawsuits and Section 11 lawsuit filings - perhaps as a result of pandemic-caused reduction in the number of merger transactions and IPO filings in the year's first half.

As of the publication of this *InSights*, it does appear that the year's second half filings activity is returning to the heightened levels that prevailed during the period 2017-2019. Thus, while there were a total of only 39 federal court securities class action

lawsuit filings in May and June, in July and August there were a total of 55 federal court securities suit filings. It could become apparent by year end, that the apparent lull in the year's first half was only a temporary, short-term phenomenon.

A 2020 securities suit filing total lower than the tallies in the last three years would be welcomed by the D&O insurance industry; however, a relatively lower year-end total that would still be well above historical levels is unlikely to have a significant impact on how D&O insurers perceive the level of securities litigation risk.

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COVID-19 RELATED D&O LITIGATION

Earlier this year, when the scale and potential impact of the coronavirus outbreak began to become apparent, many observers and commentators predicted that we could see a significant wave of COVID-19 related D&O claims. There have in fact been a number of COVID-19 related securities class action lawsuits filed so far, as well as several other types of pandemic-related D&O claims. However, the amount of COVID-19 related D&O litigation filed to date has been relatively low, at least by comparison to the level of litigation seen, for example, during and after the global financial crisis. The question is whether we will see more litigation in the months ahead as the economic and financial impact of the pandemic continues to ripple through the economy.

As of September 1, 2020, pursuant to our calculations, there was a total of 20 COVID-19 related securities class action lawsuit filings in the United States. As a general matter, the cases tend to fall into one of three categories: (1) lawsuits against companies that experienced a COVID-19 outbreak in one of their facilities (for example, cruise ship lines and private prison systems); (2) lawsuits against companies that made public statements suggesting the companies could profit from the pandemic (such as vaccine development companies, as well as manufacturers of personal protective equipment or diagnostic tests); and (3) companies whose revenues or operations were disrupted by the pandemic or government shutdown orders (such as REITs and other property-related businesses).

In addition to the securities class action lawsuits, there have been other types of COVID-19 related D&O claims filed, including several shareholder derivative lawsuits and a small number of SEC enforcement actions. All of the companies against which derivative suits were filed are also involved in parallel securities litigation involving substantially the same allegations.

A total of 20 securities suits represents a substantial litigation phenomenon, but, in the context of annual filings in excess of 400 lawsuits a year, a tally of 20 lawsuits over the

course of six months is a relatively modest number. There has not, at least so far, been anything that we would describe as a wave of coronavirus-related litigation.

The question at this point is the extent of the COVID-19 related litigation that may be ahead. One potential risk is that as companies reopen, struggle to attract returning customers or reinvigorate supply chains, the companies may make statements about their financial condition or prospects that later appear to have been overly optimistic. In addition, as the crisis continues to unfold, companies that had thus far been able to get by, may find themselves stretched to the point that they can no longer continue. The overall economic impact of the pandemic remains to be seen, and the toll the crisis and economic downturn could have on businesses, especially in terms of the number of bankruptcies, is still unknown.

In short, at least so far, the coronavirus outbreak's litigation impact has been relatively modest. How significant the litigation impact will ultimately prove to be will depend on the uncertain duration of the crisis, the extent of the economic impact, and the way that the economic recovery plays out. To the extent there are significant numbers of bankruptcies ahead, a meaningful number of D&O claims might emerge.

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BOARD DIVERSITY LITIGATION

Other than the pandemic, the biggest story of 2020 has been the racial justice movement and protests that followed in the wake of the May 2020 death of George Floyd. In response to the recent protests and social unrest, there has been a renewed focus on equality and diversity issues. Among many other things, investors and activists are raising concerns about the lack of racial diversity on corporate boards. For example, in late June, a California legislator introduced a bill that would require corporations to include on their boards persons from “underrepresented communities.”

In addition to these legislative efforts, activist investors seeking to advance board diversity objectives have launched a series of shareholder derivative lawsuits against the directors of several companies, accusing the boards of violating their legal duties by failing to diversify the company's board and otherwise failing to address diversity and equality issues. These lawsuits also allege that the boards misled investors about their companies' diversity and inclusion practices. The lawsuits typically seek a variety of remedial measures, including the addition of African American directors to the companies' boards; the creation of a fund to promote diversity and inclusion in the defendant company's workforce; the setting of minority hiring goals, with executive compensation tied to achievement of the objectives; and institution of periodic board diversity training.

There have now been a total of eight of these board diversity lawsuits. Six of these lawsuits – against the boards of Oracle, Facebook, Qualcomm, NortonLifeLock, The Gap and Monster Beverage Corporation – all were filed by the same law firm and all involved California-based companies. Based on these six filings, the board diversity litigation phenomenon looked as if it might be nothing more than the quixotic quest of a self-appointed agent of a racial justice cause. However, a lawsuit filed on September 1, 2020 against Danaher Corporation – which is based not in California, but in the District of Columbia – and another lawsuit filed on September

23, 2020 against Cisco Systems was filed by a different and higher profile plaintiffs' law firm, raising the possibility that this litigation trend may become both more generalized and more extensive. Interesting, the Cisco Systems action follows a pre-suit demand on Cisco System's board, which is in contrast to the other prior suits.

The need for greater African-American representation at the board level is not a new issue. The obvious reason these lawsuits are being filed now is the current heightened focus on racial justice issues, which the plaintiff lawyers are well aware casts a harsh light on the lack of African-Americans in corporate leadership, and puts pressure on companies and other organizations to take remedial steps.

These lawsuits have only just been filed and it remains to be seen what, if anything, they may accomplish. The filing of these lawsuits does show how the current racial justice movement in the U.S. not only has important implications for the social and political context for businesses in this country, but also creates dynamics – including the threat of litigation – that put pressure on businesses to reexamine past practices. At a minimum, these lawsuits demonstrate that, among other things, lack of board diversity may represent a D&O claim risk. There are a significant number of other companies that lack African-American directors; these companies may face the possibility that they, too, are targeted in one of these board diversity lawsuits, which by itself may motivate companies to reconsider the composition of their boards.

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