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RISKINSIGHTS

THE INSIGHTS TRILOGY EDITION

Over the last year, D&O insurers were under pressure from senior management to reorient their portfolios toward profitability. As a result, during the second half of the year, policyholders and insurance buyers increasingly faced a disrupted D&O insurance marketplace. The market correction for public D&O insurance included not only steep premium increases, but also higher retentions, and at times, a reduction in capacity, the addition of restrictive terms, and, in some cases, nonrenewal. The hardening market has been most pronounced for companies completing an Initial Public Offering and companies in certain sectors such as healthcare, life science, technology, communications, and financial services companies.

Corporate directors and officers and their insurers face a claims environment that can only be described as challenging. In order to shed some light on the current claims environment, we are introducing our inaugural InSights Trilogy, which will discuss the following three topics that have largely influenced the D&O claims landscape and D&O insurance market.

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FEDERAL COURT SECURITIES CLASS ACTION FILINGS REMAIN AT HISTORICALLY HIGH LEVELS

For the third year in a row, there were more than 400 federal court securities class action lawsuits filed against U. S. publicly traded companies. While the total number of filings during the year was inflated by the significant number of federal court merger objection lawsuits, the traditional non-merger related securities lawsuit filings alone far exceeded historical filing levels. Further, and more alarmingly, the rate of litigation (that is, the number of securities suits relative to the number of listed companies) has increased dramatically.

There were a total of 404 federal court securities class action lawsuits filed in 2019, which is slightly above the 2018 total of 402, but slightly less than the 412 filed in 2017. The 404 federal court securities lawsuit filings is nearly double the 1997-2017 annual average of 203 filings.

As was the case in 2017 and 2018, the number of federal court securities class action lawsuits filed in 2019 was inflated by the significant number of merger objection lawsuit filings. In 2019, 158 of the 404 federal filings were merger objection lawsuits, representing about 39% of filings during the year.

There were 246 traditional filings in 2019, which is about 21% above the 1996-2017 annual average of 203. While the annual number of federal court securities suit filings has been inflated in recent years by the flood of merger objection lawsuits into the federal courts, the number of filings is still well above historical levels.

In addition to the significant number of federal filings in 2019, there were also a significant number of state court securities class action lawsuit filings. The number of standalone state court securities suit filings further increases the total number of securities suits filed during 2019.

While the number of lawsuits filed each year is of significant interest to companies, insurers, and other observers, the rate of litigation (that is, number of lawsuits relative to the number of public companies) is arguably of much greater significance. As the number of lawsuits has increased and the total number of stock exchange listed companies has decreased, the litigation rate has been accelerating, especially in comparison to long-term trends.

Using the 2018 year-end number of exchangelisted U.S. publicly traded companies (4,406), and subtracting the 22 suits that were filed against non-exchange listed defendants (for example, OTC and cryptocurrency companies), it yields a 2019 litigation rate of 8.66%. This means that in 2019, about one out of every eleven U.S. exchange-listed companies was the target of a securities suit. A litigation rate of 8.66% represents the highestever annual rate of litigation, exceeding even the elevated levels experienced in 2017 and

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2018 (according to Cornerstone Research, the rate was 8.4% for both years). To put this in the simplest terms, the likelihood of a U.S. exchange-listed company getting hit with a securities suit is the highest it has ever been.

The federal court litigation rates calculated above do not factor in state court securities litigation. The litigation rate is even higher if state court litigation is taken into account.

After three consecutive years with more than 400 federal court securities class action filings, it seems that the recent elevated levels of securities class action lawsuit filings represent the new normal.

Companies and their D&O insurers must now assume that the chance of any given U.S.-listed company getting sued in a securities lawsuit is far greater than it was in the past.

The fact that over 400 federal court securities lawsuits have been filed in each of the last three years means that there is a massive pipeline of cases pending in the courts, thus swelling the D&O insurers' claims portfolios. This backlog represents a significant problem for the D&O insurers, as this mass of claims must be managed and adjusted. Reserves must be set for these cases, further undermining underwriting results. The sheer number of cases pending has a multiplicative effect on aggregate defense expenses as well, further increasing the underwriters' loss costs.

As the insurers come to grip with the now well-established trends discussed above, they are struggling to find the right approach. Insurers, including both primary and excess insurers, are seeking increased rates. Further, many primary insurers are also requiring increased retentions, and in some cases, offering only significantly altered terms and conditions.

The elevated federal court securities class action lawsuits are a large part for the reason that D&O insurance buyers currently face a disrupted insurance market. As stated above, merger objection litigation has also contributed to the current market conditions and will be fully discussed in Part Two of the InSights Trilogy.

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MERGER OBJECTION LITIGATION CONTINUES TO ELEVATE FEDERAL COURT SECURITIES FILING FIGURES

A major factor driving the overall number of filings during 2019 was the number of federal court merger objection lawsuits. In these lawsuits, the shareholders of an acquisition target alleges that the disclosures about or price to be paid in connection with a merger are inadequate. In the past, these lawsuits were filed almost exclusively in state court, particularly in Delaware. However, as a result of a series of rulings in which the Delaware courts evinced their hostility toward these kinds of actions, over the past several years, plaintiffs' lawyers have transitioned to filing these cases in federal court.

As has been the case for several years now, the vast majority of merger transactions in 2018 (the most recent year for which complete data are available) attracted at least one merger objection lawsuit. According to a June 2019 academic paper by Matthew Cain and Steven Davidoff Solomon of UC Berkley Law School, Jill Fisch of Penn Law School, and Randall Thomas of Vanderbilt Law School, during 2018, 83% of all completed deals attracted at least one lawsuit; of these lawsuits, 92% were filed in federal court.

Along with the shift of merger objection lawsuits from state to federal court has come a shift in the way that these kinds of cases are resolved. In the past, the typical pattern was that the case was settled through an agreement by the defendant company to make additional deal disclosures in exchange for a full release and an agreement to pay the plaintiffs' attorneys fees. Now, the typical pattern has changed to one in which, in exchange for the defendants' agreement to make additional disclosures and pay the plaintiffs' counsel a mootness fee, the plaintiffs' lawyers voluntarily dismiss the lawsuit. Prior to 2016, very few cases involved the payment of a mootness fee. In 2018, not only were 100% of all resolved merger objection cases dismissed, but 63% involved the payment of a mootness fee to plaintiffs' counsel.

The problem with the "mootness fee" case resolution is that the dismissal and fee payments receive little judicial scrutiny – as a result, according to the authors of the study cited above, the practice "amounts to a shakedown with little benefit beyond lining attorneys' pockets." The authors further note that the process amounts to "blackmail," observing that the defendant companies are paying the fees "just to make these cases go away."

There were promising signs during 2019 that courts have taken notice of these developments and are starting to try to address the mootness fee problem. In June 2019, Northern District of Illinois Judge Thomas M. Durkin, exercising his "inherent authority" and acting at the urging of an objecting shareholder, "abrogated" the settlement of the litigation arising out of the acquisition of Akorn,

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Inc. by Frensenius Kabi AG. He ordered the plaintiffs' lawyers to return to Akorn their $322,000 mootness fee – ruling that the additional disclosures to which the company agreed to were "worthless to shareholders" and that the underlying lawsuits should have been "dismissed out of hand." (Judge Durkin's ruling is on appeal.)

Similarly, in August 2019, District of Delaware Judge Richard G. Andrews denied the plaintiffs' fee petition in the merger objection lawsuit filed in connection with the acquisition of DST Systems, Inc. by SS&C Technologies – finding that the plaintiffs had failed to carry their burden in establishing that the supplemental disclosures produced a "substantial benefit" to DST shareholders. The Court found that a review of the supplemental disclosures "reveals that Plaintiffs have failed to carry their burden on materiality of the information." The plaintiffs, the Court said, "have not established that they provided the stockholders with a substantial benefit so as to warrant an award of attorneys' fees."

These courts' rulings represent small steps toward the possibility of putting an end to the merger objection lawsuit mootness fee racket. Unfortunately, merger objection lawsuits still continue to be filed in connection with the majority of merger transactions. These lawsuits, which are mostly filed by a very small number of so-called "emerging" plaintiffs' law firms, represent a tax on legitimate corporate activity.

The litigation frequency and legal expense surrounding these kinds of lawsuits are among the many factors adding to D&O insurers woes. As these litigation patterns emerged in recent years, many insurers began adding a separate, higher retention for merger related litigation. These higher retentions mean that the cost of this litigation is often borne exclusively by the insured companies – which underscores the fact that the plaintiffs' lawyers filing these kinds of lawsuits are effectively imposing a deal tax on merger lawsuits, a fact that is not lost on those in the business community seeking securities litigation reform.

Besides the elevated federal court securities class action filings and merger objections suits, judicial decisions have weighed on D&O underwriting behavior. Part Three will discuss the Cyan decision which has caused a great deal of disruption, and in particular, on the the litigation environment facing companies completing an initial public offering or follow-on offering.

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FALLOUT FROM THE CYAN DECISION ROILS THE D&O INSURANCE MARKET FOR IPO COMPANIES

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One of the top stories in the world of D&O back in 2018 was the U.S. Supreme Court's March 2018 entry of its opinion in Cyan, Inc. v. Beaver Country Employees Retirement Fund, in which the Court affirmed that state courts retain concurrent jurisdiction for liability actions under the Securities Act of 1933. At the time, the concern was that the Court's ruling could lead both to the proliferation of state court securities class action lawsuits and to the possibility of parallel proceedings in federal and state court. In 2019, these concerns materialized as state court securities litigation multiplied and parallel state and federal litigation became a frequent occurrence.

According to research by Stanford Law Professor Michael Klausner and his Stanford Securities Litigation Analytics colleagues, Jason Hegland, Carin LeVine, and Jessica Shin, there were 39 state court securities class action lawsuits filed in the first ten months of 2019, compared to a total of 32 for the full year of 2018. The 39 state court securities suits filed between January 1, 2019 and October 31, 2019 already represented the highest annual total number of state court securities filings ever; with the year-end 2019 total to undoubtedly be even higher.

Not only are there more state court securities lawsuits being filed, but the percentage of Section 11 lawsuit defendants getting sued in parallel lawsuits filed in both state and federal courts has increased as well. This increase in parallel litigation can be seen by comparing Section 11 lawsuit filings before and after Cyan.

According to the research of Professor Klausner and his colleagues, during the pre-Cyan period of January 1, 2014 through March 20, 2018, 66% of all Section 11 liability actions were filed in federal court only, while 18% were filed in state court only, and 16% filed in both state and federal court.

By contrast, in the post-Cyan period between March 31, 2018 and October 31, 2019, only 32% of Section 11 liability actions were filed in federal court alone, while 25% were filed in state court only, and a concerning 54% were filed in both federal and state court. In other words, post-Cyan, the majority of Section 11 class action defendants face concurrent state and federal litigation.

There are mechanisms to consolidate various actions filed in federal court. However, there is no mechanism to consolidate actions filed in state court with the federal court lawsuits, and there is no mechanism to consolidate the actions filed in different states.

Defendants must now fight a multi-front war. The fact that the defendants must now defend in multiple jurisdictions adds not

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only complexity and expense, it further adds uncertainty, and even the possibility of conflicting or inconsistent procedures and decisions.

Among other things, one question that will have to be addressed is whether the state courts will apply the discovery stay applicable in federal court. Another question is whether the state courts will apply different pleading standards than those that would be applicable in federal court. On a more practical level, if the time were to come when the defendants might seek to settle the litigation, they will struggle reaching settlements that will resolve claims as to all claimants in all putative classes.

As we are still in the early days following the Cyan decision, how all of this will work out in any particular case, or as a general matter, remains to be seen. Fortunately, the situation is not as dire as it might first appear. At least some state courts have abided by the discovery stay that is applicable in federal court actions. And the courts of at least three states (New York, Connecticut and Texas) have granted the defendants' motions to dismiss in Section 11 liability actions. However, the post-Cyan prospect for multiplied, parallel litigation has spooked the D&O insurance underwriters. A number of insurers have withdrawn from providing D&O insurance for IPO companies. Others now will write the coverage only on a high attaching excess basis. As the insurers have pulled back, the pricing for D&O insurance for IPO companies has increased significantly, and the selfinsured retentions that the insurers are requiring in order to provide primary terms have substantially increased. Moreover, these IPO-related pricing trends and increased retention requirements accelerated as 2019 progressed - and all signs are that these trends will continue into 2020.

Other than the topics discussed in our inaugural InSights Trilogy, there are other matters influencing D&O insurers. At a time when the insurers are rapidly changing their approach, and in many cases, restricting the terms and conditions they are willing to offer, and increasing premiums, it is particularly important for policyholders and insurance buyers to ensure that they have a knowledgeable and experienced insurance advisor involved to assist them through what could be a very fraught insurance purchase process. Policyholders and insurance buyers will need to understand the significance of the changes they are having to confront, as well as a full range of available alternatives.

Now, more than ever, it is critically important for policyholders and insurance buyers to enlist the assistance of an experienced D&O insurance specialist in the placement of their D&O insurance.

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